C. Discussion of Specific Issues

1. Nonqualified deferred compensation plans

Present law

In general

Deferred compensation occurs when the payment of compensation is deferred for more than a short period after the compensation is earned (i.e., the time when the services giving rise to the compensation are performed). Payment is generally deferred until some specified event, such as the individual's retirement, death, disability, or other termination of service, or until a specified time in the future. Nonqualified deferred compensation plans do not receive the favored tax treatment afforded to qualified retirements plans under the Code.[1781]

ERISA contains exemptions from its requirements for certain nonqualified deferred compensation arrangements. Most nonqualified deferred compensation arrangements are designed to fall within these ERISA exemptions.

A "top-hat plan" is the term generally used for certain nonqualified deferred compensation plans that are exempt from most ERISA requirements. The ERISA exemption applies to a plan that is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. ERISA does not provide statutory definitions of "select group," "management," or "highly compensated employees," and the Department of Labor has not issued regulations defining these terms.[1782] Employees sometimes claim ERISA protection (such as vesting or funding) for benefits under a nonqualified deferred compensation plan. However, most nonqualified deferred compensation arrangements are intended to fall under the top-hat exemption.

A top-hat plan is exempt from the ERISA requirements relating to participation and vesting, funding, and fiduciary responsibility.[1783] A top-hat plan is not exempt from the reporting and disclosure requirements or the administration and enforcement provisions under ERISA. However, under Department of Labor regulations, the reporting and disclosure requirements are satisfied by (1) a one-time filing with the Secretary of Labor of a statement that includes the name and address of the employer, the employer's tax identification number, a declaration that the employer maintains a plan or plans primarily for the purpose of providing

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[1781] This favorable treatment includes: (1) a current deduction for the employer's contributions; (2) assets of the plan set aside in a trust for the exclusive benefit of the employees; (3) tax-exempt status of the trust; and (4) no income inclusion by employees until distributions are received (i.e., constructive receipt does not apply).

[1782] The Code definition of "highly compensated employee" (sec. 414(q)) has not been applied for this purpose.

[1783] ERISA secs. 201(2), 301(a)(3), and 401(a)(1).

deferred compensation for a select group of management or highly compensated employees, and a statement of the number of such plans and the number of employees in each, and (2) providing plan documents, if any, to the Secretary of Labor upon request.[1784]

Types of nonqualified deferred compensation arrangements

Nonqualified deferred compensation arrangements are contractual arrangements between the employer and the employee, or employees, covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the employee, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

In the simplest form, a nonqualified deferred compensation arrangement is merely an unsecured, unfunded promise to pay a stated dollar amount at some point in the future. However, in most cases, such a simple arrangement does not meet the needs of the parties to the arrangement; thus, the typical nonqualified defined compensation arrangement is more complicated and may involve a funding vehicle or other mechanism to provide security to the employee.

Some nonqualified deferred compensation arrangements are structured as formal plans with formal governing documents. In such cases, the plan generally specifies the employees covered by the plan. In other cases, nonqualified deferred compensation may be provided for under the terms of an individual's employment contract and apply only to that particular individual.

A nonqualified deferred compensation arrangement may provide for the deferral of base compensation (i.e., salary), incentive compensation (e.g., commissions or bonuses), or supplemental compensation. The arrangement may permit the employee to elect, such as on an annual basis, whether to defer compensation or to receive it currently, similar to a salary reduction or cash-or-deferred arrangement under a qualified employer plan. Alternatively, the arrangement may provide for mandatory deferral of compensation.[1785]

A nonqualified deferred compensation arrangement may be structured as an account for the employee (similar to a defined contribution or individual account plan) or may provide for specified benefits to be paid to the employee (similar to a defined benefit pension plan). Under an account structure, depending on whether the arrangement is unfunded or funded, a hypothetical or actual account is maintained for the employee, to which specified contributions and earnings are credited. The benefits to which the employee is entitled are based on the amount in the account. Under a defined benefit structure, the terms of the nonqualified arrangement specify the amount of benefits (or formula for determining benefits) to be paid to the employee.

[1784] 29 CFR 2520.104-23.

[1785] Such plans are discussed in Part II.A., above.

Timing of income inclusion for the individual -- in general

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,[1786] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts and nonqualified annuities.[1787]

The following general rules regarding the taxation of nonqualified deferred compensation result from these provisions. In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received (i.e., when it is paid or otherwise made available). If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Timing of income inclusion under an unfunded arrangement

In general

As mentioned above, in the case of an unfunded nonqualified deferred compensation arrangement, amounts are includible in gross income when the amount is actually or constructively received.

An amount is constructively received if it is credited to an individual's account, set apart, or otherwise made available to the individual so that he or she can draw on it at any time, even if the individual has not actually received the income.[1788] Income is not constructively received if there is a substantial limitation or restriction on the individual's ability to withdraw it. A requirement that the individual provide advance notice in order to withdraw (or receive) the income is not considered a substantial limitation on the ability to withdraw it. However, a requirement that the individual relinquish a valuable right in order to withdraw the income is a substantial limitation.

[1786] *See, e.g., Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

[1787] Secs. 402(b) and 403(c). For a detailed discussion of the background of the taxation of nonqualified deferred compensation, *see* Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-29-02), April 7, 2002.

[1788] Treas. Reg. sec. 1.451-2(a).

For years before 1982, the constructive receipt doctrine applied to amounts payable under a qualified retirement plan.[1789] Various IRS revenue rulings held that amounts held within a qualified retirement plan were not constructively received if, in order to receive a distribution, the participant was required to discontinue participation in the plan (either permanently or for a period of at least six months), forfeit a portion of his or her benefits, or lose past service credits or job retention rights in the case of reemployment.

A variety of methods are used under nonqualified deferred compensation arrangements to provide some flexibility to individuals covered by the arrangement in obtaining distributions while attempting to avoid constructive receipt. For example, nonqualified deferred compensation arrangements frequently provide that distributions can be made in the event of financial hardship. Another technique sometimes used is to provide that the employer, plan administrative committee, or similar body can make distributions in its sole discretion. Another mechanism is to provide that withdrawals can be made at any time, but that a portion of the amount withdrawn, such as 10 percent, is forfeited to the employer if the distribution is made before some stated time or event. Other ways to try to avoid constructive receipt may also be used.

Subsequent elections

While it is generally accepted that, to avoid constructive receipt, the election to defer compensation must be made before the performance of services giving rise to the compensation, the required timing of subsequent elections to avoid constructive receipt is unclear. Revenue Procedure 71-19 sets guidelines for obtaining an advance ruling from the IRS regarding the application of the doctrine of constructive receipt to unfunded nonqualified deferred compensation arrangements.[1790] Under the revenue procedure, a ruling letter will be issued only if the plan meets certain requirements. If the plan provides for an election to defer payment of compensation, such election must be made before the beginning of the period of service for which the compensation is payable, regardless of the existence in the plan of forfeiture provisions. In addition, if any elections, other than the initial election may be made by an employee subsequent to the beginning of the service period (i.e., a "subsequent election"), the plan must set forth substantial forfeiture provisions that must remain in effect throughout the entire period of deferral.[1791] Revenue Procedure 92-65 amplified Revenue Procedure 71-19 and clarified that the period of service is generally the employee's taxable year for cash basis, calendar year taxpayers, with exceptions for new plans and new participants in existing plans.[1792]

[1789] Before 1982, amounts were includible in income when distributed or made available. Since 1982, qualified retirement plan benefits are includible in income when distributed.

[1790] 1971-1 C.B. 698, amplified by Rev. Proc. 92-65, 1992-2 C.B. 428.

[1791] Revenue Procedure 71-19 provides that a substantial forfeiture provision will not be considered to exist unless its condition imposes upon the employee a significant limitation or duty which will require a meaningful effort on the part of the employee to fulfill and there is a definite possibility that the event which will cause the forfeiture could occur.

[1792] Rev. Proc. 92-65, 1992-2 C.B. 428.

Revenue Procedure 92-65 further provides that, for an advance ruling, the plan must define the time and method for payment of deferred compensation for each payment event and also states that a plan may provide for the payment of benefits in the case of an unforeseeable emergency.[1793] Courts have sometimes taken a more lenient approach than the IRS ruling position in allowing subsequent elections.

Various courts that have dealt with the issue of subsequent elections have held that a subsequent election to change the timing or manner of payment of deferred compensation does not result in constructive receipt. Because each decision is fact specific, there is no case which can be cited for the rule that, unequivocally, constructive receipt does not result from the making of a subsequent election. While the holding of each case legally applies only to its specific facts, there are several cases that are principally cited for support of permitting subsequent elections without triggering constructive receipt.

In *Veit v. Commissioner* (known as "*Veit I*"), a subsequent election made after the performance of services was complete did not result in constructive receipt.[1794] At the time of the subsequent election, however, the amount due was not ascertainable. Additionally, the election was bilateral and was mutually beneficial to both the employer and the employee. In *Commissioner v. Oates*, constructive receipt did not apply when the taxpayer was given the right to elect to receive payments as provided in an original contract or to have them paid in monthly installments over a period not to exceed 15 years.[1795] While all services necessary to earn the payments had been performed, the final amount to be paid was not determinative. *Veit I* and *Oates* are relied upon by taxpayers for the position that constructive receipt does not result when a subsequent election is made before payment is due and the amount of compensation to be paid is ascertainable.[1796]

Taxpayers also rely on other decisions for the position that subsequent elections do not result in constructive receipt. In *Martin v. Commissioner,* a change in the payment schedule did not result in constructive receipt.[1797] In *Martin*, however, the election to receive either a lump-sum distribution or installment payments could only be made before the amounts became due and fully ascertainable. In *Veit v. Commissioner* (known as "*Veit II*"), a subsequent election

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[1793] The other requirements for an advance ruling are that the plan must provide that participants have the status of general unsecured creditors of the employer and that the plan consitiutes a mere promise by the employer to make benefit payments in the future. If the plan refers to a trust, it must conform to the terms of Revenue Procedure 92-64, 1992-2 C.B. 422, *modified in part by* Notice 2000-56, 2000-2 C.B. 393.

[1794] *Veit v. Commissioner,* 8 T.C. 809 (1947).

[1795] *Commissioner v. Oates*, 207 F.2d 700 (7th Cir. 1953).

[1796] The IRS acquiesced in both *Veit I* and *Oates*.

[1797] *Martin v. Commissioner*, 96 T.C. 814 (1991).

made after the amount of payments was determinable, but before payment was due, did not result in constructive receipt.[1798] In *Veit II*, the subsequent election was bilaterally negotiated.

Even though the IRS has attempted to enforce its position on constructive receipt, it appears that courts generally have been hesitant to apply the doctrine of constructive receipt. Many practitioners rely on case law for the position that subsequent elections to change the timing and manner of payment do not result in constructive receipt. It is not uncommon for plans to allow participants to make some type of subsequent election to change the time or manner of payment.

Income inclusion under a funded arrangement

As stated above, if a nonqualified deferred compensation arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture. An arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property.[1799]

Under section 83, the excess of the fair market value of property received in connection with the performance of services over the amount, if any, paid for the property is includible in the income of the person performing the services. Income is generally includible for the year in which the service provider's right to the property is either transferable or is not subject to a substantial risk of forfeiture. The amount includible in income is based on the fair market value of the property at that time.[1800]

Section 83 applies to a transfer of property to any service provider; its application is not limited to employees or even to individuals. A transfer of property occurs for purposes of section 83 when a person acquires a beneficial ownership interest in such property.

The term "property" is defined very broadly for purposes of section 83.[1801] Property includes real and personal property other than money or an unfunded and unsecured promise to

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[1798] *Veit v. Commissioner*, 8 T.C.M. 919 (1949).

[1799] The application of section 83 to a funded nonqualified deferred compensation arrangement is based in part on the broad scope of section 83 (i.e., section 83 applies to any transfer of property in connection with the performance of services) and the broad definition of property under section 83. Depending on the design of a particular nonqualified deferred compensation arrangement (e.g., if it covers only employees), either the economic benefit doctrine or Code provisions dealing with nonexempt employee trusts and nonqualified annuities may be relevant as legal authority for this tax treatment in addition to section 83.

[1800] Under a special rule, if property is either nontransferable or is subject to a substantial risk of forfeiture when transferred, the service provider may elect within 30 days to apply section 83 as of the time of the transfer.

[1801] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83.[1802]

Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance of substantial services (such as full-time services for two years or more) or on the nonperformance of services (such as a noncompete requirement). In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services and there is a substantial possibility that the property will be forfeited if the condition does not occur.[1803] Under a special rule, property is considered to be subject to a substantial risk of forfeiture if sale of the property at a profit could subject the person to suit under section 16(b) of the Securities Exchange Act of 1934 (relating to short-swing profits).

Risks that do not fall within this legal definition, such as the risk that the property will decline in value, do not result in a substantial risk of forfeiture. Whether a substantial risk of forfeiture exists depends on the facts and circumstances, including whether the service requirement or other condition will in fact be enforced. Property that is subject to a substantial risk of forfeiture is referred to as nonvested property; property that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested property.

Property is considered transferable if a person can transfer his or her interest in the property to anyone other than the transferor from whom the property was received. Property is not considered transferable if the transferee's rights in the property are subject to a substantial risk of forfeiture. A temporary restriction on the transferability of property (called a "lapse" restriction) is disregarded in determining the value of the property for purposes of section 83. A permanent restriction on the transferability of property (a "nonlapse" restriction) is taken into account in determining the value of the property.

[1802] In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, the cost of the current life insurance protection thereunder (i.e., the reasonable net premium cost as determined by the Commissioner) is includible in income.

[1803] For example, if contributions are made to a trust exclusively for the purpose of reimbursing employees for education expenses, but reimbursement is available only if an employee takes a course and earns a passing grade, the employee's interest in the trust is subject to a substantial risk of forfeiture until he or she takes and passes a course.

Section 132 of the Revenue Act of 1978

Section 132 of the Revenue Act of 1978[1804] was enacted in response to proposed Treasury regulations published in the Federal Register for February 3, 1978.[1805] These regulations provided that, if a payment of an amount of a taxpayer's compensation is, at the taxpayer's option, deferred to a taxable year later than that in which such amount would have been payable but for the taxpayer's exercise of such option, the amount is treated as received by the taxpayer in such earlier taxable year.[1806] Section 132 of the Revenue Act of 1978 provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978.

The term, "private deferred compensation plan" means a plan, agreement, or arrangement under which the person for whom service is performed is not a State or a tax-exempt organization and under which the payment or otherwise making available of compensation is deferred. However, the provision does not apply to certain employer-provided retirement arrangements (e.g., a qualified retirement plan), a transfer of property under section 83, or an arrangement that includes a nonexempt employees trust under section 402(b). Section 132 of the Revenue Act of 1978 was not intended to restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or interfere with judicial determinations of what principles of law apply in determining the timing of income inclusion.

Attempts to provide security for nonqualified deferred compensation

In general

Because amounts deferred that are funded are includible in gross income in the year the amount is transferable or is no longer subject to a substantial risk of forfeiture, funded arrangements can result in the imposition of tax even when no amount is actually received. For example, suppose a nonqualified deferred compensation plan provides that an employer will pay an employee (or the employee's beneficiary) $500,000 when the employee attains age 55 or dies. Further suppose that the plan is funded and provides that the employee's right to the $500,000 vests after five years of employment. Because the arrangement is funded, the employee must include the present value of $500,000 in income after he or she completes five years of employment, even if that is many years before the employee attains age 55. Given this type of result, individuals covered under nonqualified deferred compensation arrangements typically prefer for such arrangements not to be funded for tax purposes.

Nevertheless, such individuals are often interested in providing some security with respect to payment of the deferred compensation. Unfunded status presents the risk that the

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[1804] Pub. L. No. 95-600 (1978).

[1805] Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).

[1806] *Id.*

employee will not receive his or her deferred compensation payments when due.[1807] Thus, a goal of many plans is to maximize the security that can be provided for the individual without incurring current income tax consequences, i.e., without having the arrangement being considered funded for tax purposes. Various arrangements have been developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion.

Rabbi trusts

A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made.[1808] The trust or fund is generally irrevocable[1809] and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation. However, the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of bankruptcy or insolvency.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy or insolvency have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[1810] As a result, no amount is currently included in the income of a beneficiary of a rabbi trust by reason of the rabbi trust; income inclusion occurs as the deferred compensation is paid or made available.

The IRS has issued guidance setting forth model rabbi trust provisions.[1811] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

[1807] This risk is not a substantial risk of forfeiture as defined under section 83.

[1808] A rabbi trust is generally a grantor trust of the employer for tax purposes, so trust earnings are treated as income to the employer.

[1809] Some trusts provide that the trust is funded or irrevocable only upon the occurrence of a certain events, such as a change in control of the employer.

[1810] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

[1811] Rev. Proc. 92-64, 1992-2 C.B. 422, *modified in part by* Notice 2000-56, 2000-2 C.B. 393.

Since the concept of a rabbi trust was developed, other techniques have been developed that attempt to protect the assets from creditors despite the terms of the trust. For example, the trust or fund may be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets. In such a case, the existence of the assets may be unknown or the assets may be protected from creditors under the laws of the jurisdiction where the trust is located.

Secular trusts

In contrast to a rabbi trust, a "secular" trust is a trust established by an employer exclusively for the purpose of providing nonqualified deferred compensation; assets are not subject to claims of creditors. A secular trust constitutes a funding of a nonqualified deferred compensation arrangement, so that vested amounts are includible in income by the employees (i.e., such amounts are not tax-deferred).[1812] A secular trust provides security for the employees, but also causes current taxation. In some cases, under the terms of the nonqualified deferred compensation arrangement, the employer pays the taxes attributable to the deferred compensation by grossing up the employees' current compensation by a corresponding amount.

Other forms of security

Other methods are sometimes used in an attempt to provide employees with security that deferred compensation payments will be made when due, such as third party guarantees, letters of credit, and surety bonds. There is little specific guidance as to how these arrangements should be treated for tax purposes. In addition, the tax treatment depends on the facts of the particular arrangement.

Timing of employer income tax deduction

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.[1813] Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the individual performing services is deductible by the service recipient for the taxable year in which the amount is includible in the individual's income.

Payroll taxes and wage reporting

In general

In the case of an employee, nonqualified deferred compensation is generally considered wages both for purposes of income tax withholding and for purposes of taxes under the Federal Insurance Contributions Act ("FICA"), consisting of social security tax and Medicare tax.

[1812] A secular trust is generally structured as a separate entity for tax purposes, and earnings are includible in the income of the trust.

[1813] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

However, the income tax withholding rules and social security and Medicare tax rules that apply to nonqualified deferred compensation are not the same.

Income tax withholding

Nonqualified deferred compensation is generally subject to income tax withholding at the time it is includible in the employee's income as discussed above. In addition, such amounts must be reported as wages on a Form W-2. Income tax withholding and Form W-2 reporting are required even if the employee has already terminated employment. For example, if nonqualified deferred compensation is includible in income only as payments are made after retirement, income taxes must be withheld from the payments and the payments must be reported on a Form W-2.

Income tax withholding and Form W-2 reporting are required when amounts are includible in income even if no actual payments are made to the employee. For example, if nonqualified deferred compensation is provided by means of vested contributions to a funded arrangement, the amount of the contributions is includible in the employee's income and is subject to income tax withholding[1814] and Form W-2 reporting. Additional income tax withholding and reporting may be required when payments are made from the funded arrangement to the extent a portion of the payments are includible in income (i.e., amounts in excess of the employee's basis). Such amounts are subject to the income tax withholding rules that apply to pensions and are reported on a Form 1099R.

Generally, the employer is responsible for income tax withholding and Form W-2 reporting (or Form 1099R, if applicable) with respect to nonqualified deferred compensation. However, if nonqualified deferred compensation payments are made by a third party, such as the trustee of a trust, and are not under the control of the employer, the payor is responsible for income tax withholding and reporting.

Social security and Medicare taxes

The Code provides special rules for applying social security and Medicare taxes to nonqualified deferred compensation. In general, nonqualified deferred compensation is subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which, as described above, is relevant in determining when amounts are includible in income (and subject to income tax withholding). Because nonqualified deferred compensation arrangements generally cover only highly paid employees, the other compensation paid to the employee during the year generally exceeds the social security wage

[1814] The required income tax withholding is accomplished by withholding income taxes from other wages paid to the employee in the same year.

base. In that case, nonqualified deferred compensation amounts are subject only to Medicare tax.

Factual Background

Executive deferral programs in general

In recent years, Enron had two principal active deferral plans: the Enron Corp. 1994 Deferral Plan (the "1994 Deferral Plan") and the 1998 Enron Expat Services, Inc. Deferral Plan (the "Expat Deferral Plan"). The 1994 Deferral Plan was the principal deferral plan used by Enron. The 1994 Deferral Plan and the Expat Deferral Plan had almost identical terms and features, with the principal difference that the Expat Deferral Plan was used for employees of Enron Expat Services Inc., while the 1994 Deferral Plan was used for all other employees. Enron also had several older deferral plans, which did not allow current deferrals, but pursuant to which participants had made deferrals in previous years. In addition, Enron had a Project Participation Plan for international developers, which was put in place in the early 1990's. The Project Participation Plan was terminated December 31, 2000, except that payments could be made after that date with respect to awards made before such date. The Project Participation Plan allowed participants to defer receipt of payments that would otherwise be made.[1815]

Nonqualified deferred compensation was a major component of executive compensation for Enron. Documents provided by Enron show the approximate amounts deferred under all deferred compensation plans for the top-paid 200 employees for the years 1998-2001.[1816] Amounts deferred in these years are shown in the following table.

Table 21.–Amounts Deferred by Top-Paid 200 Employees 1998-2001

Year	Amounts Deferred Under All Deferred Compensation Plans for the Top-200 (millions of dollars)
1998	$13.3
1999	19.7
2000	67.0[1817]
2001	54.4

1994 Enron Corp. Deferral Plan

In general/background

Enron adopted the Enron Corp. 1994 Deferral Plan effective January 1, 1994. The stated purpose of the Plan is to allow key employees and outside directors of Enron Corp. to reduce current compensation and thereby reduce their current taxable income, earn an attractive, tax-free rate of growth on monies deferred, and accumulate funds on a tax-favored basis which can be

[1815] The Project Participation Plan is discussed in Part III.B.3., above.

[1816] EC 000599639 - EC 000599654(1998); EC 000599620 - EC 000599638 (1999); EC 001872078 - EC 001872081 (2000); and EC 000599599 - EC 000599619 (2001).

used for retirement planning or other future financial objectives. The summary of the 1994 Deferral Plan for participants states that the "Plan provides you with an opportunity to delay payment of federal and state income taxes, and earn tax-deferred returns on your deferrals. You have the flexibility of choosing an investment strategy and payment schedule to meet your financial needs."[1818]

Participation in the 1994 Deferral Plan was originally offered to approximately 300 executives and key employees.[1819] Approximately 100 individuals[1820] elected to defer 1994 compensation, including salary, bonus, and long-term incentive for total deferrals of $3 million in 1994.[1821] Enron anticipated offering the same deferral opportunity for seven consecutive years, subject to further renewal after that time, according to the value of the 1994 Deferral Plan.[1822] To provide a level of security to executives and an asset to cover Enron's future payment liabilities, a rabbi trust was approved for the 1994 Deferral Plan.[1823] The rabbi trust is discussed below in further detail.

Many executives participated in Enron's deferral programs. Information provided by Enron shows that for the years 1999-2001, there were approximately 340 participants in the 1994 Deferral Plan.[1824] As of December 2000, there were approximately 295 participants in the 1994 Deferral Plan, with account balances totaling $153.4 million. As of December 2001, there were approximately 304 participants in the 1994 Deferral Plan, with account balances totaling approximately $51.6 million. The decrease in account balances was principally due to the decline in the value of Enron Stock and the accelerated distributions, discussed below, that were made immediately preceding Enron's bankruptcy filing.

The 1994 Deferral Plan was amended and restated several times. The original plan, after being amended seven times, was restated as of August 11, 1997. The 1994 Deferral Plan,

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[1817] According to the documents provided by Enron, in 2000, Mr. Lay deferred $32 million under the 1994 Deferral Plan in 2000. EC 001872080.

[1818] Added Value for your Future (a participant brochure). EC 000768171.

[1819] Plan Funding Conclusions and Recommendations prepared by Clark/Bardes, Inc. EC 000768252.

[1820] When the 1994 Deferral Plan filed notification of its effectiveness with the Department of Labor, the plan covered 104 highly compensated employees.

[1821] Plan Funding Conclusions and Recommendations prepared by Clark/Bardes, Inc. EC 000768252.

[1822] *Id.*

[1823] *Id.*

[1824] EC 000768148.

restated as of August 11, 1997, was amended three times and was restated again as of October 6, 2000.[1825] The 1994 Deferral Plan was amended August 14, 2001.[1826]

In connection with Enron's financial situation, the 1994 Deferral Plan was amended November 28, 2001, to suspend deferrals under the Plan, effective at the end of business on November 29, 2001, until such time that the Board of Directors removed such suspension.

Eligibility

Under the 1994 Deferral Plan, key management and highly compensated employees of Enron, as determined by the Deferral Plan Committee,[1827] and outside directors of Enron Corp. and participating subsidiaries were eligible to be designated participants under the 1994 Deferral Plan. The 1994 Deferral Plan allowed Enron to determine which executives would be eligible for participation. Over time, Enron changed participation eligibility requirements.

For 2001, the following employees were eligible to participate in either the 1994 Deferral Plan or the Expat Deferral Plan, whichever was applicable: (1) vice president level and above employees of Enron Corp. or a participating subsidiary who were eligible for stock awards under the Executive Long-Term Incentive program, on the executive pay structure (job level structure), and on local payroll; and (2) lower than vice president level employees who were making current (year 2000 for 2001 eligibility) deferrals under one of the plans.[1828] Enron believed that linking deferral plan eligibility to job level and participation in another Enron-sponsored program was a

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[1825] This is the most recent version of the plan. In the October 6, 2000, restatement of the 1994 Deferral Plan, certain amendments were made. On October 6, 2000, the Compensation Committee approved a restatement of the 1994 Deferral Plan which included amendments to: (1) clarify provisions relative to deferral of gains realized upon the exercise of options utilizing a stock swap and the deferral of restricted stock that would otherwise be released; (2) provide consistency with respect to Enron's definition of retirement; (3) clarify current administrative processes; and (4) eliminate a reference that the plan may be adopted by other employing companies due to multiemployer trust issues.

[1826] The 1994 Deferral Plan as restated October 6, 2000, was first amended August 14, 2001, to: (1) allow daily investment changes instead of only once a month; (2) allow participants to make an election covering all future aggregate deferrals and to have the ability to change past and future elections by submission of a revised payout election; and (3) allow participants the ability to submit a beneficiary designation via an electronic process.

[1827] The "Deferral Plan Committee" refers to the committee established under the 1994 Deferral Plan to administer the plan. The duties and authority of the Deferral Plan Committee are discussed below.

[1828] Interoffice memorandum from Executive Compensation Department to unspecified distribution list regarding deferrals, dated October 12, 2000. EC2 000018424.

very straight-forward and thoughtful approach to determining the eligible group for executive deferrals.[1829]

In the few years preceding the bankruptcy, the group of eligible participants had changed. For 1999, employees with a September 15, 1998, salary of $130,000 or above, who were employees of Enron Corp. or a participating subsidiary, were eligible to participate in the 1994 Deferral Plan.[1830] For 2000, there was a change in eligibility for the 1994 Deferral Plan. Each business unit had the ability to select the executive and management employees who would be eligible to participate. The number of eligible participants was determined based on the numbers in each group that had been eligible to participate in the past at the advice of legal counsel. For 2000, all managing directors, executive vice presidents, business unit heads, and employees participating in the Plan during 1999 were automatically eligible to participate. Up to 43 additional employees in a group could be selected to participate based on specified criteria. In order to participate, an employee had to earn a minimum base salary of $120,000.

Regular deferrals

Under the 1994 Deferral Plan, a participant could defer up to 35 percent of base salary, up to 100 percent of annual bonus payments and up to 100 percent of select long term incentive payments. Prior to the Third Amendment to the 1994 Deferral Plan (as amended and restated effective as of August 11, 1997) dated August 8, 2000, participants could defer only up to 25 percent of base salary. The minimum deferral for each category of compensation was $2,000 for any deferral year.

Deferral elections were to be made in writing. Elections to defer compensation were irrevocable and were required to be made prior to the first day of the calendar year in which the compensation to be deferred was earned and payable.[1831] As discussed below, the 1994 Deferral Plan also allowed for stock option deferral and restricted stock deferral for certain employees. Enron could also make company deferral contributions on a participant's behalf.

Under the 1994 Deferral Plan, Enron would establish a deferral account in the name of each participant on its books and records. The account would carry the amount of the deferrals made, plus any earnings thereon, as a liability of Enron to the participant. Participant materials state that the account would be utilized solely as a device for the measurement and determination of the amount to be paid to the participant pursuant to the Plan.

Participants could choose to have their deferrals treated as having been invested in two types of investment accounts -- the Phantom Stock Account and the Flexible Deferral Account. A percentage of deferred compensation could be allocated to either account or the entire deferral could be allocated to only one account.

[1829] *Id.*

[1830] Interoffice memorandum from Corporate Compensation Department regarding 2000 deferrals, dated October 21, 1999. EC2 000018664.

[1831] A special rule applied for deferral elections of new employees.

Deferrals invested in the Phantom Stock Account were treated as if the participant purchased shares of Enron Corp. common stock at the closing price on the date of deferral. Under the Plan, credits for dividends declared for Enron Corp. common stock would be made quarterly to the Participant's Phantom Stock Account Deferral Account, and would be administered as though reinvested in Enron Corp. common stock.

During 1994 and 1995, deferrals into a participant's Flexible Deferral Account earned a fixed annual return of nine percent. Beginning in 1996 and thereafter, participants were allowed to select investment funds for the crediting of earnings to their account balances, and returns on Flexible Deferral Accounts were based on the performance of the participant's investment choices, less an administrative fee. Investment options were to include different levels of risk and return such as growth, balanced asset and bond funds, and fixed interest accounts. In 1999, in connection with a change to the Enron Savings Plan's recordkeeper, the investment options under the Flexible Deferral Account were changed to mirror those of the Enron Savings Plan. For 2001, participants could allocate among 17 investment choices that mirrored funds available in the Enron Savings Plan.[1832] The account would be credited with cumulative appreciation and/or depreciation based on the market price of chosen investments.

It appears that participants' deferrals were not actually invested to match participants' investment elections, but that participants' investment elections may have been followed generally in investing the assets of the rabbi trust associated with the 1994 Deferral Plan. According to Enron, only initially did Enron direct investments to generally correspond with participant elections.[1833] The investment of the trust's assets is discussed in further detail below. According to Enron's summary of the 1994 Deferral Plan,[1834] because of constructive receipt rules, Enron could credit a participant deferral account with earnings that tracked a chosen mix of investment funds, but the actual investments were required to be made by Enron Corp. or by the Trustee appointed by Enron Corp. at the direction of Enron Corp.

A participant could not transfer balances between the Phantom Stock Account and the Flexible Deferral Account, but could change investment choices within the Flexible Deferral Account once each calendar month. The First Amendment to the 1994 Deferral Plan dated August 14, 2001, allowed for daily changes in election choices instead of monthly changes.

[1832] For 2001, the Flexible Deferral Account investment choices were: Stable Asset Fund, Fidelity Balanced Fund, Fidelity Equity-Income Fund, Fidelity Growth & Income Portfolio, Fidelity Magellan Fund, Fidelity Growth Company Fund, Fidelity OTC Portfolio, Fidelity Overseas Fund, MSDW Institutional International Equity Fund, MSDW Institutional Equity Fund Growth Portfolio, PIMCO Total Return Fund II, T. Rowe Price Small Cap Stock Fund, Vanguard Index Trust 500, Vanguard Windsor II, Vanguard Conservative Growth Portfolio, Vanguard Moderate Growth Portfolio, and Vanguard Growth Portfolio.

[1833] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1834] EC2 000018443.

Under the 1994 Deferral Plan, within 120 days after the close of each plan year, each participant was to be provided a statement setting forth the participant's balance in the deferral accounts.

Distributions

Distributions from the 1994 Deferral Plan could be made upon the participant's retirement, disability, death or termination of employment. The 1994 Deferral Plan provides how retirement benefits, disability benefits, death benefits and termination benefits would be triggered and paid.

The 1994 Deferral Plan originally provided that elections with respect to payment options had to be made annually at the time the election to defer was made. Participants could elect to receive payments in a lump sum or up to 15 annual installments. Payments from an account could be received beginning the first quarter of the year following retirement, death, disability or termination. Payment elections could be revised at any time, but would not be effective until one full calendar year after receipt of the revised payment election form. Only one installment payment option could apply at any given time, e.g., an employee could not elect to have certain deferrals payable over 10 years and other deferrals payable over 15 years. If a participant was terminated for cause, the participant would receive deferrals only, with no earnings, in a lump sum during the first quarter of the year following termination.

The First Amendment to the 1994 Deferral Plan (as amended and restated October 6, 2000) dated August 14, 2001, changed the Plan to allow participants to make an election covering all future aggregate deferrals, rather than requiring payment option elections to be made annually, and to have the ability to change past and future elections by submission of a revised payout schedule. The 1994 Deferral Plan provided specific rules for beneficiary designations and the First Amendment allowed beneficiary designations by electronic processes.

In addition to distributions on account of retirement, death, disability or termination, the 1994 Deferral Plan allowed for hardship withdrawals. Participants were required to petition the Deferral Plan Committee, described below, in writing for such distributions, which could be granted, in the sole discretion of the Deferral Plan Committee, on account of unforeseeable circumstances causing urgent and severe financial hardship for the participant. According to the 1994 Deferral Plan, the types of circumstances that usually met the criteria were accidents and illness, large theft and fire loses, severe financial reversals, and large personal judgments. The distribution amount was limited to a reasonable, necessary amount to eliminate the hardship. The 1994 Deferral Plan was amended in 1996 to prohibit hardship distributions from the Phantom Stock Account for participants subject to section 16(b) of the Securities Exchange Act of 1934.

For circumstances other than financial hardship, an accelerated withdrawal of all or a portion of the account balance was also available, subject to the consent of the Deferral Plan Committee. The accelerated distribution provision was added to the plan in the First Amendment to the 1994 Deferral Plan (as restated effective August 11, 1997) dated October 13, 1997. If a participant elected an accelerated withdrawal, 10 percent of the elected distribution amount was required to be forfeited and 90 percent of the elected distribution would be paid to

the participant. Upon such distribution, a participant would not be eligible to participate in the 1994 Deferral Plan for at least 36 months following the distribution. The account balance distributed would be determined as of the last day of the month preceding the date on which the Deferral Plan Committee received the written request of the participant.

Deferrals into the Phantom Stock Account would be paid out in shares of Enron Corp. common stock, with the exception of pre-1998 deferrals, which would be paid out in cash unless the participant signed a waiver to receive stock. The plan provides that the value of the shares, and resulting payment amount, would be based on the closing price of Enron Corp. common stock on the January 1 before the date of payment. Dividends would be credited to a participant's Phantom Stock Account and would be administered as if reinvested in Enron Corp. common stock.

Payments from the Flexible Deferral Account would be made in cash over the payment period selected. Earnings/losses would be applied to the Flexible Deferral Account during the payout period, based upon the investment choices made. Earnings on the declining account balance would be paid annually. Losses, if any, would be subtracted from the remaining account balance, which could shorten the payment period. Payments would begin during the first quarter of the year following the termination event.

Special purpose deferrals

The Second Amendment to the Enron 1994 Deferral Plan (as restated effected August 11, 1997) dated October 12, 1998, changed the Plan to allow participants to elect to make special purpose deferrals beginning in 1999. Participants could receive special purpose deferral payments while remaining actively employed. Special purpose deferral payments could be received as soon as three years following the deferral in a lump sum or up to five annual installments. Special purpose deferrals were intended to assist with anticipated expenses, such as a child's college expenses.

Taxes

Participant information states that Federal and State income taxes associated with deferrals were not incurred until the receipt of payments. FICA and Medicare taxes on amounts deferred were due at the time of deferral. Such amounts were said to be subtracted from compensation that was not deferred.

Information supplied to the IRS by Enron states that, for all deferrals of compensation made to the various plans, FICA tax was withheld at the time the deferral was made and deposited along with other payroll taxes for the pay period in which the deferral was made.

Enron deferral contributions

The Second Amendment to the 1994 Deferral Plan (as restated effective August 11, 1997) dated October 12, 1998, allows for deferral contributions by Enron. Under the amendment, Enron could make contributions on a participant's behalf in any amount as Enron determined in its sole discretion and to any investment account under the 1994 Deferral Plan. Such contributions could be made on behalf of some participants to the exclusion of others, and

could vary among individual participants in amount and/or with respect to the investment account in which they may be credited. Such Enron deferral contributions were said to be cash bookkeeping credits made to the records of the 1994 Deferral Plan.

Documents obtained from the IRS show that, as part of one executive's employment agreement, Enron agreed to make contributions to the 1994 Deferral Plan in the amount of $500,000 to be deposited each February 15th of calendar years 2000, 2001, 2002, and 2003. It is unclear to what extent Enron made deferral contributions on behalf of other employees.

Deferral of stock option gains and deferral of restricted stock

The 1994 Deferral Plan allowed for deferral of income attributable to stock options and restricted stock. The Stock Option Deferral Account was established by the Fifth Amendment to the 1994 Deferral Plan, dated December 10, 1996. The Restricted Stock Deferral Account was established by the Sixth Amendment to the 1994 Deferral Plan, dated May 5, 1997.

Under the deferral of stock option gains program, participants designated by the Deferral Plan Committee could make an advance written election to defer the receipt of shares of Enron Corp. common stock from the exercise of a stock option granted under a stock plan sponsored by Enron, when such exercise was made by means of a stock swap using shares owned by the participant.[1835] The deferral election applied to the number of shares that the employee was due to receive in addition to the shares exchanged in the stock for stock exercise.

In 2001, nonemployee directors and members of the Enron Executive and Policy Committees were eligible to participate in the deferral of stock option gains program. An election to defer stock was required to be made prior to the end of the tax year preceding the year in which the option was exercised and at least six months prior to the exercise. The election was irrevocable, remained in effect for all tax years subsequent to the year the election was made, and remained in effect until to the Phantom Stock Account was to be paid out.

If an executive made a deferral election, Enron would credit share units to the Stock Option Deferral Account under the 1994 Deferral Plan, to be payable in stock upon death, disability, retirement or termination as elected by the executive (over a period of one to fifteen years) instead of delivering shares to the executive upon exercise of the option. Credits for dividends would be accrued in a separate account and paid in cash pursuant to the distribution provisions under the 1994 Deferral Plan. Phantom stock units derived through deferral counted for purposes of meeting Enron stock ownership requirements for executives. The tax issues associated with this program are discussed below.

Under the deferral of restricted stock program, participants designated by the Committee could make an advance written election to defer the receipt of shares of Enron Corp. common stock to be released according to a grant of restricted shares under a stock plan sponsored by Enron Corp. In 2001, nonemployee directors and executives who were current deferral plan participants or who met criteria for deferral in accordance with ERISA regulations for top-hat

[1835] Issues relating to stock-for-stock exercises are discussed in detail in Part III.C.2, below.

plans, as determined by the Deferral Plan Committee, were eligible to participate in the deferral of restricted stock program under the 1994 Deferral Plan. Eligible holders of shares of restricted stock could make an advance election, in the nature of a deferred compensation election, prior to the end of the tax year preceding the release date, and at least six months prior to release date, to defer receipt of shares which would otherwise vest and be released. Instead of delivering shares of restricted stock upon vesting, Enron would credit the value of such shares of restricted stock to the participant's Phantom Stock Account under the 1994 Deferral Plan, to be payable in shares of Enron Corp. common stock upon death, disability retirement or termination, as selected by the participant, over a period from one to fifteen years. Credits for dividends would be accrued in a separate account and paid in cash pursuant to the distribution provisions under the 1994 Deferral Plan.

Administration

According to the plan document, the 1994 Deferral Plan was to be administered by a committee of not more than three people appointed by the Chief Executive Officer of Enron ("Deferral Plan Committee"). The Deferral Plan Committee had the authority to make, amend, interpret and enforce all appropriate rules and regulations for the administration of the 1994 Deferral Plan and decide or resolve any and all questions, including interpretations of the 1994 Deferral Plan. In addition to other enumerated powers, the Deferral Plan Committee had the right, power, authority and duty to determine the amount, manner and time of payment of any benefits under the 1994 Deferral Plan and to prescribe procedures to be followed in obtaining benefits.

Effective October 26, 2001, Kenneth L. Lay appointed Lawrence Gregory ("Greg") Whalley to serve as the sole member of the Deferral Plan Committee. Mr. Whalley accepted the appointment October 29, 2001. Even though eligible, Mr. Whalley was not a participant in the 1994 Deferral Plan. There is no record of a Deferral Plan Committee before October 2001. Enron employees interviewed by Joint Committee staff said that an informal administrative committee would be formed when an issue arose, which was infrequently. Informal committees may have been composed of the head of Human Resources, compensation staff members, and legal counsel.

Claims procedures

Under the 1994 Deferral Plan, any claim for benefits was required to be submitted to the Deferral Plan Committee. The Deferral Plan Committee was responsible for deciding whether such claim was within the scope provided by the 1994 Deferral Plan. Notice of a decision by the Deferral Plan Committee with respect to a claim was required to be furnished to the claimant within 90 days following the receipt of the claim. If a claim was wholly or partially denied, notice was required to be in writing and worded in a manner to be understood by the claimant.

Rights of participants

The 1994 Deferral Plan provides that compensation deferred is part of the general assets of Enron. Enron was not required to segregate, set aside or escrow compensation deferred, nor earnings credited thereon. With respect to benefits payable under the 1994 Deferral Plan,

participants have the status of general creditors of Enron. Participants could look only to Enron and its general assets for payment of their account balances.

Establishment of rabbi trust

Under the 1994 Deferral Plan, Enron, in its sole discretion, could acquire insurance policies or other financial vehicles for the purpose of providing future Enron assets to meet its anticipated liabilities under the 1994 Deferral Plan. Such policies or other investments would at all times remain unrestricted general property and assets of Enron. Participants in the 1994 Deferral Plan would have no rights, other than as general creditors, with respect to such policies or other acquired assets. As discussed below, Enron did acquire insurance policies on the lives of certain participants in the 1994 Deferral Plan.

The 1994 Deferral Plan provides that, notwithstanding any other provision or interpretation of the plan, Enron shall establish a trust in which to hold cash, insurance policies or other assets to be used to make or reimburse Enron for payments to participants of the benefits under the plan, provided that the trust assets shall at all times remain subject to the claims of general creditors of Enron in the event of Enron's insolvency. The 1994 Deferral Plan further provides that Enron, and not the trust, shall be liable for paying the benefits under the 1994 Deferral Plan. On April 5, 1994, Enron Corp. established an irrevocable rabbi trust for the executive nonqualified deferred compensation program.[1836] The provisions of the trust document were incorporated in the 1994 Deferral Plan.

The use of variable life insurance products was approved for investment of trust assets, because such products provided tax-free buildup of earnings.[1837] Upon the establishment of the trust, 100 trust-owned life insurance ("TOLI") policies were purchased through Cigna on the lives of 100 participants in the Plan. It was also approved that the assets for the 1992 Deferral Plan, which credited deferrals with Enron's mid-term cost of capital, be included in the rabbi trust and used to purchase life insurance.[1838]

Documents obtained from Enron[1839] show that a new grantor trust agreement was entered into with Wachovia Bank, N.A. as trustee dated January 1, 1999.[1840] Even though approved by

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[1836] In response to questions asked by the Joint Committee staff, Enron responded that the trust was established April 5, 1995. This appears to have been an error; because several documents provided by Enron state that the trust was established in 1994.

[1837] Plan Funding Conclusions and Recommendations prepared by Clark/Bardes, Inc. EC 000768252.

[1838] *Id.*

[1839] Trust under the Enron Corp. 1994 Deferral Plan. EC2 000030938.

[1840] The Trust Agreement dated January 1, 1999, was actually executed in August 2000. The minutes of the August 7, 2000, Compensation Committee meeting show that executive compensation staff, in-house and outside legal advisors, and trust experts from Wachovia conducted a thorough review of the trust document dated April 5, 1994, to make sure that it

the Compensation Committee, members of the Compensation Committee interviewed by the Joint Committee staff did not know whether Enron had such a trust.

The January 1, 1999, trust replaced the prior trust dated April 5, 1994, and the assets from the prior trust were transferred to the 1999 trust.[1841] The 1999 trust was established with $1,000, plus the transfer of the assets from the 1994 trust.[1842] Enron could make additional deposits of assets, but according to Enron, other than the contribution in 1994 of the trust-owned life insurance policies, no additional funding other than a pay-as-you go mechanism was established (i.e., current deferrals funded current benefit obligations).[1843] According to Enron, the assets of

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incorporated sufficient protection to plan participants in the event of a change in control. Several changes were recommended and were incorporated into a replacement trust document. The new trust included several changes relating to the following areas: (1) the establishment and funding of a new trust (under the new trust, all income received by the trust could be returned to Enron upon request at any time prior to a change in control); (2) the trustee's responsibility regarding payments (the new trust provides a process for confirming the insolvency or alleged insolvency of Enron, and for tax or payment claims handling); (3) provisions regarding payments if a short fall of the trust assets occurs (the new trust described how payments would be handled in the event of a short fall of trust assets that could result if Enron were to become insolvent); (4) insurance contracts to provide an irrevocable trust (the new trust confirmed the trustee as owner of life insurance policies, and beneficiary of death proceeds); and (5) provisions regarding the resignation and removal of the trustee (the new trust allowed for removal or termination of the trustee with majority consent of participants following a change in control). EC 000101470.

[1841] The Third Amendment to the 1994 Deferral Plan (as amended and restated effective as of August 11, 1997) dated August 8, 2000, amended the plan to incorporate provisions of the new trust document in order to link the replacement trust to the 1994 Deferral Plan.

[1842] Minutes from the February 12, 1996, Compensation Committee meeting report that the deconsolidation of Enron Oil & Gas ("EOG") in December 1995, resulted in EOG establishing a 1996 Oil & Gas Deferral Plan which included the assumption of deferral plan liabilities for active participants. It was anticipated that EOG would assume the deferred compensation obligations attributable to EOG and that there would be a separation of the trust under the 1994 Deferral Plan into an Enron trust and an EOG trust. The minutes note that as of December 31, 1995, the assets to be placed in the EOG trust equaled $2.085 million, with all trust assets totaling $11.480 million. Evidently, the transfer did not take place when originally contemplated, as the minutes of the May 3, 1999, meeting of Compensation Committee state that they approved, for recommendation to the Board, a proposed amendment to the 1994 Deferral Plan to allow the transfer of assets to the EOG trust. It is unclear whether such transfer eventually took place.

[1843] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

the trust were not intended to be sufficient to entirely pay for the nonqualified deferred compensation obligations under the 1994 Deferral Plan.[1844]

Under the trust document, a change in control would trigger funding of the trust so that the trust would contain assets necessary to meet the liability for benefits credited under the plan.

Under the trust document, in the event that a participant or beneficiary was determined to be subject to Federal income tax on any amount credited under the 1994 Deferral Plan prior to the time of payment, whether or not due to the establishment of or conditions to the trust, a portion of the taxable amount equal to the Federal, state and local taxes owed would be, at the direction of Enron, distributed by the trustee as soon thereafter as practicable to such participant or beneficiary. Enron would reimburse the trust for such distributions. Enron would also bear the expenses to defend any tax claims (related to deferred amounts) asserted by the IRS against any participant or beneficiary.

Under the trust document, the trustee was to cease any payment of benefits if Enron were insolvent. The trust provides that, all times during the continuance of the trust, all principal and income of the trust is subject to the claims of all of the general creditors of Enron.[1845] The trust was to be used as a source of funds to assist Enron in satisfying its obligations under the 1994 Deferral Plan. No assets held by any trust established were to constitute security for the performances of obligations under the 1994 Deferral Plan.

The trust document provides that the trustee has the power to invest and reinvest the assets of the trust in its sole discretion. It also provides, however, that prior to a change in control, Enron shall have the right to direct the trustee with respect to the investment of all or any portion of the assets of the trust. One former Enron employee interviewed by the Joint Committee staff stated that the trust assets were invested in a manner to correspond to participant investment selections. In response to questions asked by the Joint Committee staff, Enron responded that only initially were investments of trust assets directed so as to correspond generally to participant elections.[1846]

[1844] One former employee interviewed by Joint Committee staff said that the assets of the trust were intended to be sufficient to satisfy obligations under the 1994 Deferral Plan.

[1845] At the February 12, 1996, Compensation Committee meeting, it was reported that Vinson & Elkins informed Enron that if one of Enron's subsidiaries were to file bankruptcy, the creditors of that company would not be able to obtain access to amounts in the trust because the trust was held at the corporate level. To prevent current taxation of deferred amounts, Enron management recommended, and the Compensation Committee approved, that all employees deferring compensation into the 1994 Deferral Plan be transferred into Enron Corp., with their payroll costs charged back to the original subsidiaries.

[1846] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

Employees were notified of the existence of the trust and were notified that they did not have any interest or ownership in the trust assets. Employee information[1847] regarding security of deferrals stated that the 1994 Deferral Plan was secured by a rabbi trust to hold assets that would be used to make payments directly to participants in the event that Enron Corp. defaults on its obligation to make payments, but that benefits were contractually payable by Enron. Participant information explained that the trust would secure deferrals in the event of a change in control, or for any other circumstances, except bankruptcy. Participants were informed that in the event of bankruptcy, trust assets would be subject to the claims of creditors in bankruptcy proceedings.

Distributions to participants were not made from the trust, but were made from the general assets of Enron. The 1994 Deferral Plan trust is still in existence. According to Enron, the cash surrender value of the 78 policies with CIGNA was $25 million as of October 28, 2002 (the latest valuation report received from the insurance company).[1848] According to Enron, the general ledger of Enron Corp. reflected a trust value of $31.1 million as of December 2001.[1849] According to Enron, earning from the trust were included in income when information was received from a third party recordkeeper.[1850]

1998 Enron Expat Service, Inc. Deferral Plan

The 1998 Enron Expat Services Inc. Deferral Plan ("Expat Deferral Plan") is very similar to the 1994 Deferral Plan and was established to allow key employees of Enron Expat Services Inc. to reduce current compensation and thereby reduce current taxable income, earn an attractive, tax-free rate of growth on monies deferred, and accumulate funds on a tax-favored basis which could be used for retirement planning or other financial objectives.[1851] The Expat Deferral Plan was established for expatriates who were ineligible to participate in the 1994 Deferral Plan because they were employed by Enron Expat Services Inc.[1852] A participant was eligible for either the 1994 Deferral Plan or the Expat Deferral Plan. Following repatriation,

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[1847] 2000 Deferral Plan Choices. EC2 000018665.

[1848] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002. In a subsequent response, Enron stated that Wachovia is the owner of the TOLI policies and Enron is the beneficiary. EC 002680494 - EC 002680495.

[1849] EC 002680493. Enron Corp.'s general ledger reflected a balance of $33.5 million as of November 2000; $32 million as of December 1999; $24.7 million as of November 1998; $18.4 million as of December 1997; $12.8 million as of December 1996; and $8.5 million as of December 1995.

[1850] EC 002680496.

[1851] Attachment to May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

[1852] Attachment to May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

compensation of participants in the Expat Deferral Plan would be deferred under the 1994 Deferral Plan.

The most recent version of the Expat Deferral Plan was restated as of September 1, 2001,[1853] and has most of the same features as the 1994 Deferral Plan. The Expat Deferral Plan mirrored the 1994 Deferral Plan in that it provided executives the benefit of having their deferral balances track a chosen mix of investment funds. Under the Expat Deferral Plan, participants could defer up to 35 percent of base salary, up to 100 percent of annual incentive plan bonus payments, and up to 100 percent of select long-term incentive payments into the Expat Deferral Plan. Deferrals could be allocated into the Phantom Stock Account or the Flexible Deferral Account. The 17 investment options in the Flexible Deferral Account were the same as those for the 1994 Deferral Plan. The Expat Deferral Plan also included the deferral of stock option gains and deferral of restricted stock programs.

Unlike the 1994 Deferral Plan, a trust or other funding mechanism was not established in connection with the Expat Deferral Plan. The Plan provides that Enron could acquire insurance policies or other financial vehicles for the purpose of providing future assets to meet its anticipated liabilities under the Expat Deferral Plan. However, documents provided by Enron show that because there were only a few eligible participants (approximately 25 in 1998), the Expat Deferral Plan was established on an unfunded basis.[1854] Enron Corp. periodically agreed to serve as guarantor of benefit payments from the Expat Deferral Plan.[1855]

Information provided by Enron shows that there were approximately 55 total participants in the Expat Deferral Plan.[1856] As of December 2000, there were approximately 45 participants in the Expat Deferral Plan, with account balances totaling $14 million.[1857] As of December 2001, there were approximately 48 participants in the Expat Deferral Plan, with account balances totaling $5.4 million.[1858]

In connection with Enron's financial situation, the Expat Deferral Plan was amended November 28, 2001, to suspend deferrals, effective at the end of business November 29, 2001, until such time that the Board of Directors removed such suspension.

[1853] There was a 1997 Expat Services Inc. Deferral Plan, which appears to have been merged into the 1998 Expat Deferral Plan.

[1854] Attachments to the May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

[1855] In 1997, the Compensation Committee approved Enron Corp. as the guarantor of payments made from the 1997 Enron Expat Services Inc. Deferral Plan. Attachments to the May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

[1856] EC 000768135.

[1857] EC 000768209.

[1858] EC 000768210.

The Expat Deferral Plan was also administered by a committee. As with the 1994 Deferral Plan, it appears that no formal committee was ever established.

One Enron employee told the Joint Committee staff that the Executive Vice President, Human Resources and Community Relations had been appointed to the Expat Deferral Plan committee. The Joint Committee staff interviewed this individual, and she said she had no recollection of such an appointment. Enron employees interviewed by Joint Committee staff stated that, as with the 1994 Deferral Plan, an informal committee would be formed when an issue arose, which was infrequently. It was suggested that the committee could be composed of the head of human resources, compensation department staff members, or legal counsel. An accelerated distribution from the Expat Deferral Plan in April 2001 was approved by three compensation staff members.[1859] When asked whether these individuals were the committee for the Expat Deferral Plan, Enron responded that although there is no documentation which reflects the appointment of a formal committee, plan administrators responsible for securing approvals of Expat Deferral Plan amendments and Expat Deferral Plan administration collectively approved the accelerated distribution in accordance with plan provisions.[1860]

Change in recordkeeper

In connection with the change in recordkeeper for the Enron Savings Plan, the recordkeeper for the 1994 Deferral Plan and the Expat Deferral Plan was changed from Northern Trust Retirement Consulting to Hewitt Associates. The change in recordkeeper occurred at the same time for the 1994 Deferral Plan, Expat Deferral Plan, and the Enron Savings Plan.[1861] The change was completed on November 13, 2001, which was an accelerated date. The originally scheduled date for completion of the change was November 20, 2001. In interviews with the Joint Committee staff, Enron employees who worked on the change in recordkeeper stated that there had been problems with the old recordkeeper for some time, but that because the deferral plans were relatively small plans, vendors generally were interested in recordkeeping only in conjunction with other, larger Enron plans. Thus, they had to wait until a change in recordkeeper was made for the Enron Savings Plan. Enron Compensation Department staff stated that they had minimal involvement in selecting the new recordkeeper. They stated that the Benefits Department staff, who were handling the change in recordkeeper under the Enron Savings Plan, took the principal role in selecting the criteria and making the final decision regarding the new recordkeeper.

[1859] The document provided by Enron lists three Enron Human Resources employees as the committee approving the accelerated distribution from the Expat Plan as of April 2001. EC2 00032287.

[1860] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1861] The change in recordkeeper under the Enron Saving Plan is discussed in Part II.C.4., above.

Because the investment accounts in the deferral plans mirrored those in the Enron Savings Plan, Enron employees interviewed by Joint Committee staff stated that Enron believed that there was an advantage to having the same recordkeeper for both the Enron Savings Plan and the 1994 Deferral Plans and Expat Deferral Plan. In 1999, when investment options for the 1994 Deferral Plan and the Expat Deferral Plan were changed to match those of the Enron Savings Plan, the recordkeeping services for the 1994 Deferral Plan and the Expat Deferral Plan were transitioned from Clark/Bardes to Northern Trust Retirement Consulting, who was the recordkeeper for the Enron Savings Plan at that time. For the future, Enron intended to keep the same recordkeepers for the Enron Savings Plan and the 1994 Deferral Plans and Expat Deferral Plan, as having one recordkeeper would be easier and more efficient for participants.

In connection with the change in recordkeeper of the 1994 Deferral Plan and Expat Deferral Plan, there was a blackout period from November 1, 2001, through November 13, 2001. During this period, reallocation of balances and changes to investment choices were restricted. According to Enron, participants were notified of the change in recordkeeper and blackout period through a notification, which was mailed with the notification sent regarding the Enron Savings Plan blackout.[1862] Information provided by Enron states that participants were mailed a brochure providing the first notice of the change in recordkeeper on October 4, 2001, and were mailed a transition date update postcard on November 8, 2001.[1863] Information provided by Enron shows that the notifications were mailed to 303 participants in the 1994 Deferral Plan and 48 participants in the Expat Deferral Plan.[1864] The notification informed participants that October 31, 2001, would be the last day to access account information.

Even though there was a blackout period for the 1994 Deferral Plan and the Expat Deferral Plan, the blackout did not result in a major interruption of activities for participants. Under the 1994 Deferral Plan and Expat Deferral Plan, participants were not allowed to change investments from the Phantom Stock Account. Other changes in investment could be made daily in the Flexible Deferral Account.[1865] Unlike participants in the Enron Savings Plan, participants in the 1994 Deferral Plan and Expat Deferral Plan received distributions during the blackout. The 1994 Deferral Plan and Expat Deferral Plan provide that a participant's account balance is determined as of the last day of the month preceding the date on which the Deferral Plan Committee received the written request of the participant. Therefore, the participants' account balances as of October 31, 2001 (which was the last day on which account information could be accessed), could be used for distribution requests submitted during the blackout.

[1862] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1863] *Id.*

[1864] *Id.*

[1865] As noted above, participant investment elections had the result of directing the source of investment returns, rather than directing actual investments.

Other deferred compensation plans

In general

Enron also had other deferral plans that were the predecessor programs to the active plans. These included the: InterNorth, Inc. Director's Unfunded Deferred Income Plan; InterNorth Deferral Plan; Houston Natural Gas Corporation Deferred Income Program for Directors; HNG Deferred Income Plan; HNG/InterNorth Deferral Plan; Enron Corp. Deferral Plan; Enron Corp. 1988 Deferral Plan; Enron Corp. 1992 Deferral Plan; Enron Corp. Director's Deferral Plan; Enron Deferral Repatriation Plan; Portland General Holdings, Inc. Management Deferred Compensation Plan; and Portland General Holding, Inc. Outside Directors' Deferred Compensation Plan.[1866]

Information provided by Enron shows that there were approximately 200 participants in the InterNorth, HNG/InterNorth, and 1988 Deferral Plans.[1867] As of December 31, 2000, there were approximately 87 participants in the HNG Deferral Plan, with account balances totaling $7.5 million.[1868] The account balances totaled $7 million as of December 31, 2001.[1869] According to Enron, no trusts or other funding arrangements were used in connection with any deferral plans other than the 1994 Deferral Plan.[1870]

1992 Deferral Plan

The 1992 Deferral Plan preceded the 1994 Deferral Plan. Enron filed the 1992 Deferral Plan with the Department of Labor on January 20, 1992, and stated that there were 76 employees participating in the Plan.[1871] Rather than allowing participants to select investments, account earnings under the 1992 Deferral Plan were based on Enron's midterm cost of capital. The 1992 Deferral Plan allowed distributions in the event of hardship, but did not permit the accelerated distributions (i.e., distributions with a 10 percent forfeiture) like the 1994 Deferral Plan and the Expat Deferral Plan. The 1992 Deferral Plan was amended in 1995 to allow Enron to establish a trust which would fund obligations of plans of deferred compensation of Enron provided that

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[1866] Enron also had a deferred compensation agreement, which appears to have been a nonqualified deferred compensation plan for one individual.

[1867] EC 000768139 - EC 000768145.

[1868] EC2 000031598 - EC2 000031600.

[1869] EC2 000031601 - EC2 000031603.

[1870] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1871] Enron letter to the Department of Labor dated January 20, 1992. Documents provided by Enron show that there were 18 participants in the 1992 Deferral Plan. EC 000768147.

trust assets at all times remain subject to the claims of general creditors of Enron. According to Enron, no trust was established.

Directors' deferral opportunities

As discussed in the section of this report describing of Board of Directors compensation,[1872] beginning January 1, 1997, it was mandatory that 50 percent of the annual retainer fee of directors be deferred into the Phantom Stock Account under the 1994 Deferral Plan, which, as discussed above, tracked the performance of Enron Corp. common stock. Directors could elect to receive their remaining fees (less mandatory deferrals) in cash, elect to defer remaining fees into the 1994 Deferral Plan, and/or elect to receive Enron Corp. phantom stock units or stock options in lieu of remaining fees.[1873]

Before the use of the 1994 Deferral Plan, there were separate plans maintained for director deferrals. These included the InterNorth, Inc. Director's Unfunded Deferred Income Plan, the Houston Natural Gas Corporation Deferred Income Program for Directors, and the Enron Corp. Director's Deferral Plan. Information provided by Enron shows that there were approximately 29 participants in the Director Deferral Plans (HNG, InterNorth, and Enron).[1874] In prior years, directors also deferred into the 1985 Enron Corp. Deferral Plan and the HNG Deferral Plan.

As discussed above,[1875] Enron sent letters to directors on December 11, 2001, informing them of the status of their nonqualified deferred compensation in connection with the bankruptcy and provided them with a statement of their account balances.[1876] Documents provided by Enron show that nonemployee director account balances in the deferral plans as of November 30, 2001, totaled $9.4 million.[1877]

The Enron Deferred Repatriation Incentive Plan

The Enron Deferred Repatriation Incentive Plan ("EDRIP") was a plan designed for U.S. employees on long-term assignment to the United Kingdom.[1878] The stated purpose of the

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[1872] *See* Part III.B.4., above.

[1873] Letter to the Enron Board of Directors regarding deferrals, dated December 11, 2002. EC2 000018654.

[1874] EC 000768146.

[1875] *See* Part III.B.4.

[1876] It is unclear whether all deferral plan participants received such notification.

[1877] The account balance of one individual, Robert Belfer, totaled $6.086 million. *See* Part III.B.4.,above, for a table of individual director balances.

[1878] Added Value for your Future (a participant brochure). EC2 000018643.

EDRIP was to promote the success of Enron by providing a means of securing and retaining the continued success of key personnel on foreign assignments through their initial period of repatriation to the United States.[1879] Enron would nominate selected key personnel for participation in the EDRIP while on overseas assignments. Only those selected could choose to participate. Under the EDRIP, Enron made discretionary payments into a U.S.-based escrow account, which would pay out the total accrued balance, including interest, approximately six months after repatriation to the United States. In connection with the EDRIP, Enron would make discretionary bonus payments that were less than they would otherwise be. The employee could express a preference between an EDRIP payment and a bonus, but such preference would not be binding on Enron.

Documents provided by Enron show that the advantages of the EDRIP depended on four assumptions: (1) the U.K. Inland Revenue would not tax a payment that relates to future services; (2) the IRS would allow an election under section 83(b) to recognize earnings currently that may not be paid until some point in the future; (3) in using this election, the earnings were effectively treated as having been earned while on foreign assignment and became eligible for offset by foreign tax credits; and (4) traditionally the level of U.K. taxes has been higher than U.S. taxes and consequently there is often a surplus of foreign tax credit that could be used.[1880]

According to documents provided by Enron, the EDRIP was advantageous to employees because Enron would not withhold U.S. hypothetical taxes at their marginal rate (possibly 39.6 percent) on payments into the EDRIP. Instead Enron would take a flat (15 percent) special hypothetical tax on any deferrals. According to documents provided by Enron, an employee would benefit to the extent of the difference between his or her marginal U.S. tax rate and 15 percent.[1881] The EDRIP balance, including the accrued interest, from the escrow amount would therefore be paid to the employee, contingent on certain factors, free of any further U.S. or U.K. tax liability, except on the accrued interest income. Any earnings deferred into the EDRIP were subject to forfeiture in the event that the individual was not still in the employment of Enron approximately six months after returning to the United States.

Early distributions from deferral plans

Accelerated distributions[1882]

In general.–In the months preceding Enron's bankruptcy, early distributions from the 1994 Deferral Plan and the Expat Deferral Plan were made to certain participants. As discussed

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[1879] EC 002634805.

[1880] Added Value for your Future (a participant brochure). EC2 000018643.

[1881] EC2 000018842.

[1882] The amounts discussed herein as accelerated distribution are approximate amounts. Documents provided by Enron regarding early distributions do not exactly reconcile. The information summarized is from the document most recently provided by Enron, which is included in Exhibit D. EC 002634761 - EC 002634769.

above, the 1994 Deferral Plan and the Expat Deferral Plan had a special feature which allowed participants to request early withdrawals of their account balances subject to a 10-percent forfeiture. The request was subject to approval at the discretion of each plan's committee. Upon an early withdrawal, participants were also prohibited from participating in the plan for a period of three years. The plan was presumably designed this way to attempt to avoid constructive receipt.

In the fall of 2001, participants began to make requests for early distributions from their accounts in the 1994 Deferral Plan and Expat Deferral Plan. Documents provided by Enron show that, in the last quarter of 2001, there were a total of approximately 211 requests for accelerated distributions from the 1994 Deferral Plan and the Expat Deferral Plan.[1883] There have been reports in the media that certain employees were notified that they should make distribution requests; however, the participants interviewed by the Joint Committee staff stated that they were not notified that they should make an early distribution request. Several current and former employees mentioned that there were general rumors regarding the financial status of Enron circulating at the time the requests for early distribution were made.

The Joint Committee staff interviewed several current and former Enron employees regarding the early distribution requests. The Joint Committee staff also interviewed the sole member of the 1994 Deferral Plan Committee,[1884] who was responsible for making the determination of whether distribution requests from the 1994 Deferral Plan should be approved.

1994 Deferral Plan.–Documents provided by Enron show that there were approximately 181 requests for early distributions from the 1994 Deferral Plan.[1885] According to interviews with current and former Enron employees, accelerated distributions had not been made in the past from the 1994 Deferral Plan. Information provided by Enron shows that there were no accelerated distributions made in 1998, 1999, or 2000. In interviews with Joint Committee staff, Enron employees stated that in the fall of 2001, Enron had to create a form and process for handling early distribution requests, because such requests had not been made in the past. After the creation of a form to be used, requests for early distributions were accepted by the Enron Compensation Department, forwarded to the Deferral Plan Committee for consideration, and then, if payment was approved, were processed for payment by the Compensation Department.

Some current and former employees interviewed by Joint Committee staff, including one employee who was involved with administering the early distribution requests, stated that they believed the only early distribution requests approved were those made by active employees.

[1883] EC 002634761 - EC 002634769. At that time, there were approximately 350 participants in the plans.

[1884] As discussed above, Mr. Whalley was appointed as the Deferral Plan Committee as of October 26, 2001.

[1885] EC 002634761 - EC 002634769.

Documents provided by Enron show that while many requests made by inactive employees were not approved, some early distribution requests made by inactive employees were approved.[1886]

In an interview with Joint Committee staff, the sole member of the 1994 Deferral Plan Committee explained the procedure that was used in making the determination of whether requests for early distributions should be approved. This process was arrived at after discussions with several people, including legal advisors. According to the Deferral Plan Committee, participants with account balances were treated as unsecured creditors of Enron. Three possible primary operating conditions of Enron were identified and decisions were made as to whether distribution requests would be granted or not, depending on the operating condition.

(1) The first condition was when Enron was considered a going concern. Under such condition, all bills would be paid when due. Thus, if Enron was operating as a going concern, all requests for early distributions would be approved.

(2) The second condition was when Enron was operating as a going concern, but there were cash flow issues. Under the second condition, Enron would pay distribution requests made by active employees only, because active employees were needed to keep Enron operating, while inactive participants were providing no current service to Enron. The Deferral Plan Committee stated that Enron made similar assessments in handling other unsecured creditors.

(3) The third condition was when Enron was in bankruptcy or insolvent, in which case no early distribution requests would be paid.

According to the Deferral Plan Committee, in late October and early November, Enron was operating under the second condition (going concern with cash flow issues); therefore, the Deferral Plan Committee approved payments to all of the active employees who had made requests. On November 9, 2001, Enron closed the Dynegy deal and on November 12, 2001, received a large cash payment. At that time, Enron was operating under the first condition (going concern); therefore, all requests were approved. This included requests by inactive participants that had not been approved originally.[1887] This operating condition lasted approximately one week. According to the Committee, during the week of November 19, 2001, there were questions as to whether the Dynegy deal would go through and Enron was eventually downgraded below investment grade. The Committee did not believe that the inactive participants were paid after November 19, 2001.[1888]

[1886] *Id.* According to Enron and Mr. Whalley, no requests were formally denied, but amounts subject to a request were either paid or not paid. For simplicity, "approved" is used here for those distributions that were made, and "not approved" refers to distributions that were not made.

[1887] Documents provided by Enron show that requests by inactive participants made in October and early November 2001, were approved on November 14, 2001. EC 002634763.

[1888] Minutes from the November 28, 2001, meeting of the Board of Directors show that the Board had authorized management to pay bills selectively to maximize the value of Enron.

Documents provided by Enron detailing the timing of the approval of payments of early distributions requests are not inconsistent with the approval system discussed above as described by the Deferral Plan Committee. While most employees interviewed by the Joint Committee staff believed that all requests made by active employees were approved, and that requests by inactives were not, documents provided by Enron show that accelerated distribution requests made by active employees on November 30, 2001, were not approved.[1889] Documents provided by Enron show that while some requests made by inactive participants were approved, no such requests were approved after November 14, 2001, which was the last approval date before November 19, 2001.[1890] No requests made after the bankruptcy filing were approved.

Of the approximately 181 participants who requested early distributions from the 1994 Deferral Plan, approximately 109 participants received distributions from the Flexible Deferral Accounts totaling $46.2 million.[1891] Payments were made from the general funds of Enron and not from the 1994 Deferral Plan rabbi trust. In addition to the cash distributions from the Flexible Deferral Accounts, stock distributions from the Phantom Stock Account equal to $502,452 were made to participants.[1892] In the case of a distribution from the Phantom Stock Account, shares were withheld to cover taxes owed.[1893]

Expat Deferral Plan.–As discussed above, like the 1994 Deferral Plan, subject to the discretion of the Expat Deferral Plan Committee, the Expat Deferral Plan also allowed an accelerated withdrawal of all or a portion of a participant's account balance, with 10 percent of the elected distribution amount forfeited. An accelerated distribution had been approved from the Expat Deferral Plan in April 2001. In the fall of 2001, approximately 30 participants in the Expat Deferral Plan made requests for early distributions. The committee for the Expat Deferral Plan was responsible for determining whether early distribution requests should be granted.[1894]

[1889] EC 000768237.

[1890] EC 002634761 - EC 002634769.

[1891] EC 002634761. Approval of one request for distribution of an account balance of $4.8 million is listed as "pending." Distributions to 11 participants in the aggregate amount of $2.1 million were approved, but were not wired. Two distribution requests were withdrawn. One request was approved, but the check bounced. EC 002634761 - EC 002634769.

[1892] EC 002634761 - EC 002634769. Payments from the Phantom Stock Account were paid in shares of Enron Corp. common stock, with the exception of pre-1998 deferrals, which would be paid out in cash unless the participant signed a waiver to receive stock. Documents provided by Enron show varying amounts in participants' Phantom Stock Accounts. The amount cited above is from the document most recently provided by Enron, which is included in Appendix D.

[1893] According to Enron, Exhibit 3b.2 to the bankruptcy filing incorrectly considered the net value of the share distribution in the calculation of deferral payments.

[1894] As discussed above, there does not appear to have been a formal committee under the Expat Deferral Plan.

Distributions from the Flexible Deferral Account were made to approximately 18 participants in the amount of $6.9 million.[1895] In addition, distributions of stock equal to $52,342 were made from Phantom Stock Accounts.[1896]

Hardship requests

Three participants in the 1994 Deferral Plan and one participant in the Expat Deferral Plan made requests for hardship distributions in the weeks immediately preceding the bankruptcy.[1897] There were no hardship requests granted in 2001. Participants submitted distribution requests for both hardship distributions and early distributions. In at least one case, after an accelerated distribution was made, the participant requested the 10 percent forfeited as a hardship. The request was denied.

From Joint Committee staff interviews with Enron employees, it appears that the process for evaluating hardship withdrawal requests was more complicated and time consuming than the process for accelerated distribution requests. In the case of a hardship request, the participant had to prove hardship and necessary documentation was required. In an interview with Joint Committee staff, one Enron employee stated that Enron filed for bankruptcy before there was sufficient time to process the hardship withdrawal requests. Another former employee stated that none of the requests qualified for hardship under the terms of the plans. Many of the reasons for the requested hardship distributions claimed by participants were tied to the financial situation of Enron.

The older deferred compensation plans did not allow accelerated distributions, but did allow for hardship distributions. Documents provided by Enron show that hardship withdrawal requests were made in November 2001 from participants in the 1988 Deferral Plan, the 1992 Deferral Plan, the Project Participation Plan, the 1994 Deferral Plan and the Expat Deferral Plans totaling $5.9 million.[1898] There were 11 requests from the 1998 Deferral Plan, one request from the 1992 Deferral Plan, and three requests from the Project Participation Plan.[1899] As mentioned above, no hardship requests were granted. Although infrequent, hardship withdrawals had been made in the past. Documents provided by Enron show that one hardship request was granted from the 1992 Deferral Plan in 1998.

[1895] EC 002634761. Three distributions in the aggregate amount of $283,027 were approved for payment, but were not wired.

[1896] EC 002634763 - EC 002634769. Documents provided by Enron show varying amounts in participants' Phantom Stock Accounts. The amount cited above is from the document most recently provided by Enron.

[1897] EC2 000018410 - EC2 000018411.

[1898] EC2 000018404.

[1899] EC2 000018404 - EC2 000018411.

Discussion of Issues

In general

Nonqualified deferred compensation is a common form of executive compensation. From the executive's perspective, the desire to save taxes is generally the key motivating factor behind deferred compensation. Individuals may want to defer compensation to a future date because they believe that their tax burden will be lower in the future than it is currently, thus resulting in payment of lower taxes than if the compensation had been received currently. Individuals may defer compensation in order to provide a future income stream in retirement. Employers may structure deferred compensation arrangements to induce or reward certain behavior. In many cases, the desire to accommodate the compensation wishes of an individual that a company wants to attract or retain as an employee may be a sufficient motivating factor to provide a deferred compensation arrangement. In some cases, a company may require the deferral of certain amounts of compensation, e.g., salary in excess of $1 million, in order to comply with the limitation on the deductibility of compensation in excess of $1 million.[1900] ERISA's exemptions for nonqualified deferred compensation arrangements allow great flexibility in designing plans and individual arrangements.

Nonqualified deferred compensation arrangements are often compared and contrasted to qualified retirement plans. Qualified retirement plans are subject to rules that do not apply to nonqualified arrangements, including nondiscrimination rules designed to ensure that the plans cover a broad group of employees. The benefits of qualified plans include tax advantages for the employer and the employee,[1901] security for the employee,[1902] and flexibility regarding payment.[1903]

Some argue that nonqualified deferred compensation arrangements are necessary because of the limits on qualified plans.[1904] The structure of some nonqualified deferred compensation arrangements is similar to qualified plans without the restrictions imposed by the Code. In many

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[1900] Sec. 162(m). This limitation is discussed in Part III.C.6., below.

[1901] In the case of a qualified plan, the employer receives a current deduction, while in the case of a nonqualified plan, the deduction is postponed until the time at which the employee includes the amount in income.

[1902] Assets of a qualified plan cannot be reached by creditors of the employer, and are set aside for the sole purpose of paying plan benefits. In addition, as described above, within limits, the PBGC guarantees benefits under defined benefit plans.

[1903] Constructive receipt rules do not apply to qualified retirement plans. In some cases, however, the Code may restrict the earliest point at which benefits may be paid.

[1904] The maximum benefit that can be payable out of a qualified defined benefit plan is $160,000 a year (sec. 415(b)). This is far less than the annual salary of many Enron executives. In addition, the ***annual*** limit on contributions to qualified defined contributions plans, $40,000 for 2003, (sec. 415(c)) is far less than the ***monthly*** salary of many Enron executives.

cases, nonqualified deferred compensation offers even greater advantages for executives than qualified plans. For example, while qualified plan distributions are subject to a 10-percent additional tax on early withdrawals,[1905] Enron executives could defer amounts under the 1994 Deferral Plan and structure the arrangement so that payment would be made in as little as three years from the time of deferral (i.e., special purpose deferrals). To the extent that nonqualified deferred compensation arrangements have features more like qualified plans, there may be less incentive for employers to adopt broad-based qualified retirement plans.

As discussed above, neither the Code nor ERISA limit the amount of nonqualified deferred compensation. Because the employer is denied a deduction for deferred compensation until the employee includes the compensation in income, there is often said to be a tension between the interests of the employer and the employee that will result in an appropriate limit on deferred compensation.

In Enron's case, the deferral of its tax deduction was not a paramount concern, and the supposed "tension" between the interests of the employer and the employee from a tax perspective did little, if anything, to limit the amount of deferred compensation. Many Enron executives participated in Enron's nonqualified deferred compensation programs. As discussed above, from 1998 through 2001, over $154 million in compensation was deferred.

In connection with Enron's financial problems, many executives lost a considerable amount of compensation that had been deferred. Participants who had balances remaining in the deferral plans as of the bankruptcy may recover some of those amounts as unsecured creditors in the bankruptcy proceeding. This would include participants in plans that did not allow early distributions (e.g., the 1998 Deferral Plan), participants who could have but did not request an early withdrawal, or participants whose requests for early withdrawals were not approved. In addition, the value of Phantom Stock Accounts is currently minimal, because the account balances were treated as if invested in Enron stock.

On the other hand, many executives were able to access their deferred compensation, primarily by means of the early withdrawal provisions under the 1994 Deferral Plan and the Expat Deferral Plan. In the few months immediately preceding the bankruptcy, approximately 117 people received distributions totaling over $53 million.

As described above, there are no clear rules governing many aspects of deferred compensation arrangements. As a result, taxpayers may design deferred compensation arrangements based on varying interpretations of authority that may not be strictly applicable to the situation in question. Under present law, a variety of practices have developed with respect to deferred compensation arrangements which are intended to achieve the desired tax deferral, while at the same time attempting to provide some sense of security to executives as well as some degree of flexibility regarding time of payment and other plan features. In order to make such arrangements more attractive to the employee, some taxpayers may push the limits of present law.

[1905] Sec. 72(t).

While deferred compensation arrangements vary greatly, many of the plan features used by Enron are not uncommon. Even though certain aspects of the plans may be within common practices, some issues may be raised with respect to whether they meet the requirements necessary to obtain the desired tax deferral. In addition, even if the present-law rules are satisfied, certain of the arrangements Enron maintained raise broader questions of whether they fall within the spirit of the present-law rules or whether they should, as a policy matter, result in tax deferral. Particular issues raised under the Enron deferral arrangements are addressed below.

Funding issues

It appears that Enron may have intended the rabbi trust used in connection with the 1994 Deferral Plan to comply with the safe harbor requirements of Revenue Procedure 92-64.[1906] It was certainly intended that the trust not result in current income taxation; Enron employees and counsel interviewed by Joint Committee staff stated that it was intended that current taxation not result from the structure of the deferred compensation arrangements. Even if the trust were a valid rabbi trust when evaluated solely on the basis of the trust document, there is an issue as to whether other provisions under the 1994 Deferral Plan would cause the trust to be considered funded for tax purposes.

As discussed above, in the case of a rabbi trust, trust terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy or insolvency have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes. In the case of Enron, even though the trust document provided that the assets of the trust were subject to the claims of creditors, because participants had the ability to obtain early distributions, there is an argument that the rights of such employees were effectively greater than the rights of the creditors, making the trust funded for tax purposes. If, in fact, the arrangement was not subject to the claims of creditors, the arrangement should be considered funded, and income inclusion should have occurred when there was no substantial risk of forfeiture.

It may be argued that the ability to obtain the money did not give the participants rights greater than general creditors. Under the terms of the 1994 Deferral Plan and the rabbi trust, participants had no interest in any particular assets of Enron. In addition, Enron employees told the Joint Committee staff that the decisions whether to approve requests for distributions were made in the same way as Enron would treat the claims of other unsecured creditors.

However, because of the early distribution provisions in the 1994 Deferral Plan and the Expat Deferral Plan, plan participants received over $53 million under the Plans within approximately two months preceding the bankruptcy, precluding such amounts from being available to the claims of creditors. They would not have been able to obtain this amount in the absence of the withdrawal provisions. The financial condition of Enron appears to have been a

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[1906] Because the revenue procedure describes a "safe harbor," a trust may be a valid rabbi trust without satisfying the safe harbor. However, the IRS will not rule on trusts that do not satisfy the safe harbor, except in rare and unusual circumstances.

motivating factor behind the requests for distribution; such requests had not previously been received under the Plans.

Constructive receipt

In general

Income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart, or otherwise made available so that the taxpayer may draw on it at any time. Income is not constructively received if the taxpayer's control of the income is subject to substantial limitations or restrictions. While the 1994 Deferral Plan and the Expat Deferral Plan were designed to impose restrictions or limitations on the participant's control of amounts deferred, such restrictions or limitations could be seen as illusory. While under present law the plan provisions may not result in constructive receipt, there is an issue as to whether the existence of such features should result in the application of the constructive receipt doctrine. When viewed collectively, the existence of the opportunities for accelerated distributions, participant-directed investment, and change in participant elections lend credence to the argument that the doctrine of constructive receipt should apply.

Accelerated distributions

Even if the 1994 Deferral Plan is considered unfunded, there is an issue as to whether participants should have been considered in constructive receipt of deferred amounts. A participant's unfettered right to withdraw amounts deferred results in constructive receipt. As discussed above, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Enron's treatment of deferred amounts reflects the view that even though participants could receive accelerated distributions under the 1994 Deferral Plan and Expat Deferral Plan, the 10-percent forfeiture, the inability to participate in the Plan for three years following an accelerated distribution, and the requirement subjecting distributions to the discretionary authority of the plan committee were substantial limitations or restrictions on the right to receive deferred amounts.

The IRS has not explicitly authorized the use of forfeiture provisions (i.e., "haircuts") in nonqualified deferred compensation plans. Many nonqualified deferred compensation plans utilize a 10-percent forfeiture limitation preventing constructive receipt, based on the 10-percent early withdrawal tax applicable to distributions from qualified retirement plans and IRAs.[1907]

Some may argue that the fact that some participants made requests for early distributions, but such requests were not granted supports the argument that the discretionary authority of the plan committee was a substantial limitation or restriction on the right to receive the deferred amounts, which should prevent the application of constructive receipt.

As a practical matter, the 10-percent forfeiture provision did not appear to impose much of a deterrent for 1994 Deferral Plan participants in requesting distributions. As noted above, many participants requested distributions. One former Enron executive who did not request a

[1907] Sec. 72(t).

distribution indicated that he did not make a request because he did not want to contribute to the already bad financial position of Enron.

Participant-directed investment

An issue may also exist due to the ability of participants to direct investments of amounts deferred. As discussed above, participants in the 1994 Deferral Plan and Expat Deferral Plan were able to direct investments of amounts deferred into the Flexible Deferral Account. More precisely, they were able to direct how earnings on deferred amounts should be credited.

According to Enron, only initially did Enron direct investments to track generally with participant elections.[1908] According to Enron's summary of the 1994 Deferral Plan,[1909] because of constructive receipt rules Enron could credit an employee's deferral account with earnings that tracked a chosen mix of investment funds, but the actual investments were required to be made by Enron Corp. or by the Trustee appointed by Enron Corp. at the direction of Enron Corp.

The model rabbi trust safe harbor under Revenue Procedure 92-64 only requires that the trustee must be given some investment discretion, such as the authority to invest within broad guidelines established by the parties. It does not provide precise guidelines on how trust assets must be invested. The IRS has ruled, in the case of one taxpayer, that no amount would be considered made available as a result of the fact that the participant has a right to designated deemed investments.[1910] Some commentators have noted that allowing participant directed investments presents no tax issues and should be allowed in plans.[1911]

Change in participant elections

Participants in the 1994 Deferral Plan were allowed to change payout elections at any time. Elections would be effective one year after being received by Enron. As previously discussed, under present law, courts have generally been lenient in applying the constructive receipt doctrine with respect to subsequent elections. While no single case can be relied upon for the position that subsequent elections will not result in constructive receipt, given the case law in the area, the position that the ability to make a subsequent election has some support.

Nevertheless, allowing participants to change payout elections gives them control over the amounts deferred. Changing payout elections allows participants to control the timing and

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[1908] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1909] EC2 000018443.

[1910] Priv. Ltr. Rul. 200148054. (The private letter ruling involved a qualified governmental excess benefit arrangement under section 415.)

[1911] *See* SMITH, ET. AL, NONQUALIFIED DEFERRED COMPENSATION ANSWER BOOK (3rd ed. 1996).

amount of payment, which is the basis for the general principle of constructive receipt. Thus, the ability to make subsequent elections arguably should result in constructive receipt.

Fairness concerns relating to early distributions

Nontax issues have been raised regarding the pre-bankruptcy accelerated distributions made from the 1994 Deferral Plan and the Expat Deferral Plan. Media reports allege that distributions were wrongfully allowed. While it may seem unfair for some participants to receive their account balances while other participants' requests were not approved, the 1994 Deferral Plan and the Expat Plan documents clearly state that accelerated distributions are made subject to the consent of the relevant plan committee. The plans provide that the committee has 60 days to approve or deny a request, but do not discuss what criteria must be used by the committee in approving or denying requests. Furthermore, the plans provide generally that all determinations provided for in the plan shall be made in the absolute discretion of the committee and that determinations shall be binding on all persons.

Employees were aware that the committee had discretion regarding accelerated distribution payments. Employee materials state that the committee was to interpret the plans, including but not limited to decisions regarding suspension of deferrals, hardship withdrawals, accelerated distributions, and other matters that would arise under the terms of the plans.[1912] There appears to be no obvious violation of the terms of either plan.

While there may be some perceived inequity, modifying the rules relating to nonqualified deferred compensation arrangements to eliminate any perceived equities in the treatment of active and inactive employees would be counter to tax policy because such a modification would give participants in nonqualified deferred compensation arrangements greater control over their deferred amount.

Deferral of stock option gains program

As discussed above, Enron amended the 1994 Deferral Plan in 1996 to provide for the deferral of stock options gains program, which established a Phantom Stock Account to which gains realized from stock-for-stock exercises of options could be deferred. Under the program, executives were able to pay the exercise price of options with already-owned Enron stock, transfer their basis in the old stock to an equal amount of new stock, and transfer the additional stock that would otherwise be received into the Phantom Stock Account.

The deferral credited to the participant's stock option deferral account was an amount equal to the number of shares deferred multiplied by the current per share market price, and was treated as if the amount of the deferral had been used to purchase shares of Enron Corp. common stock at such per share market price. Credits for dividends would be accrued in a separate account and paid in cash, pursuant to the normal payment terms of the 1994 Deferral Plan.

[1912] Deferral plan questions and answers (brochure for participants). EC2 000018440.

The 1994 Deferral Plan includes an example of how the stock option gain deferral works:

- Executive optionee holds an option for 20,000 shares at $50 per share (an aggregate exercise price of $1 million).

- Optionee makes an advance election to defer receipt of the additional shares received in a stock-for-stock exercise until a fixed time in the future (from one to 15 years beginning at death, disability, retirement or termination).

- Optionee owns 12,500 previously acquired mature shares (held at least six months) with a current market price of $80 per share (an aggregate market value of $1 million).

- Optionee exercises the 20,000-share option in a stock-for-stock exercise (either by actual delivery of already-owned share or by "attestation," i.e., instead of delivering shares to Enron, the executive simply provides an affidavit of ownership of the shares).

- Enron credits 7,500 share units to a Phantom Stock Account under the Plan (executive retains the already-owned 12,500 shares at the original cost basis). During the deferral period, dividend equivalents would be credited in the form of cash.[1913]

- Upon death, disability, retirement or termination, the share units are converted to shares which are issued to the executive according to the payment election made by the executive at the time of the deferral election (i.e., if at termination there are 1,000 share units in the account and the executive chose 10 annual payments, 100 shares would be distributed each year, in addition to credits attributable to dividends on such shares which will be paid out in cash).

While this type of program may be commonly used, there are questions whether it should result in effective income deferral.[1914] There is no authority clearly addressing stock option gain deferrals.[1915] The program does not fit within the IRS ruling guidelines on the application of

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[1913] Absent the deferral, the executive would include in income the fair market value of the 7,500 additional shares, i.e., $600,000 (7,500 x $80). Rev. Rul. 80-244,1980-2 C.B. 234.

[1914] *See* Geer, "*Why not just pay the tax?*," FORBES (March 10, 1997) at 156.

[1915] Some taxpayers may attempt to rely on Priv. Ltr. Rul. 199901006 in taking the position that the IRS has approved the transaction. In addition to the fact that private letter rulings may not be used or cited as precedent, the ruling cannot be relied upon, as the facts of the ruling are different from that those of the stock option gains program. For example, in the ruling, the election to exchange options for deferred compensation was made before the options were vested. Additionally, distributions of the amounts deferred would generally be made at the time that the employee's options would have vested. Further deferral was not allowed at the election of the employee.

constructive receipt to nonqualified deferred compensation.[1916] The principles used are a combination of the rules relating to a stock-for-stock exercise and nonqualified deferred compensation.

As discussed above,[1917] upon a stock-for-stock exercise, the employee is taxed on the fair market value on the additional shares received. Under the deferral of stock option gains program, the employee would not be taxed on the shares, but would defer the gain recognition to some time in the future. Enron took the position that the Phantom Stock Account would amount to an unfunded promise to pay, thereby avoiding inclusion of the gain amount.[1918] Upon exercise, the employee would be treated as receiving the number of already-owned shares that he or she used for payment (in a tax-free exchange) and the employer's promise to deliver additional shares in the future. It appears that the timing of income inclusion is deferred by having the employer and employee alter the terms of the original option agreement so that the employee's right to receive the additional shares is delayed until a specific time in the future.

To avoid possible constructive receipt, Enron required that the exercise occur six months or more after the deferral election was made. Deferrals were required to be made prior to the end of the preceding tax year and at least six months prior to exercise. The timing of the election is different from the timing that is typically required for an election to effectively defer compensation. In order to obtain a ruling concerning the application of constructive receipt to unfunded deferred compensation arrangements, generally elections must be made before the beginning of the period of service for which the compensation is payable.[1919] In the case of option gain deferral in Enron's plan, the election could be made after the options are vested and after services have been performed with respect to such compensation, as long as it is made at least six months prior to exercise.

The tax position taken with respect to the deferral of stock options gains is similar to that of the exercise of an option for stock which is restricted. If an individual were to engage in a stock-for-stock exercise receiving stock subject to a substantial risk of forfeiture, the stock would not be included in income until the substantial risk of forfeiture expires. In the deferral of stock option gains, taxation is not postponed by imposing restrictions on the stock, but by having the employee's right to receive the shares delayed until a specified time in the future. Because the employee only has an unfunded promise to pay, which is not property under section 83, income inclusion is postponed.

[1916] Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-33 I.R.B. 16.

[1917] *See* Part III.C.2., above.

[1918] The company's deduction is postponed until the amounts are distributed and included in the employee's income.

[1919] Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-33 I.R.B. 16.

Documents provided by Enron show that Mr. Lay participated in the deferral of stock option gains program.[1920] It is unclear to what extent other employees participated in the program. Enron-provided documents show that spread at exercise was subject to FICA/FUTA and Medicare taxes. Documents provided by Enron show that upon a stock-for-stock exercise where shares were deferred, shares were withheld for Medicare taxes.[1921]

Recommendations

In general

The experience with Enron demonstrates that the theoretical tension between the employer's interest in a current tax deduction and the employee's interest in deferring tax from a tax perspective has little, if any, effect on the amount of compensation deferred by executives. In Enron's case, because of net operating loss carryovers, denial of the deduction did not have a significant impact on its tax liability. Despite any possible effect on its tax deduction, Enron's deferred compensation arrangements allowed executives to defer millions of dollars in compensation that would otherwise be currently includible in income.

Enron's nonqualified deferred compensation arrangements contained a variety of features which serve to blur the distinction between nonqualified deferred compensation and qualified plans. Enron's nonqualified deferred compensation plans included features that to some extent provided the advantages of a qualified plan, such as security for and access to benefits without current income inclusion, despite not meeting the qualified plan requirements. Because nonqualified arrangements have features like qualified plans, there may be less incentive from employers to adopt broad-based qualified retirement plans. If executives are able to fulfill their retirement needs through the use of nonqualified plans, for some employers there would be no incentive to offer qualified plans to rank and file employees.

While there are a number of reasons why nonqualified deferred compensation arrangements are adopted, a primary factor is the desire by the executive to defer payment of income tax. For example, a stated purpose of the 1994 Deferral Plan and Expat Deferral Plan was to allow executives to reduce current compensation and thereby reduce their current taxable income and earn returns on a tax-favored basis. Without the tax benefit of deferral, it is unlikely that nonqualified deferred compensation arrangements would exist, and certainly would not exist to the extent they do under present law.

Some argue that nonqualified deferred compensation is merely an avoidance of current income taxation, and that rules should be adopted to prevent inappropriate deferral. For

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[1920] EC 000769187 - EC 000769197. The election to defer was made August 4, 1999. Shares were credited to the Phantom Stock Account in the 1994 Deferral Plan in February 2000. The stock-for-stock exercises were done through attestation. Shares were withheld to pay Medicare taxes.

[1921] Mr. Lay's compensation generally would have been over the maximum amount subject to FICA and FUTA taxes (i.e., the taxable wage base); therefore, only Medicare (HI) taxes would apply to these amounts.

example, some have suggested rules that compensation should be includible in income when earned or, if later, when there is no substantial risk of forfeiture of the rights to such compensation.[1922] In the case of Enron executives, this would have resulted in earlier income inclusion, as amounts deferred would have been included in income when earned and vested. The Joint Committee staff believes that this approach would result in a better measure of income than under present-law rules in which an unfunded promise to pay, even if vested, is not currently taxable. However, this approach would represent a significant change in policy.

The Joint Committee staff believes that some changes to the present-law rules regarding the taxation of deferred compensation are appropriate. Following are some specific options relating to deferred compensation which would preserve the ability to obtain tax deferral, but would reduce the use of practices which give executives control over amounts deferred. This is not intended as an exhaustive list of possible alternatives. Other options should also be considered. The options mentioned here would affect current practices, but would have less impact on current practices than would a broad change in policy.

In evaluating changes to the rules relating to deferred compensation, one factor to keep in mind is that taxpayers are likely to change their behavior to adapt to any given set of rules. For example, if the law were changed to restrict the use of one particular practice, it is likely that, over time, taxpayers would develop other ways to achieve the intended result.

Section 132 of the Revenue Act of 1978

As discussed above, section 132 of the Revenue Act of 1978 was enacted in response to proposed Treasury regulation 1.61-16, and provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. The restriction imposed by section 132 of the Revenue Act of 1978 may have prevented Treasury from issuing more guidance on nonqualified deferred compensation and may have contributed to aggressive interpretations of present law.

Section 132 of the Revenue Act of 1978 should be repealed. Repealing section 132 would allow Treasury to provide more guidance to taxpayers and may also help to stem abusive practices. Especially given the lack of statutory rules in this area, the lack of administrative guidance in this area allows taxpayers latitude to create and promote arrangements which push the limit of what is allowed under the law. Because of the lack of rules and guidance in this area, the current state of practice has, to a great extent, evolved from variations of private letters ruling issued by the IRS to various taxpayers. Because there are no clear rules or guidance, taxpayers continue to create new variations of arrangements that, in their basic form, are generally perceived as allowed by the IRS.

[1922] This would be similar to the rule under Code section 457(f) relating to deferred compensation of employees of tax-exempt organizations and governments. Another alternative would be to impose a tax on the investment income. *See* Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986).

Accelerated distributions

Under present law, a requirement of surrender or forfeiture of a valuable right is a sufficient restriction to preclude constructive receipt of income. The Joint Committee staff recommends that under nonqualified deferred compensation arrangements, plan provisions allowing accelerated distributions at the request of the participant, should trigger constructive receipt rather than resulting in deferral. Distributions made to executives in the period immediately preceding the bankruptcy drained Enron's cash by over $53 million that would have been available to the creditors and raises questions regarding whether, in fact, a substantial limitation existed.

As part of any specific proposal, consideration should be given to the circumstances under which withdrawals should be permitted without triggering constructive receipt. Distribution options under current arrangements include: financial hardship, death, disability, retirement, the passage of a period of time specified by the employee (e.g., three years), and change in control.

Rabbi trusts

Enron had a rabbi trust to provide some security with respect to deferred amounts. Rabbi trusts are common arrangements. Arrangements have developed which appear to fit within the technical guidelines for a valid rabbi trust, but which provide security to executives. For example, as discussed above, even though the trust document stated that participants' rights were not greater than those of general creditors, the fact that millions of dollars in distributions were made immediately before the bankruptcy supports the conclusion that the rights of participants were greater than those of general creditors. Consideration should be given as to whether rabbi trusts are appropriate for deferred compensation, or whether additional requirements should be imposed with respect to such trusts.

Participant-directed investment

Allowing participants to direct investment of amounts deferred gives participants control over the earnings on the amounts deferred. The Joint Committee staff recommends that the ability of participants to direct investments of amounts deferred should result in current inclusion of income.

Subsequent elections

While the rules regarding subsequent elections are not clear under present law, many taxpayers take the position that subsequent elections allowing participants to change the payout term of their deferred compensation do not result in constructive receipt.

The Joint Committee staff recommends that plan provisions allowing participants to make subsequent elections should trigger constructive receipt. Subsequent elections allow taxpayers to control the timing and amount of their distributions. Allowing participants to accelerate or postpone the payment of their accounts should result in constructive receipt.

Alternatively, limited opportunities to change elections could be provided for in the law. If limited opportunities to make subsequent elections are allowed, the time that such elections are allowed to be made should be specified.

Deferral of stock option gains and restricted stock

As described above, Enron provided opportunities for executives to defer gains that would otherwise have been taxable due to the exercise of stock options and the vesting of restricted stock. The deferral of stock option gains program can be viewed as a manipulation of the rules for deferred compensation and stock-for-stock exercise, which were not intended to be combined, thus resulting in an unintended and inappropriate result for taxpayers. The Joint Committee staff believes that it is inappropriate to allow deferral of stock option gains and restricted stock.

Reporting

Other than an initial plan filing with the Department of Labor, until amounts are includible in income, there is no required reporting of nonqualified deferred compensation. Requiring reporting of amounts deferred to the IRS, even if the taxpayer takes the position that such amounts are not currently includible in income, could provide the IRS greater information regarding such arrangements. In most cases, the IRS does not have any information regarding amounts deferred, and therefore, no indication that a particular arrangement should be examined.

2. Stock-based compensation

Present Law

General background

Stock-based compensation is a commonly used form of compensation for employees and may be also provided as compensation for service providers who are not employees, such as outside directors. Commonly used forms of stock-based compensation include stock options, restricted stock, stock appreciation rights, and phantom stock arrangements.

Similar to nonqualified deferred compensation arrangements, an employer may have a formal plan that provides stock-based compensation to employees on a regular basis. For example, the employer may have a plan under which stock or stock options are granted to employees annually. Alternatively, or in addition, an individual's employment contract may provide for stock-based compensation for that individual. In some cases, stock-based plans are a means of providing nonqualified deferred compensation.

Stock-based compensation is often used in connection with incentive compensation. For example, bonuses may be paid in the form of stock; grants of stock or stock options may depend on corporate performance; or the rate at which restrictions on stock lapse or the rate at which stock options become exercisable may be accelerated if certain corporate earnings targets are met.

Some argue that the use of stock-based compensation is an appropriate means of compensation because it aligns the interests of the shareholders and corporate executives and rewards performance. On the other hand, some argue that an increase in stock price or corporate earnings alone is not an appropriate measure of performance because such an increase may not be directly linked to an individual's performance and may encourage executives to inappropriately inflate earnings and focus on short-term earnings.

Compensatory stock (including restricted stock)

In general

Stock may be granted to an employee (or other service provider) without restrictions in the sense that the stock is fully vested and transferable. In some cases, the employee is granted "restricted" stock in the sense that the stock must be forfeited or sold back to the company in certain circumstances. For example, an employee may receive stock that is subject to a substantial risk of forfeiture because of a requirement that the stock be forfeited if the employee terminates employment within some stated number of years. As another example, restricted stock may be granted pursuant to a five-year vesting schedule, pursuant to which 20 percent of the stock granted becomes available to the employee for each year of service. In this example, if the employee were to leave after three years of service, 60 percent of the shares of restricted stock would have vested and 20 percent would be forfeited.

Restricted stock (i.e., stock that is subject to a substantial risk of forfeiture) is often referred to as nonvested stock; stock that is not (or is no longer) subject to a substantial risk of forfeiture is often referred to as vested stock. Restrictions that no longer apply are often said to have "lapsed." Shares that vest are sometimes referred to a being "released."

Tax treatment

Stock that is granted to an employee (or other service provider) is subject to the rules that apply under section 83 to transfers of property in connection with the performance of services. Accordingly, if vested stock is transferred to an employee, the excess of the fair market value of the stock, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

If nonvested stock is transferred to an employee, no amount is includible in income as a result of the transfer unless the employee elects to have income inclusion in the year of transfer.[1923] Otherwise, the excess of the fair market value of the stock at the time of vesting, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which vesting occurs.

In the case of an employee, the amount includible in income under section 83 is also subject to income tax withholding and to social security tax (subject to the social security wage

[1923] Sec. 83(b).

base) and Medicare tax and must be reported on a Form W-2.[1924] The amount includible in the income of the employee (or other service provider) is generally deductible by the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.[1925]

Compensatory stock options

In general

A stock option is the right to purchase stock at a specified price (or at a price determined under a specified formula) at a specified time or during a specified period. Stock options granted to employees or other service providers are considered to be compensation for services. There are two general types of compensation-related stock options under the Code: nonqualified options and statutory options.

Statutory options include incentive stock options[1926] and options provided under an employee stock purchase plan.[1927] Nonqualified options are any other options granted in connection with the performance of services.

Nonqualified options

The income taxation of a nonqualified option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value when granted. A nonqualified option has a readily ascertainable fair market value if (1) the option is actively traded on an established market, or (2) the option is transferable, it is immediately exercisable in full, the stock subject to the option is not subject to any restriction or condition that has a significant effect on the value of the option, and the fair market value of the option privilege is readily ascertainable. The option privilege is the opportunity to benefit from increases in the value of the stock during the option period without risking capital.

If an individual receives a nonqualified option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount, if any, paid for the option is includible in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or is not subject to a substantial risk of forfeiture (or, if the taxpayer elects, in the taxable year in which the option is

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[1924] Because there is no transfer of cash upon the vesting of the stock, the withholding requirements may present administrative issues. Enron utilized several methods for handling withholding in such cases, as described below.

[1925] The employer must comply with applicable reporting requirements in order to claim the deduction. Treas. Reg. sec. 1.83-6(a)(2). The amount of any deduction may also limited by the $1 million limitation on the deduction of compensation of the top-five executives. Sec. 162(m). This limitation is discussed in Part III.C.6., below.

[1926] Sec. 422.

[1927] Sec. 423.

granted). No amount is includible in the gross income of the option recipient due to the exercise of the option.

If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise. In most cases, compensatory stock options do not have a readily ascertainable fair market value.

In the case of an employee, the amount includible in income under section 83 with respect to nonqualified stock options is also subject to income tax withholding and to social security tax (subject to the social security wage base) and Medicare tax and must be reported on a Form W-2.

The amount includible in the income of the employee (or other service provider) is generally deductible by the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.[1928]

Statutory options

The Federal tax rules applicable to statutory options are not discussed in detail here because Enron did not utilize such options.[1929]

[1928] The employer must comply with applicable reporting requirements in order to claim the deduction. Treas. Reg. sec. 1.83-6(a)(2). The amount of any deduction may also limited by the $1 million limitation on the deduction of compensation of the top-five executives. Sec. 162(m). This limitation is discussed in Part III.C.6., below.

[1929] The following general rules apply to statutory options. No amount is includible in the gross income of the option recipient on the grant or exercise of a statutory option. No compensation expense deduction is allowable to the employer with respect to the grant or exercise of a statutory option. If an employee disposes of stock acquired upon exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement. For a detailed description of the rules relating to statutory options, *see* Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation,* JCX-29-02, at 41-44 (April 17, 2002).

Special techniques for exercising options

Cashless exercise of stock options

Stock option plans may allow employees to exercise their options through a cashless exercise program generally operated by a company-designated broker. In a cashless exercise, on behalf of the employee, the broker exercises the option and sells some of the stock acquired pursuant to the option in one transaction. The amount of stock sold generally is sufficient to generate cash in an amount needed to cover the exercise price and any taxes that the employer is required to withhold upon exercise of the option. The remaining stock is then transferred to the employee.[1930]

The funds required to exercise the options may be provided either by the issuer (e.g., by advancing shares to the broker) or by the broker (by making a loan to the option holder and then deducting the amount loaned from the proceeds of the sale). If the funds for the exercise of the options are provided by the issuer, the broker transfers the exercise price along with tax withholdings back to the issuer.[1931]

Stock-for-stock exercise of stock options

Employers often allow optionees to pay the amount due on the exercise of an option with already owned stock of the employer (a "stock-for-stock" exercise) rather than requiring executives to pay cash. An IRS revenue ruling,[1932] addresses the use of employer stock to exercise stock options. Under the ruling, if stock of a corporation is exchanged for similar stock in the same corporation, the transfer qualifies as a nontaxable transaction and the taxpayer is not required to recognize the gain realized in the exchange.[1933] Instead, the taxpayer's basis in the stock exchanged is transferred to an equal amount of new shares.[1934] Shares received by the employee that are in addition to the number of shares exchanged are treated as compensation for

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[1930] For purposes of section 83, in a cashless exercise, the employee is treated as having received all the stock subject to the option, followed by a separate sale of stock. The amount includible in the gross income of an employee as a result of the exercise of the option is not affected by a cashless exercise.

[1931] Some have suggested that cashless exercise programs may be affected by the prohibition on loans to executives in the Sarbanes-Oxley Act of 2002, because such programs involve the extension of credit (or the arranging of credit) by the employer. Pub. L. No. 107-204, sec. 402 (2002).

[1932] Rev. Rul. 80-244, 1980-2 C.B. 234.

[1933] Sec. 1036.

[1934] Sec. 1031.

services under section 83(a).[1935] The employee is required to include in gross income the fair market value of the additional shares received.

The stock-for-stock exercise effectively allows an employee to use the untaxed appreciation in already owned shares on a tax-free basis to purchase new shares. Upon a stock-for-stock exercise, taxes can be satisfied with already-owned shares or cash. The participant does not incur a brokerage fee because the swap does not involve a sale on the open market. A plan may provide that the employee does not have to physically surrender the previously owned shares. Delivery of the shares may be accomplished through "attestation," in which case the executive provides an affidavit of ownership of the shares.

A stock-for-stock exercise can be illustrated by the following example:

> An employee exercises an option to purchase 200 shares of stock with a fair market value of $100 per share at an exercise price of $50 per share. To pay for the exercise price, the employee exchanges 100 previously-owned shares, with a fair market value of $100 per share, and a basis of $30 per share. The basis in the previously-owned 100 shares would transfer to 100 new shares. The fair market value of the additional 100 shares received ($10,000) is includible in income.

The use of a stock-for-stock exercise provides more favorable tax results to the executive than would be the case if the executive first sold previously owned shares and then used the cash to pay the purchase price. With a stock-for-stock exercise, the executive can postpone the recognition of gain on the previously-owned shares.[1936]

Gifting of stock options

Some employer plans permit the executive to transfer options to family members or others as a gift. The IRS issued guidance on the gifting of options in 1998, which concludes that the gratuitous transfer of a stock option is a completed gift at the later of: (1) the date of transfer, or (2) when the right to exercise the option is no longer conditioned on the performance of services by the transferor.[1937] Upon exercise of the option by the transferee, the income tax is generally required to be paid by the transferor.

The IRS guidance describes how an unexercised compensatory stock option is valued for gift or estate tax purposes.[1938]

[1935] Rev. Rul. 80-244.

[1936] In a stock-for-stock exercise, the amount includible income is the same amount that would be includible in income if the employee paid the exercise price with cash, although the amounts are arrived through different analyses.

[1937] Rev. Rul. 98-21, 1998-18 I.R.B. 7.

[1938] Rev. Proc. 98-34, 1998-18 I.R.B. 34.

Accounting for stock options

In general

The accounting rules for treatment of stock based compensation generally are governed by Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, ("APB 25") and Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ("FAS 123"). FAS 123 is the preferred accounting method, but is not mandatory. If a company accounts for options using APB 25, disclosure of the impact of FAS 123 on the income statement is required.

APB 25 treatment of stock options

APB 25 requires compensation costs for stock-based employee compensation plans to be recognized based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. No increase in value is ascribed to the right to purchase the stock at a fixed price for a period of years. Correspondingly, no decrease in value is ascribed to restrictions on the option. The comparison of the market price to the exercise price is generally done on the grant date.[1939] The approach is effectively a snapshot of the difference between the market price and exercise price at a specific date.

As a result of these rules, under APB 25, generally no compensation cost is recorded in financial statements for stock options issued to employees if the exercise price is equivalent to or greater than the market price on the grant date.

FAS 123 treatment of stock options

FAS 123, issued in 1995, defines a fair value method of accounting for employee stock options. Under FAS 123, except in extremely rare situations, the fair value determination of an option is made on the grant date.

The fair value of stock options is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option. The fair value of an option estimated at the grant date is not subsequently adjusted for changes, such as in the price of the underlying stock, its volatility, or the life of the option.

The total amount of compensation cost recognized for an award of stock options is based on the number of options that eventually vest. No compensation cost is recorded for options that do not vest. If compensation cost has been recorded in a prior period and the employee does not vest, such cost is reversed in the current period. Once an option vests no reversal of cost is permitted if the option is forfeited or expires.

[1939] An exception applies to certain variable plans, a type of stock option plan that is not very common.

Other types of stock-based compensation

Stock appreciation rights

A stock appreciation right ("SAR") is an arrangement under which the employee has the right to receive the amount of the increase in the value of stock of the employer during a specified period. The employee receives the increase in value by cashing out or exercising the SAR. For example, the employee may be granted stock appreciation rights with respect to 1,000 shares of employer stock at a time when the stock is valued at $100 a share, and the SAR may be exercisable for three years. As a result, the employee has the right at any time during the three years to receive cash in the amount of the increase in value of 1000 shares of stock since the time the SAR was granted. Variations in the terms of an SAR may include limitations on the exercisability of the SAR until (or unless) certain stock value goals are met or allowing the proceeds of the SAR to be paid in the form of stock rather than cash.

Because the employee has the right to receive on request the increase in stock value that has already occurred (i.e., the current increase in stock value), SARs raise constructive receipt issues. However, under IRS revenue rulings, a substantial limitation on the employee's ability to receive the current increase in stock value results from the fact that the employee must forego the right to benefit from additional increases in stock value during the SAR period (i.e., the employee must surrender a valuable right) in order to exercise the SAR.[1940] Therefore, the current increase in stock value is not considered constructively received. The amount received on exercise of the SAR is includible in income and wages for employment tax purposes at that time.

Phantom stock

A phantom stock unit is a contractual obligation of the company equal in value to one share of the company which, until paid, is an unfunded bookkeeping credit on the records of the company. Upon the vesting of phantom stock units, the holder is generally entitled to payment in cash or in shares of common stock at the rate of one share of common stock for each phantom stock unit, plus dividends that have accrued from the grant date until vesting. Payments made in cash under a phantom stock plan are includible in gross income and wages when received. Payments made in the form of stock are includible in income as provided under section 83.

Factual Background

In general

Enron utilized various types of programs to provide its employees with compensation tied to the equity or long-term performance of the company. Included in these programs were stock-based plans such as the 1991, 1994 and 1999 Stock Plans,[1941] as well as one-time stock or option

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[1940] Rev. Rul. 80-300, 1980-2 C.B. 165.

[1941] Other stock-based plans, such as the 1978, 1984 and 1988 Stock Option Plans were no longer active during the 1990s.

grants such as the All-Employee Stock Option Program, the 2001 Special Stock Grant, and "Project 50." Long-term compensation programs that were not based on Enron stock included the Performance Unit Plan, which was terminated in 1999.

In recent years, Enron used stock options and restricted stock as the long-term component for executive compensation.[1942] Various documents provided by Enron show that participation in the long-term incentive program was limited to employees in the vice president job group and above.[1943] An employee involved in compensation matters interviewed by Joint Committee staff stated that restricted stock was limited to executives. The Joint Committee staff asked Enron whether nonexecutive level employees (i.e., employees below the vice president level) were granted stock options and restricted stock other than through all-employee programs. Enron responded that stock options and restricted stock/phantom stock were also granted to nonexecutive level employees.[1944]

As part of its compensation package, Enron provided its executives with long-term incentives designed to "encourage and reward...the enhancement of stockholder wealth."[1945] According to the proxy statements, the value of the long-term incentives, like base salary and annual incentives, was targeted at the 75th percentile of Enron's industry peer group.

Prior to 1999, long-term incentive grants were given in performance units under the Performance Unit Plan[1946] and in stock options.[1947] Occasionally, restricted stock was granted for specific reasons, such as: (1) individual performance; (2) company performance; (3) to accommodate special situations such as promotions; (4) in lieu of other benefits; or (5) to remain

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[1942] According to Enron, options were never repriced.

[1943] *See, e.g.*, Enron Corp. Executive Compensation program brochure. EC 002634796.

[1944] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002. Joint Committee staff asked Enron for data regarding stock options and restricted stock granted to nonexecutives. In providing the data, Enron stated that there is some overlap in grants to executives, so that data does not clearly indicate the amount of options and restricted stock provided to nonexecutives. Because the data provided does not provide the requested information, it is not included here.

[1945] 1992 Enron Corp. Proxy Statement.

[1946] See the discussion below for an explanation of this long-term incentive program.

[1947] According to the proxy statements, the value of an Enron stock option was based upon the value of Enron stock at the time of the grant and other factors, including stock price volatility, dividend rate, option term, vesting schedule, termination provisions and long-term interest rates. In 2000, stock options were granted with a seven-year term, 25 percent vesting on date of grant and 25 percent vesting each anniversary date thereafter. In 2001, the term of stock options was changed to five years and the portion of the grant vesting each year was increased to 30 percent.

market competitive.[1948] Aggregate stock holdings of the executives had no bearing on the size of long-term incentive grants.

In 1999, citing difficulties in identifying an appropriate peer group for comparison and the tenuous connection between peer group performance and executive management, Enron ceased giving long-term incentive grants under the Performance Unit Plan. Consequently, for the years 1999 to 2001, long-term grants to executives consisted of fifty percent nonqualified stock options and fifty percent performance-based restricted stock with a performance accelerated vesting feature.[1949] According to the 1999 proxy statement, the ultimate value of the performance based restricted stock awards made to executives was to depend upon the achievement of recurring after-tax net income targets established by the Compensation Committee for the years 1999, 2000, and 2001 and Enron's stock price.

During the 1990s, Enron had two principal stock plans: the 1991 Stock Plan and the 1994 Stock Plan. In 1999, Enron approved the 1999 Stock Plan as a funding mechanism for the issuance of common stock in connection with special circumstances. The plans are described below.

1991 Stock Plan

History

The 1991 Stock Plan was created in 1991 as an unfunded plan with the purpose of encouraging Enron employees and other eligible persons to "develop a proprietary interest in the growth and performance of the Company . . . generate an increased incentive to contribute to the Company's future success and prosperity . . . and enhance the ability of the Company to retain key individuals."[1950] The Plan was restated and approved by the shareholders in 1994, 1997, 1999, and 2001. Various amendments that did not require shareholder approval were approved throughout the years.

Eligibility

When the 1991 Stock Plan was created in 1991, eligible participants included all employees of Enron Corp. and its affiliates as well as nonemployee directors of Enron Corp. or an affiliate.[1951] Nonemployee contractors were added as eligible participants in 1994. In 1999,

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[1948] 1998 Enron Corp. Proxy Statement.

[1949] 2000 Enron Corp. Proxy Statement. According to the proxy statement, restricted stock was subject to four-year cliff vesting from the date of grant. However, vesting could be accelerated based upon Enron's annual cumulative shareholder return relative to the S&P 500. For example, if Enron's cumulative shareholder return exceeded the 90th percentile, 100 percent would vest on the date of grant.

[1950] 1991 Stock Plan, section 1.

[1951] 1994 Enron Corp. Proxy Statement.

however, the entire class of eligible participants in the 1991 Stock Plan was changed to include only employees who were residents of the United Kingdom or members of the Management Committee of Enron, and nonemployee directors. The change in eligibility decreased the number of individuals eligible to receive benefits under the 1991 Stock Plan from approximately 7,000[1952] to 500.[1953]

Grants under the 1991 Stock Plan

Initially, the 1991 Stock Plan provided for grants of (1) stock options,[1954] including incentive stock options meeting the requirements of section 422 of the Code,[1955] and stock options with a grant price that is discounted from the fair market value to be used only in lieu of cash bonus payments, (2) stock appreciation rights ("SARs"), and (3) restricted stock.[1956]

In 1996, the 1991 Stock Plan was amended to provide that phantom stock units would be given to Enron directors in lieu of restricted stock and to permit the grant of phantom stock units interchangeably with restricted stock to eligible persons other than directors.[1957] According to documents provided by Enron, the decision to grant phantom stock units in lieu of restricted stock was motivated by the desire to avoid constructive receipt for employees who met the 1991 Stock Plan's definition of retirement.[1958] Under the 1991 Stock Plan, vesting of restricted stock was to be accelerated when an employee met the plan's definition of retirement. Employees who

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[1952] 1997 Enron Corp. Proxy Statement.

[1953] 1999 Enron Corp. Proxy Statement.

[1954] The 1991 Stock Plan provided that exercise price of a stock option could not be less than the fair market value of the stock on the date of grant.

[1955] Although the 1991 Stock Plan provided for incentive stock options, Enron did not grant such options.

[1956] The 1991 Stock Plan provided that restrictions placed on restricted stock would remain in place for at least three years in the case of restricted stock and, in the case of performance-based restricted stock, for least one year. Dividends or credits associated with the restricted stock were to be withheld during that period but credited to the participant's account. When shares became vested, all accumulated credits and dividends were to be distributed to the participant. The Plan provided that non-vested restricted stock would be forfeited if the participant terminated service for any reason other than death, disability, retirement, or involuntary termination. On the occurrence of certain events such as such as a merger, dissolution, sale of assets and consolidation, the Plan provided for the accelerated vesting of restricted stock and stock options.

[1957] Minutes of the meeting of the Compensation Committee (May 6, 1996).

[1958] EC 000102953. While documents provided by Enron state that there was an issue of constructive receipt, the actual issue appears to be a section 83 issue regarding a transfer of property.

met the definition of retirement but who remained employed with Enron would be vested in restricted stock and could be subject to taxation before actual receipt of the shares. To defer taxation until the payout of the shares, the plan was amended to grant phantom stock units instead of restricted stock, on the theory that phantom stock is considered an unfunded promise to pay stock which would be taxable when actually or constructively received, rather than section 83 property, which would be taxed upon vesting.

In 1997, Enron eliminated the availability of discounted options under the 1991 Stock Plan, and the plan was amended to provide that the exercise price of options would not be less than fair market value of the stock on the date of grant. In 1999, stock appreciation rights were eliminated from constituting an option for award under the 1991 Stock Plan.

Performance-based compensation

In 1994, in order for awards under the 1991 Stock Plan to qualify as performance-based compensation for purposes of the $1 million limitation on the deduction of certain executive compensation,[1959] the 1991 Stock Plan was amended to provide that: (1) the issuance of awards was contingent upon attainment of preestablished performance criteria: (2) restrictions would lapse contingent upon attainment of preestablished performance criteria, and (3) the issuance was in lieu of cash payments under the Annual Incentive Plan or Performance Unit Plan, based upon attainment of the performance criteria established under the terms of those stockholder approved plan. Likewise, limitations were placed on the number of options, stock appreciation rights and performance-based restricted stock that could be given to any one individual during a calendar year. The limit on options and stock appreciation rights was set at one million, while the number of performance-based restricted stock was capped at 100,000.[1960]

Shares available

When the 1991 Stock Plan was first approved in 1991, the number of shares available for grant under the plan was 11 million.[1961] The number of shares authorized for granting awards under the 1991 Stock Plan was increased by 10 million in each of the years 1994, 1997, and 1999. In 2001, an additional 21 million shares (reflecting a two-for-one stock split that took place in 1999) were added to the 1991 Stock Plan. No more than an aggregate of 25 percent of the shares available under the 1991 Stock Plan could be granted as restricted stock or phantom stock units.[1962]

[1959] This limitation is discussed in Part III.C.6., below.

[1960] As a result of the stock split, the caps were set at 2 million for both restricted stock and stock appreciation rights and at 200,000 for performance-based restricted stock.

[1961] This is equal to 2.75 million shares, adjusted for stock splits in December 1991 and August 1993.

[1962] 1996 Enron Corp. Proxy Statement.

Assignability and transferability of awards

Originally, the 1991 Stock Plan contained an antialienation provision prohibiting the assignment or transfer of awards (with the exception of transfer pursuant to a qualified domestic relations order.) In 1996, the 1991 Stock Plan was amended to allow the transfer of stock options to immediate family members, family trusts, and family partnerships.[1963] This transfer program is discussed in more detail, below.

On October 9, 2000, the 1991 Stock Plan was amended to allow the transfer by an eligible participant of options to a private charitable foundation described in 501(c)(3), the assets of which are controlled by the participant and one or more members of his or her immediate family.[1964]

Nonemployee directors

Nonemployee directors were eligible to receive awards under the 1991 Stock Plan, except for incentive stock options. Under the 1991 Stock Plan, nonemployee directors were to receive each year an amount equal to half of their retainer fee in restricted stock or stock options.[1965] In 1994, the 1991 Stock Plan was amended to allow non-employee directors to elect to receive a portion or all of their retainer fees in restricted stock and stock options.

Pursuant to the terms of the 1991 Stock Plan, nonemployee directors were required to defer fifty percent of their annual retainer fee into the 1994 Deferral Plan. On August 11, 1999, the 1991 Stock Plan was amended to allow nonresident, nonemployee directors whose deferral was regarded as the receipt of taxable income in their country of residence, to elect to waive the portion of the retainer fee required to be deferred and receive an award of phantom stock units under the 1991 Stock Plan.[1966]

On August 14, 2001, the 1991 Stock Plan was amended to provide that if a nonemployee director resigned with the approval of the board, the Compensation Committee could fully vest

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[1963] 1997 Enron Corp. Proxy Statement. This change followed the 1996 amendments to the short-swing profit liability rules under section 16(b) of the Securities Exchange Act of 1934, which eliminated the requirement that stock options be nontransferable.

[1964] Sixth amendment to the 1991 Stock Plan (as amended and restated May 4, 1999). According to documents provided by Enron, the change would allow employees to claim charitable contribution deductions on the transfers to private charities.

[1965] Only 20 percent of the options granted could be exercised on the date of grant, with an additional 20 percent becoming exercisable in each of the following four years. On May 2, 2000, the 1991 Stock Plan was amended to provide that the 20 percent portions of the options granted were to become exercisable only upon the completion of a full term of service by the nonemployee director. Fourth Amendment to the 1991 Stock Plan, as amended and restated May 4, 1999.

[1966] First Amendment to the 1991 Stock Plan (as amended and restated May 4, 1999).

grants of restricted stock made to the director and extend the time in which he or she could exercise options after resignation.[1967]

Other provisions

The 1991 Stock Plan was amended to allow for broker cashless exercise of stock options. As mentioned above, in a cashless exercise, the broker loans money to exercise the options, sells the shares, deducts taxes and commissions from the sales proceeds, and sends the participant the remaining proceeds.

Under the 1991 Stock Plan, the payment of the exercise price and applicable tax withholding amounts was required to be made at the time of option exercise and could be made by delivery of cashier's checks, shares of stock, or other property, which allowed participants to use stock-for-stock exercises. Prior to 1996, shares could not be used to satisfy tax withholding obligations.

1994 Stock Plan

History

The 1994 Stock Plan was created in 1994 to provide long-term incentives to employees in a similar way to the 1991 Stock Plan. The purpose of the 1994 Stock Plan was "to enable all employees employed by Enron Corp. . . . and its Affiliates and other eligible persons to develop a proprietary interest in the growth and performance of the Company, to generate an increased incentive to contribute to the Company's future success and prosperity, thus enhancing the value of the Company for the benefit of its stockholders, and to enhance the ability of Enron and its Affiliates to attract and retain employees who are essential to the progress, growth and profitability of Enron."[1968] The 1994 Stock Plan was amended several times and restated on October 12, 1999.

Eligibility

Eligible participants in the 1994 Stock Plan included any employee of Enron or of an affiliate, any nonemployee director of an affiliate, and any nonemployee contractor performing services for Enron. Originally, any person who was subject to section 16(b) of the Securities Exchange Act of 1934 or any officer or director of Enron who was covered by the New York Stock Exchange listing requirements was not eligible to be designated a participant. This participation restriction was subsequently removed.[1969]

[1967] First Amendment to 1991 Stock Plan (as amended and restated May 1, 2001).

[1968] Enron Corp. 1994 Stock Plan.

[1969] June 28, 1999.

Grants

When originally enacted, stock options and restricted stock could be awarded under the 1994 Stock Plan. The 1994 Stock Plan was later amended to allow the grant of phantom stock units.[1970] Grants of incentive stock options could not be made under the 1994 Stock Plan.[1971] The number of shares of restricted stock available for grant under the 1994 Stock Plan was limited to not more than 25 percent of the total number of shares available under the 1994 Stock Plan.

On February 7, 2000, the 1994 Stock Plan was amended to provide that bookkeeping credit for phantom stock units given to individuals who were subject to the tax laws of specified countries would be made in cash rather than Enron stock.[1972]

Shares available

When the 1994 Stock Plan was created, the number of shares approved for awards was three million. On May 3, 1994, the number of shares under the Plan was increased to 11 million.[1973] The number of shares was further increased to 18 million, 26.5 million and then to 30 million between the years 1994 and 1997. In June of 1999, additional shares were added for a total of 45 million (updated to 90 million after the 1999 two-for-one stock split). Finally, in February and December of 2000, the number of shares available was increased to 104 million and 124 million, respectively.[1974]

Antialienation provisions

Under the 1994 Stock Plan as originally enacted, no rights under the 1994 Stock Plan could be pledged, alienated, attached or encumbered, except pursuant to a domestic relations order.

On August 8, 2000, the antialienation provision was amended to allow for the transfer of awards under the 1994 Stock Plan by a participant to: (1) a member of his or her immediate family; (2) a trust solely for the benefit of the participant and his or her immediate family; or (3)

[1970] December 12, 1997.

[1971] Enron Corp. 1994 Stock Plan (as amended and restated in October, 1999).

[1972] The change was made in response to the tax laws of China. Second Amendment to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

[1973] First amendment to 1994 Stock Plan.

[1974] Second and Fifth Amendments to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

a partnership or limited liability company whose only partners are the participant and his or her immediate family.[1975] This transfer program is discussed in more detail, below.

On October 9, 2000, the provisions were further amended to allow transfers of awarded options by a participant to a section 501(c)(3) charitable foundation the assets of which are controlled by the participant and/or one or more of his or her immediate family members.[1976]

Other provisions

The 1994 Stock Plan was amended to allow for broker cashless exercise of stock options. As mentioned above, in a cashless exercise, the broker loans the money to exercise the options, sells the shares, deducts taxes and commissions from the sales proceeds, and sends the participant the remaining proceeds.

Under the 1994 Stock Plan, the payment of the exercise price and applicable tax withholding amounts was required to be made at the time of exercise and could be by delivery of cashier's checks, shares of stock, or other property, which allowed participants to use stock-for-stock exercises. Prior to 1996, shares could not be used to satisfy tax withholding obligations.

1999 Stock Plan

The 1999 Stock Plan was created to "provide a funding source for the issuance of common stock of Enron Corp. in connection with special situations, including, but not limited to divestitures, outsourcing, remuneration payable under compensatory programs sponsored by Enron and its affiliates, and any other circumstance deemed, by the Compensation Committee of the Board of Directors as such a special situation."

Eligible participants included all employees of Enron Corp. and its affiliates, nonemployee directors, nonemployee contractors, and any individual who had accepted an offer of employment with Enron Corp. or an affiliate.

Under the 1999 Stock Plan, awards could be given in restricted stock, stock options, or phantom stock units. No grants of incentive stock options could be made under the 1999 Stock Plan. The number of shares available for grant under the 1999 Stock Plan was initially 3 million. Awards granted were inalienable with the exception of a transfer pursuant to a qualified domestic relations order.

Under the 1999 Stock Plan, the payment of the exercise price and applicable tax withholding amounts were required to be made at the time of exercise by delivery of cashier's checks, shares of stock, or other property, thus allowing stock-for-stock exercises.

[1975] Third Amendment to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

[1976] Fourth Amendment to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

Stock option transfer program

After amending the 1991 and 1994 Stock Plans to allow for the transfer of options to family members or family controlled entities, Enron instituted the stock option transfer program. In 2000, the 1991 and 1994 Stock Plans were amended to allow transfers to private charitable foundations controlled by participants or their immediate family members. Originally, eligibility for participation in the program was limited to nonemployee directors and Management Committee members. In August 2000, eligibility was expanded to include all employees who received grants from the 1991 or 1994 Stock Plans.

Pursuant to the stock option transfer program, employees could irrevocably gift stock options granted under the 1991 and 1994 Stock Plans to family members or certain family-controlled entities.[1977] Transfers could be made to immediate family members, to a trust for the exclusive benefit of immediate family members, or to a partnership in which immediate family members are the only partners. As mentioned above, the plans were later amended to allow transfers to private charitable foundations controlled by a participant or his or her immediate family.[1978] The employee would pay gift tax on the present value of the options, subject to the annual gift-tax exclusion or the lifetime unified tax credit. Enron advised employees against gifting unvested stock options given the IRS' position[1979] that the transfer of unvested options would not be considered a completed gift, the result being that gift tax would be assessed on the value of the options on the date of vesting rather than the date of the gift.

When the transferee exercised the options, the employee would be responsible for income tax payments on the gains realized.[1980] No additional payment of gift tax or estate tax would be required on the death of the employee since the options were already removed from the employee's estate by the transfer.

As stated in materials given to employees explaining the program "[t]he gifting technique allows you, with little or no additional tax, to pass on stock option gains that would have been in the estate and subject to estate rates of up to 55 percent."[1981] In addition, for transfers to family charitable foundations, the employee could be eligible for a charitable deduction.

[1977] In February 2001, the Compensation Committee approved administrative procedures to be followed under the stock option transfer program.

[1978] Even though allowed by the plans, program information given to participants does not include transfers to private charitable foundations as a permissible under the program.

[1979] Rev. Rul. 98-21, 1998-18 I.R.B. 7.

[1980] Documents provided to participants state that upon exercise of an option by the transferee, Federal income tax withholding was required to be paid to the Company by the executive for the amount of withholding tax imputed to the executive.

[1981] Memorandum to Executive Committee Members regarding the stock option transfer program. EC2 000019353.

Enron used the Black-Scholes option pricing method to value options transferred.[1982] Employees were advised that more recent grants would have the lowest estimated value and would create the lowest gift tax liability and the greatest benefit.

As stated in employee materials provided by Enron, benefits to the transferor included: (1) the ability to pass on stock options that would have otherwise been in the estate and subject to estate taxes; (2) the ability to gift vested stock options immediately after vesting at a discounted theoretical value which reduces the gift tax when the gifting occurs; (3) the ability to provide a benefit that appreciates over time and is tax free to heirs upon exercise; and (4) the ability to maximize the benefits to heirs by utilizing the $10,000 per recipient annual gift tax exclusion and/or the $675,000 lifetime unified tax credit.[1983]

The Compensation Committee was required to be notified of the terms and conditions of any transfer and was required to determine that the transfer complied with the requirements of the applicable plan. Documents provided by Enron indicate that transfers by at least five persons, including Ken Lay and two members of the Board of Directors, were approved by the Compensation Committee.[1984]

Stock option tax shelter

The materials provided in response to the Joint Committee staff's general request for information regarding Enron compensation arrangements included documents describing a technique purporting to defer inclusion of income upon the exercise of an employee's stock options.[1985] The documents indicate that Enron apparently considered whether to have a role in facilitating the technique and in letting Arthur Andersen show the technique to employees. The

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[1982] Documents provided by Enron show that in some years, multiple valuations were considered. For an assumed transfer date of November 15, 2000, one set of valuations that conforms strictly to Revenue Procedure 98-34 and qualified for safe harbor treatment was considered, as was another set of valuations which Enron believed conformed to Revenue Procedure 98-34, but took a more aggressive approach.

[1983] Enron informed participants that the possible drawbacks are: the inability to control the timing of the exercise, which must be relinquished to the transferee; the income tax that the executive must pay; income tax consequences to the transferee if the executive dies before the options are exercised; and if the executive pays gift tax upon the transfer and the stock does not appreciate, tax would be paid on income never realized.

[1984] The documents indicate that the Compensation Committee approved transfers during 1997-1998 to family members, family partnerships, and trusts of executives. EC 000104417; EC 000102332; EC2 000019444 - EC2 000019470; EC 002634789.

[1985] Sale of Executive Options Techniques, EC 000770979 – EC 000770981, and Sale of Executive Options Technique – Advantages and Disadvantages, EC 000770978. Enron also received a draft opinion letter for employees from Arthur Andersen (1999) (EC2 000038589 – EC2 000038616), but it is not known whether Enron ever supplied the letter to any employees. These materials are included in Appendix D of this Report.

technique involves the purported sale of the option to a partnership consisting of the employee's family members, followed by the partnership's exercise of the option and possible sale of the stock. In order for the technique to be effective, it would require Enron not to report gain on the exercise of the stock option on the employee's W-2 statement.[1986]

In an interview with Joint Committee staff, Mr. Hermann indicated that he understood that the technique was considered to be of interest to one employee. He declined to name this individual. He also told the Joint Committee staff that the tax department had reviewed the technique and had advised that Enron was required to withhold. Thus, the technique would not achieve the intended result. Mr. Hermann stated that he believed that Enron had not facilitated this type of transaction. From the materials received by the Joint Committee staff, it is not clear whether or not any Enron executives entered into a transaction of this type.

Performance Unit Plan

The Performance Unit Plan was created to provide long-term incentive compensation tied to increases in stockholder value to key Enron executive employees.[1987] According to the Performance Unit Plan, eligible participants included employees of Enron Corp. and its subsidiaries who participated in the Enron Executive Compensation Program. Dr. Charles LeMaistre, the Chairman of the Compensation Committee, submitted written testimony to the Permanent Subcommittee on Investigations on May 7, 2002, regarding, among other things, the Performance Unit Plan.[1988] In his statement, Dr. LeMaistre stated that Enron granted performance units to corporate and certain operating company executives who were not in an Enron long-term incentive plan. These operating company executives were, for the most part, in commercial support and pipeline businesses. Dr. LeMaistre stated that he believed that performance unit awards were granted pursuant to the Performance Unit Plan between 1987 and 1998.

Prior to the beginning of each calendar year, the Compensation Committee would designate the employees that were eligible to receive performance units during that year and the number of performance units to be given to each individual. Each performance unit had a value at the time of grant of $1. No single individual could be granted more than 3 million performance units in one calendar year.

Pursuant to the Performance Unit Plan, the total shareholder return of Enron was compared to that of a selected peer group comprised of 11 publicly held companies over a four-

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[1986] Sale of Executive Options Technique – Advantages and Disadvantages, EC 000770978. This document states, "Enron will require guidance from Arthur Andersen as the executive's tax advisor to operationalize manually overriding the payroll system to legally keep income off of the executive's W-2 statement."

[1987] 1994 Enron Corp. Proxy Statement.

[1988] *Hearing on The Role of the Board of Directors in Enron's Collapse before the Permanent Subcommittee on Investigations of the Committee on Government Affairs*, 107th Cong. (May 7, 2002) (testimony of Dr. Charles LeMaistre).

year period. The value of the performance units was then determined with reference to the ranking of Enron's shareholder return relative to its peer group as shown in Table 22, below.

Table 22.–Performance Unit Adjusted Values

Enron's Total Shareholder Return Ranking Position	Adjusted Value
1	$2.00
2	$1.50
3	$1.00
4	$0.75
5	$0.50
6	$0.25
7 through 12	$0.00

Additionally, irrespective of the ranking position of Enron's shareholder return, if the total return for the period did not exceed the cumulative percentage return for 90-day U.S. treasury bills, the performance unit would have no value.

In 1995, the Plan was restated and approved by shareholders to comply with the requirements of section 162(m) for deductions of performance-based compensation.[1989]

All-employee stock option arrangements

In general

Enron periodically made stock option grants to all employees. These grants were made to allow all employees to become shareholders of Enron.

All-Employee Stock Option Program

Under the All-Employee Stock Option Program, participants were entitled to receive a one-time up-front grant of Enron stock options. The six-year program was created in 1994 and was offered to all full-time Enron employees and part-time employees who completed at least 1,000 hours of service. The grants were made under the 1991 Stock Plan for Section 16 officers and under the 1994 Stock Plan for all other employees.

Initial grants under the program were made in 1994 and were equal in value to 30 percent of the annual base salary of each employee. For those joining the All-Employee Stock Option Program in subsequent years, the benefit was reduced by five percent for each year. For example, so that those joining in 1999 received a grant equal to five percent of their annual benefits. The grant was awarded on the last business day of the calendar year in which the employee was hired. Stock options awarded under the All-Employee Stock Option Program vested ratably over five years or over the remaining years of the program, whichever was shorter.

[1989] 1995 Enron Corp. Proxy Statement.

Enron documents indicate that the program was implemented in lieu of a company match under the Enron Savings Plan because of the cost savings that could be achieved by Enron. Documents provided by Enron show that a 401(k) match would have cost the Enron $43.9 million more than the All-Employee Stock Option Program.[1990] Documents provided by Enron show that if options would have been held to a $75 stock price, they would have delivered $1.77 billion in option value, while a 401(k) match, if implemented, would have delivered only $359.2 million in value.[1991] The Compensation Committee decided to repeat the program in 2000 through 2005.

One Enron - "Project 50" Stock Option Program

Eligible employees on the payroll as of December 31, 1999, participated in "Project 50." Under the program, employees were given a one-time grant of 50 stock options on January 18, 2000, in recognition of Enron's stock price reaching $50 after the 1999 two-for-one stock-split. Included in the Project 50 informational materials provided by Enron to participants is a message from Mr. Lay thanking the employees' contributions to Enron's success. In his words, "I look forward to working with you as we continue to make Enron a successful global energy and communications company. And it would not surprise me if our stock continued to $50 milestones after two-for-one splits on an even more frequent basis. In fact, anything is possible, if we are focused, if we work together, as a team, as One Enron."[1992]

EnronOptions

In May 2000, Enron approved a new all-employee stock option program called "EnronOptions - Your Stock Option Program" which was to commence in 2001 and continue for a five-year period. Pursuant to the program, all full-time and part-time employees on the payroll of Enron as of December 29, 2000, were awarded a one-time grant of stock options equal in value to 25 percent of their annual base salary.[1993] Employees joining after 2001 were to receive the annual grant in the year they were hired equal in value to five percent of their annual base salary multiplied by the number years remaining in the program. Stock options awarded under the program were to vest ratably on June 30 of each year remaining in the program.

Pursuant to bankruptcy rules, the EnronOptions program was terminated effective with the December 20, 2001, Compensation Committee meeting.[1994]

[1990] EC 000101777.

[1991] EC 000101777.

[1992] EC2 000019565.

[1993] 2001 Enron Corp. Proxy Statement.

[1994] Compensation Committee Meeting Minutes, December 20, 2001.

2001 Special Stock Grant

In the summer of 2001, when Enron's financial problems were getting much attention, Enron made an all-employee stock grant. The 2001 Special Stock Grant was made to most eligible Enron employees; some Enron companies' employees were not eligible due to legal, accounting, tax, labor or business issues.[1995] Grants were made to eligible employees who were active, regular employees of participating companies on August 13, 2001. Such employees received options equal to five percent of their annual base salary, as of August 13, 2001. Most employees were granted options on August 21, 2001, with an exercise price equal to the closing price of Enron stock ($36.88) on that date. The number of options that an eligible employee would receive was based on five percent of an employee's annualized base salary, as of August 13, 2001, and a theoretical stock option value of $15 (the Black-Scholes value for Enron stock on the grant date). The grant date for some non-U.S. locations was made at a later time due to pending legal/business issues. The grant price for grants made to eligible employees after August 21, 2001, was determined on the date of grant.

Options granted through the 2001 Special Stock Option Grant were 100 percent vested on the date of grant. Eligible employees who received the grant had five years to exercise the stock options unless they terminated employment. Although examples in employee communications assumed that the stock price would increase, Enron noted that there was no assurance that Enron common stock would increase in value.

Enron employees interviewed Joint Committee staff stated that the grant was done for goodwill and morale reasons on account of concerns that the stock price continued to decline. In connection with the 2001 Special Stock Grant, Mr. Lay circulated an electronic mail message to employees stating "one of my highest priorities is to restore investor confidence in Enron. This should result in a significantly higher stock price . . . I ask for your continued help and support as we work together to achieve this goal."[1996]

Miscellaneous

As discussed in Part III.B.2., above, Enron had two bonus deferral programs. Under the Bonus Phantom Stock Program and the Bonus Stock Option Program, participants were given the opportunity to receive stock options and/or phantom stock in lieu of cash bonus.

In addition, Enron offered the deferral of stock options gains and deferral of restricted stock programs in which participants could defer taxation attributable to such compensation. The deferral of stock option gains program allowed executives to exercise options without outlaying cash or incurring any current income tax liability. The program would be particularly useful for options due to expire. These programs are discussed in Part III.C.1.

Before Enron revised its compensation system in 1999, many other stock/equity plans existed throughout the various business units. These included the: Enron Capital & Trade

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[1995] EC2 000019566.

[1996] EC 000851236.

Resources Corp. Phantom Stock Unit Plan; Enron Energy Services, LLC Phantom Equity Plan; Enron Power Corp. Phantom Equity Plan, Enron International Stock Plan; Enron Renewable Energy Corp. Tandem Option Program; Northern Plains Natural Gas Company Phantom Stock Unit Plan; and Azurix Corp. Stock Option Plan. Miscellaneous stock-related programs may have also existed for various groups of employees or business units.[1997]

Discussion of Issues

In general

Enron used considerable amounts of stock-based compensation, and the amount of compensation generated from such arrangements increased dramatically in the years immediately preceding the bankruptcy, particularly in 2000.

Table 23, below, shows the Enron's deduction attributable to stock options for 1998 through 2000.[1998]

Table 23.–Enron Deduction Attributable to Stock Options 1998-2000

Year	Amount of Deduction
1998	$125,343,000
1999	$585,000 as filed $367,798,000 as amended
2000	$1,549,748,000

Table 24, below, shows the amount of income attributable to stock options for the highest paid 200 employees for 1998, 1999, and 2000. This is summary information provided by the IRS, based on information provided by Enron to the IRS.

Table 24.–Income Attributable to Stock Options for Top-200 Most Highly Paid Enron Employees (1998-2000)

Year	Amount of Compensation
1998	$61,978,000
1999	$244,579,000
2000	$1,063,567,000

Table 25, below, shows the income generated from the release, i.e., vesting, of stock options for the top-200 most highly paid Enron employees for 1998-2000. This information is also summary information provided by the IRS based on information provided by Enron to the IRS.

[1997] Minutes of the Compensation Committee show that the committee approved two other miscellaneous programs, the Key Performer Stock Option Retention Program and the NationsBank OptionPlus Program. It is unclear whether such programs were implemented.

[1998] Information from Schedule M1.

Table 25.–Income Attributable to the Vesting of Restricted Stock for Top-200 Most Highly Paid Enron Employees (1998-2000)

Year	Amount of Compensation
1998	$23,966,000
1999	$21,943,000
2000	$131,701,000

Enron's stock-based compensation programs can be analyzed both from a Federal tax perspective and from a nontax perspective. As discussed below, while Enron took advantage of tax planning opportunities in implementing its stock-based compensation programs, with two exceptions, the issues raised by these programs are not primarily tax-related.

Federal tax issues, in general

From a Federal tax perspective, Enron structured its stock-based compensation arrangements with an eye toward tax planning, sometimes from the point of view of Enron, sometimes from the point of view of the executive. For example, the use of nonqualified stock options resulted in tax deductions for Enron that would not have been available if Enron had used qualified stock options.[1999]

Enron also made use of techniques that benefited the executives from a tax perspective. For example, the use of stock-for-stock exercises provided a more favorable tax result for the executive than would have resulted if the executive sold Enron stock and used the cash proceeds to exercise options. In addition, the stock option transfer program, which allowed the gifting of stock options to family members and certain other persons, was clearly an estate planning device and was described to employees as such. However, both of these programs appeared to operate in accordance with published IRS rulings.[2000] In these cases, Enron appeared to do little more than take advantage of tax planning opportunities provided clear IRS authority.

There are two aspects of Enron's stock-based compensation programs that raise Federal tax issues. The first is the ability to defer gain on the exercise of options and restricted stock, which is discussed in Part III.C.1., above. The second is the sale of executive stock options tax shelter technique, which, if utilized by Enron executives, would raise signification tax issues. As mentioned above, it is unclear whether Enron executives engaged in this transaction. Issues with respect to this technique are discussed below.

[1999] There may be other reasons Enron did not use qualified options, including the restrictions placed on those options under applicable Code requirements.

[2000] It also appears that Enron attempted to comply with withholding requirements for stock-based compensation.

Stock option tax shelter technique

Recent news articles have drawn attention to attempts to defer inclusion of income upon the exercise of employees' stock options.[2001] Publicity has focused on the question of whether the sale of the option to the partnership can be an arm's length transaction.[2002]

Enron received a copy of a draft opinion letter (not addressed to any particular individual) from Arthur Andersen that could be provided to individuals who utilize the technique.[2003] In the transaction contemplated in the draft Arthur Andersen opinion letter, an employee who holds stock options sells the options to a family partnership owned 79 percent by himself, 17 percent by his wife, and one percent by each of his two sons. The partnership is capitalized with cash contributed by the option holder and his family ($180,000 by the employee, and $20,000 by the other family members). The purchase price of the options is set at $2 million as determined by an appraisal performed by Arthur Andersen. Upon the sale of the stock options to the partnership, the option holder takes back an unfunded and unsecured promissory obligation to repay the purchase price after 20 years, at 8 percent interest. The terms of the purchase agreement are described as "designed to be comparable to similar commercial transactions."[2004]

The draft opinion letter concludes it is more likely than not that: (1) the partnership will be recognized as a valid partnership for Federal income tax purposes; (2) the sale of options to the partnership will be respected as a valid sale between two separate taxable entities; (3) the assignment of income doctrine will not apply to the sale; (4) a disposition of options at fair market value under commercially reasonable terms satisfies the arm's length standard of section 83; (5) once the options are disposed of at arm's length under section 83, thereby triggering the realization of ordinary income, any subsequent exercise of the options by the partnership does not invoke the re-application of section 83; (6) the transferor's receipt of the partnership's unfunded and unsecured promise to pay the appraised value of the options plus interest will not constitute the "receipt of property" for purposes of section 83, so recognition of compensatory ordinary income should be delayed until the transferor receives principal payments under the promissory obligation; and (7) the timing and amount of the grantor corporation's deduction for compensation paid correspond to the timing and amount of compensation included in the transferor's gross income.

[2001] Johnston, *Costly Questions Arise on Legal Opinions for Tax Shelters*, N.Y. Times, Feb. 9, 2003, at A15; Glater and Labaton, *Auditor Role in Working for Executives is Questioned*, N.Y. Times, Feb. 8, 2003, at B1; Johnston and Glater, *Tax Shelter Is Worrying Sprint's Chief*, N.Y. Times, Feb. 6, 2003, at C1; Blumenstein, Lublin and Young, *Sprint Forced Out Top Executives Over Questionable Tax Shelter*, Wall St. J., Feb. 5, 2003, at A1.

[2002] *Id.*

[2003] Draft opinion letter to Mr. Client from Arthur Andersen, dated 1999 (EC2 000038589 – EC2 000038616). Appendix D contains this document.

[2004] EC2 000038591.

One element of the draft opinion letter is the conclusion that, more likely than not, the note received from the partnership does not constitute property for purposes of section 83, because the note is unfunded and unsecured. The opinion letter relies on the regulations under section 83 providing that an "unfunded and unsecured promise to pay" is not "property."[2005]

The conclusion that the partnership's obligation is "unfunded and unsecured" is arguably not directly contrary to the conclusion that the obligation is at "arm's length," as discussed below. However, whether this obligation is unfunded and unsecured could be challenged based on the practical meaning and application of the "unsecured and unfunded" language of the section 83 regulation in the context of a third party note as opposed to an obligation of an employer.

The draft opinion letter concludes that it is more likely than not that sale of options to the partnership will be respected as being at arm's length. In discussing this issue, the draft opinion letter relies on the assumed facts that the partnership may not make distributions other than to meet its partners' tax obligations, which is similar to security arrangements required by commercial lenders; this restriction helps to assure that the partnership will be able to meet its obligation to pay after 20 years. The draft opinion letter also relies on the fact that the partnership's primary activity is investing, so its exposure to liabilities or creditors' claims is likely to be small.

The draft opinion letter does not mention or alert the transferor to any possible economic risk of the transfer. For example, if the payments are in fact unsecured and unfunded, then it is possible that the value of the options (or of the optioned stock) in the hands of the partnership could decline. To the extent this can occur and the transferor is not protected except by the value of the options (or stock, if the options are exercised) in the partnership and by the cash contribution largely funded by the transferor, it could be argued that he did not in fact transfer the risk of loss of value of the options or underlying stock to the partnership, a key element of a "sale." Thus, it could be the conclusion that the transaction would be a contribution to capital rather than a sale, or perhaps even a "sham" transaction that did not actually shift the benefits and burdens of option ownership significantly to the partnership.[2006]

[2005] The draft opinion letter refers to Treas. Reg. Sec. 1.83-3(e). The draft opinion letter recognizes that the authorities it cites interpreting that regulation involve a promissory obligation of an employer rather than a third party, but concludes that there is no special rule limited the provision to employers and that the theoretical support should apply equally to a third party. EC2 000038611.

[2006] Although the draft opinion letter does make reference to concepts such as the common law "sham transaction" and "substance over form" doctrines, it relies in large part on its conclusion that the transfer is more likely than not an "arm's length" sale to distinguish cases in which such doctrines have been applied. EC 000038599.

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),

The draft opinion letter also takes the position that the sale of the options is at arm's length, even though the transaction is between an individual and a partnership whose partners are the members of his immediate family. In discussing the issue, the draft opinion letter concludes that the state of the law is merely ambiguous, and that the sale between related parties can be considered at arm's length. This conclusion fails to take into account the absence of any adverse interest between the parties.

The draft opinion letter relies entirely upon the application of specific regulations under section 83, and does not consider whether any other provisions of the tax law might apply. For example, the letter does not mention section 453(e), generally applicable to installment sales between parties that are related but otherwise respected as independent. Section 453(e) provides that if a sale of property occurs between related parties and, within two years of the first sale, the transferee makes a second disposition of the transferred property, then the original transferor is not entitled to use the installment method of reporting income to defer recognition of income from the sale until payments are received, but rather must include all gain in income at the time of the second disposition. The opinion letter does not address whether this provision might have relevance to the transaction, or whether an exercise of the option (or a sale of the optioned stock) by the partnership might invoke this section.[2007]

Nontax issues

A noticeable aspect of Enron's stock-based compensation programs is the emphasis placed on stock as a form of compensation. Enron used stock-based compensation as a principle form of compensation for executives. Management believed that executive compensation should be tied to company performance. There was a stock ownership requirement for certain executives, the stated purpose of which was to align the interests of executives and stockholders. A stated focus of the Compensation Committee was ensuring that there was a strong link between the success of the shareholder and the rewards of the executive. The Compensation Committee believed that a great deal of executive compensation should be dependent on company performance.

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).

[2007] Some published discussion of similar structures has discussed section 453, both by way of exploring possible beneficial capital gain treatment of a sale of options and also by way of exploring whether there might be risks in the case of transfers to related parties. *See, e.g.*, Hammill and Lusby, *Intrafamily Installment Sales of Nonqualified Stock Options*, 31 Tax Advisor 494 (July 2000).

As noted elsewhere, the Enron culture also Enron stock ownership by employees. For example, Joint Committee staff were told that there was a monitor in the lobby of the Enron headquarters in Houston so that the performance of Enron stock could be viewed by all who entered the building. Even up to the months immediately preceding the bankruptcy, employees were encouraged that the company was in strong financial shape. Stock-based compensation for was used for all employees in a variety of forms, including as an investment in the Enron Savings Plan and Enron ESOP, in addition to the all-employee stock option programs. Stock was used as a form of compensation for nonemployee directors.

While some argue that linking shareholder and executive success is beneficial for shareholders, conflicts may arise. Linking compensation of executives to the performance of the company can result in executives taking measures to increase short-term earnings instead of focusing on longer-term interests.

The use of stock options by Enron brings renewed attention to discussions regarding the proper treatment of stock options for accounting purposes, and the difference between the treatment of options for tax and accounting purposes. As discussed above, under APB 25, which Enron followed, generally no compensation cost is required to be recorded in financial statements for stock options issued to employees if the exercise price is equivalent to or greater than the market price on the grant date. FAS 125, the "preferred," but optional, approach, would require stock option costs to be taken into account when options are granted, based on a determination of the value of the option.

Because of the differences between accounting rules and tax rules, the amount shown on financial statements as a cost attributable to stock options, even under FAS 125, can be substantially less than a company's tax deduction for stock options. Accounting rules and tax rules have somewhat different purposes, and it may be appropriate for different rules to apply in order to achieve the differing purposes. For example, under the tax laws, one principle is the proper matching of income and deductions; in the case of stock options, the corporation is not allowed a deduction until an amount is includible in gross income, which is generally upon exercise. This is an appropriate rule from a tax perspective; however, accounting rules might reasonably take the approach that options should be recorded earlier for financial reporting purposes.

Nevertheless, the sheer magnitude of the amount of corporate deductions and executive income generated by the exercise of stock options in some cases, such as Enron's, may appropriately focus attention on whether proxy disclosure rules and accounting rules are sufficient to properly inform shareholders.

3. Employee loans

Present Law

Overview

It is not uncommon for employers to make loans to some employees, particularly executives. From a Federal income tax perspective, a question that may arise is whether the arrangement is in fact a loan or a payment of compensation.

The tax treatment of loans is different from the tax treatment of compensation for both the employer and the employee. Compensation is generally currently includible in the gross income of the employee, and includible in wages for employment tax purposes. Compensation is generally deductible by the employer as an ordinary and necessary business expense,[2008] subject to the $1 million limitation on the deduction of compensation for certain executives.[2009]

On the other hand, a loan is not includible in the gross income of the employee (or in wages for employment tax purposes). Similarly, no deduction is allowed the employer with respect to the making of a loan to an employee. Interest payments may in some circumstances be deductible by the employee;[2010] accrued interest is includible in the gross income of the employer.

Under present law, a loan that provides for the payment of interest at a rate below the applicable Federal rate (a "below-market-rate loan") between certain parties is recharacterized as a transaction in which the lender made a loan to the borrower is exchange for a note requiring the payment of interest at the applicable Federal rate. In the case of loans in the employment context, the rule results in the parties being treated as if: (1) the borrower paid interest to the lender at the applicable Federal rate which is includible in income by the lender; and (2) the lender paid compensation to the employee in the amount of imputed interest.[2011] Because of these rules, the stated interest rate on loans to executives is often the applicable Federal rate.

If an employer makes a bona fide loan to an employee and subsequently forgives any outstanding debt, the amount forgiven is includible in gross income as compensation in the year forgiven and subject to employment taxes. The employer is generally entitled to a compensation deduction upon such forgiveness, subject to the general rules applicable to deduction of compensation expenses.

[2008] Sec. 162.

[2009] Sec. 162(m). This limitation is discussed in Part III.C.6., below.

[2010] Sec. 163.

[2011] Sec. 7872.

Determining whether an arrangement is a loan to an employee or compensation is generally based on all the facts and circumstances. Present-law rules applicable in making this determination are discussed below.

Laws other than tax laws may also affect the structure of employee loan transactions. Federal securities laws regarding reporting of stock transactions by corporate executives have influenced the decision of whether to use stock of the company to repay a loan. These rules are discussed in brief, below.

Definition of a bona fide loan

In general

A transfer of funds from one taxpayer to another may constitute a loan, a gift, compensation for services, a contribution to capital, or something else.[2012] Whether the transfer will be treated as a loan for tax purposes depends on the intentions of the parties as well as the objective facts and circumstances of the transaction.[2013]

In general, in order for a loan to exist, at the time the transfer of funds takes place, there must be an unconditional obligation on the part of the transferee to repay the funds coupled with an unconditional intention on the part of the transferor to secure repayment.[2014] In analyzing whether there is an unconditional obligation to repay on the part of the payee, courts have examined whether, under the loan agreement, the obligation to repay the loan is contingent upon a future event.[2015] If the obligation to repay is conditional if the condition of repayment may be easily satisfied by the borrower[2016]or is under the borrower's control, the transfer of funds generally will not be regarded as a bona fide loan.[2017]

[2012] For example, a transfer by a corporation to a shareholder employee may be a dividend.

[2013] *Haber v. Commissioner*, 52 T.C. 255, 266 (1969) *aff'd*, 422 F.2d 198 (5th Cir. 1970).

[2014] *Id.; Haag v. Commissioner*, 88 T.C. 604, 615-616 (1987), *aff'd* 855 F.2d 855 (8th Cir. 1988).

[2015] *See, e.g., Frierdich v. Commissioner*, T.C. Memo 1989-103, *aff'd*, 925 F.2d 180 (7th Cir. 1991); *also see Bouchard v. Commissioner*, T.C. Memo 1954-243, *aff'd*, 229 F.2d 703 (7th Cir. 1956)

[2016] *Saunders v. Commissioner*, 720 F.2d 871, 874 (5th Cir. 1983) (holding that where agreement contained "exceedingly generous" forgiveness clauses and the recipients of the loans could easily qualify for cancellation of the loan, no creditor-debtor relationship was established).

[2017] *Milenbach v. Commissioner*, 106 T.C. 184, 197 (1996). In *Milenbach*, repayment was to be made out of future profits generated from residential suites the borrower was to construct at a time in its "reasonable discretion." The borrower never constructed the suites and thus never repaid the loan. The Tax Court held that because the agreement provided for only a

Courts have often looked beyond the intentions of the parties to objective factors that may indicate whether a creditor-debtor relationship has been created.[2018] Frequently cited factors include (1) the existence of a promissory note or other evidence of indebtedness, (2) the existence of a specified repayment schedule including interest, (3) the presence of a collateral or security for the loan, and (4) the payee's ability to repay.[2019] Additional factors include whether repayments were made, and the manner in which the loan was treated in the taxpayers' books.[2020]

Loans in the employment context

Loans to employees may be subject to challenge on the ground that they constitute compensation for services rather than a true debt. Two factors, in addition to the general rules for determining whether a bona fide loan exists, have been applied in the employment context.

First, the manner in which the loan is to be repaid--whether through the provision of services or monetary payments--has been a significant indicator of whether a bona fide loan exists in the employment context. Generally, loans made with the expectation that they would be repaid through the provision of future services have been held not to create a creditor-debtor relationship between the employer and the employee and to constitute advance compensation rather than loans.[2021] The same result has been reached even if employment was ultimately terminated and monetary repayment ensued.[2022]

Second, if under the loan agreement repayment is to be satisfied with monetary payments, the focus has been on whether the repayment is to be satisfied solely from the future

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conditional obligation to repay the loan, the satisfaction of which was under the sole control of the borrower, it did not constitute a true loan.

[2018] *Geftamn v. Commissioner*, 154 F.3d 61, 68 (3rd Cir. 1998); *Haag*, 88 T.C. at 616; *Morgan v. Commissioner*, T.C. Memo 1997-132.

[2019] *Geftamn*, 154 F.3d at 68; *Morgan*, T.C. Memo 1997-132.

[2020] *Haag*, 88 T.C. at 616.

[2021] *Beaver v. Commissioner*, 55 T.C. 85, 91 (1970) ("in the case of a loan, satisfaction is to be made by making monetary payments pursuant to the parties' agreement. In such case a debtor-creditor relationship is established at the outset. In the case of compensation for future services, satisfaction is to be made by actually performing such services. Only when such services are not rendered does there arise a debtor-creditor relationship requiring satisfaction by monetary repayment."); *see also Morgan*, T.C. Memo 1997-132 ("an intent to repay a purported loan by the performance of services...[renders the loan] nothing more than an advance salary or other payment for services"); and *Frierdich*, T.C. Memo 1989-103 (holding that a loan to an attorney by his client, the repayment of which was due upon the occurrence of a future event and which could be offset by legal fees owed to the attorney, was not a loan but advance payment for legal services).

[2022] *See Beaver, supra.*

earnings of the employee during the period of employment or whether the obligation to repay continues after the employment relationship is terminated. Thus, in cases in which the loan agreement provided that repayment was to be made out of the future earnings of the employee but that the obligation would continue to exist after termination of employment, the transfer was treated as a true loan.[2023] Conversely, when repayment of the loan was limited to the future earnings of the employee during employment and could not be enforced against the employee after termination, the transfer was deemed to constitute compensation rather than a loan.[2024] Further, if there existed a high probability that, in fact, repayment would not be enforced against the employee or would be forgiven by the employer the transfer was not regarded as a loan but as compensation for services.[2025]

In a private letter ruling, the IRS ruled that advances made pursuant to an arrangement whereby they had to be repaid, in effect, only if the employee left the employment prior to the end of a required period of service constituted advance compensation for services rather than true loans.[2026] Under the loan agreement in the ruling, the employees had to work five years throughout which portions of the debt were forgiven on a yearly basis. The IRS reasoned that the fact that the obligation to repay would only arise if the employee's employment terminated prematurely rendered the repayment a conditional obligation "not sufficient to characterize the transfer as a loan." Any repayment obligation that would arise would be, according to the IRS, "liquidated damages for breach of the employment contract."[2027]

[2023] Rev. Rul. 68-337, 1968-1 C.B. 417 (holding that advance payments made to employees which were to be repaid out of future earnings, but which included an acknowledgment of the debt and had to be repaid even if employment was terminated, were true loans rather than compensation); *see also Rosario v. Commissioner*, T.C. Memo 2002-70 (holding that payments made pursuant to an income guarantee agreement which were to be repaid during the term of employment from excess earnings were loans rather than compensation, if any balance remaining after termination of employment was to be repaid to the employer).

[2024] Rev. Rul. 68-239, 1968-1 C.B. 414 (holding that loans made to employees to be paid out of future earnings but which would not be enforced if employment were terminated were "wages" for income tax purposes); *see also Kinzy v. United States*, 87-2 USTC ¶ 9520, 60 AFTR 2d 5770 (N.D. Ga. 1987), (holding that when an employee received an advance payment which would be charged off as long as he remained employed and which had to be repaid only if employment terminated prior to the discharge and even then only out of earned commissions, the liability was contingent rather than an unconditional obligation to pay the advances and, therefore, the payment was compensation rather than a loan).

[2025] Rev. Rul. 83-12, 1983-1 C.B. 99 (holding that advance payments made to insurance agents which were to be repaid out of earned commissions and for which the agent was personally liable beyond the employment relationship, did not constitute true loans where the employer had a practice of forgiving and not enforcing the debt).

[2026] Priv. Ltr. Rul. 200040004 (June 12, 2000).

[2027] *Id.*

Nontax laws relating to employee loans

SEC reporting requirements regarding insider sales of securities

In some cases, Enron executives used stock to repay loans from Enron. Such transactions are affected by SEC reporting rules. Generally, any sale or purchase of the stock of a publicly held by its officers and directors is subject to reporting requirements under the Securities Exchange Act of 1934.[2028] In general, these rules require that purchases or sales of a company's stock in public markets must be reported within 10 days of the close of the month in which the transaction occurs.

However, during the time period covered by the Joint Committee staff review, in the case of transactions between officers and directors and the company itself, if certain requirements were satisfied, the transaction did not have to be disclosed until 45 days after the close of the company's fiscal year.[2029] Among the requirements that may apply in order for a transaction to qualify for delayed reporting is a requirement that the transaction be approved by the Board of Directors of the company or a committee of the Board consisting solely of two or more nonemployee directors. For example, if the applicable requirements are met, then transfers of stock by a corporate insider to the company in order to make payments on a loan from the company would qualify for delayed reporting.

Following the recent exposures of significant volumes of undisclosed insider-issuer dispositions and pursuant to section 403 of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission has adopted new disclosure rules relating to transactions between the issuer and its officers and directors.

Prohibition on loans to executives

The Sarbanes-Oxley Act of 2002,[2030] enacted in the aftermath of the Enron bankruptcy, contains a prohibition on the provision of personal loans to executives of companies with securities registered under the Securities Exchange Act of 1934.[2031] Subject to certain exceptions, the provision prohibits such a company from directly or indirectly (including through a subsidiary) extending or maintaining credit, arranging for the extension of credit, or renewing an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of the company.

If certain requirements are satisfied, the prohibition on loans does not apply to:

[2028] 15 U.S.C. sec. 78p(a).

[2029] *See* Rule 16b-3 of the Securities Exchange Act of 1934; 17 CFR § 240.16b-3 which exempted transaction with the issuer from Rule 16(b).

[2030] Pub. L. No. 107-204 (2002).

[2031] Sec. 402(a) of the Sarbanes-Oxley Act of 2002.

- Home improvement and manufactured home loans as defined in the Home Owners' Loan Act,[2032]
- Consumer credit as defined in the Truth in Lending Act,[2033]
- any extension of credit under an open end credit plan or a charge card,[2034] or
- certain extensions of credit by a broker or dealer registered under the Securities Exchange Act of 1934 to any employee of that broker or dealer to buy, trade, or carry securities.

In order for one of these exceptions to apply, the following requirements must be satisfied. The loan must be:

- made or provided in the ordinary course of the consumer credit business of the company,
- of a type that is generally made available by the company to the public, and
- made by the company on market terms, or terms that are no more favorable than those offered by the company to the general public for such extensions of credit.

The prohibition also does not apply to loans made or maintained by an insured depository institution if the loan is subject to the insider lending restrictions of the Federal Reserve Act.

The provision is generally effective on the date of enactment of the Sarbanes-Oxley Act (July 30, 2002), but does not apply to extensions of credit maintained on that date if there is no material modification to any term of the arrangement or any renewal of the arrangement on or after that date.

Factual Background

In general

Enron did not have a general policy or program relating to executive loans. However, from time to time Enron extended loans to various executives. These loans were individually designed arrangements, and varied considerably. In Enron documents, most of the loans are described as personal loans. Interviews with current and former Enron personnel indicate that there was no single person or department that kept track of loan information, and that in some cases only one or two people within Enron may have been aware of the loan arrangements. Some of these arrangements have received considerable media attention, particularly the loans extended to Kenneth L. Lay.

[2032] 12 U.S.C. 1464(c)(1)(J).

[2033] 15 U.S.C. 1602.

[2034] These terms are as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602) and section 127(c)(4)(e) of the Truth in Lending Act (15 U.S.C. 1637(c)(4)(e), respectively).

In repose to requests for information, Enron provided to the Joint Committee staff account reconciliation statements regarding executive loans. These statements show the amount of loans, payments made, and interest accrued with respect to loans to Mr. Lay, Jeffrey Skilling, Rebecca Mark, Rodney Gray, Clifford Baxter, and Mark Frevert. These account reconciliation statements are included in Appendix D to this Report. Other documents provided by Enron describe loans to Mark Pickering, and David Oxley. The loans to each of these individuals are discussed below.[2035] The loan arrangements of Mr. Lay and Mr. Skilling are highlighted, due to the amounts involved, the position they held within Enron (both served as Chief Executive Officer at different times), and the attention garnered by the these particular arrangements. All of these arrangements were treated by Enron as loans for Federal tax purposes.

Kenneth L. Lay

On September 1, 1989, Mr. Lay entered into a loan agreement with Enron. Under the agreement, Enron provided him with a revolving line of credit in the amount of $2.5 million.[2036] Mr. Lay also received an advance of $5 million to be used to purchase shares of Enron common stock, which were used as collateral.[2037] Mr. Lay signed a promissory note and pledged as collateral certain deferral benefits under the Deferral Plan, death benefits, Enron stock granted under the 1988 Stock Plan, financed stock held by Enron, and any severance remuneration payable.[2038] Mr. Lay was responsible for paying the full amount of interest which was to accrue at the applicable Federal rate. Mr. Lay repaid the entire principal of the $2.5 million loan and the $5 million advance, plus accrued interest, in 1994.[2039]

On March 25, 1994, Mr. Lay's employment agreement was renewed to provide him with a noncollateralized,[2040] interest-bearing revolving line of credit in the amount of $4 million.[2041]

On May 3, 1999, the Compensation Committee approved an amendment to the loan agreement that allowed Mr. Lay to repay his loans with Enron stock, and the loan agreement was accordingly amended. Compensation Committee minutes indicate that the approval of the new

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[2035] All of these loan arrangements are also described in proxy materials, except those to Mr. Frevert, Mr. Pickering, and Mr. Oxley.

[2036] The 1996 proxy characterizes the line of credit as a one-time loan. The loan agreement, however, suggests that the loan was in the form of a line of credit.

[2037] The shares were pledged as collateral.

[2038] *See* Loan Commitment Agreement, September 1, 1989 (EC000752817).

[2039] The renewed employment agreement signed in 1994 provided that Mr. Lay had to pay all outstanding balances within 30 days of its execution.

[2040] The proxy statements indicate that the loan was not collateralized.

[2041] 1996 Enron Corp. Proxy Statement.

repayment option was intended as evidence of compliance with the exemption from reporting under applicable securities laws.[2042]

On August 13, 2001, the amount available to Mr. Lay under the line of credit was increased to $7.5 million.[2043] Mr. Lay resigned on January 23, 2002, with a remaining unpaid principal balance of $7.5 million. According to Enron, the total outstanding amount, plus accrued interest, is $7.794 million.[2044]

The account reconciliation statements for Mr. Lay's loans show that the aggregate amounts withdrawn pursuant to his line of credit from 1997 through 2001, was over $106 million.[2045] In 2001 alone, Mr. Lay engaged in a series of 25 transactions involving withdrawals under the line of credit. The total amount of withdrawals for 2001 was $77.525 million (of which all but $7.5 million was repaid). The account reconciliation statements also show that during 1997 through 2001, Mr. Lay repaid principal amounts of $99.3 million. Over $94 million of this amount was repaid with 2.1 million shares of Enron stock.[2046]

The Joint Committee staff sent a series of written questions to Mr. Lay's counsel, Piper Rudnick, regarding Mr. Lay's compensation arrangements. In response to a question regarding Mr. Lay's use of stock to repay loans, Mr. Lay's counsel stated that it was their understanding that in 2001 Mr. Lay drew down on the Enron line of credit and then repaid it with stock principally because he needed funds to avoid or, if unavoidable, to pay margin calls on secured lines of credit Mr. Lay had established with certain banks and brokerage firms. These lines were secured primarily by Enron stock, the price of which was falling. Mr. Lay's counsel also stated it was their understanding that, because Mr. Lay's holdings in Enron stock represented a high percentage of his liquid assets, he used Enron stock to repay the Enron loan.

[2042] Minutes of the Meeting of the Compensation Committee, at 10 (May 3, 1999).

[2043] EC2000026955.

[2044] EC002679852.

[2045] *See* Appendix D to this Report. The total outstanding principal amount at any one time varied, but did not exceed $7.5 million.

[2046] In the account reconciliation statements, the use of Enron stock to repay an outstanding loan is referred to as "swapping in" Enron stock. *See, e.g.,* EC002680500 in Appendix D.

Jeffrey K. Skilling[2047]

On October 13, 1997, Mr. Skilling's employment agreement was amended to incorporate a loan provision, allowing Mr. Skilling to borrow $4 million. Interest was to accrue at the applicable Federal rate until maturity on December 31, 2001. Under the agreement, Mr. Skilling was responsible for paying the interest. The loan agreement further provided that if Mr. Skilling remained in the employ of Enron until December 31, 2001, 50 percent of the loan principal would be forgiven. If, however, he voluntarily terminated his employment prior to that or was terminated for cause, the entire amount of the loan would become due. As collateral, Mr. Skilling pledged his Enron restricted stock and the right to receive certain deferral benefits under the 1994 Deferral Plan.[2048]

Mr. Skilling borrowed $4 million from Enron on October 23, 1997, and signed a promissory note. On May 3, 1999, the Compensation Committee approved an amendment to the loan agreement that allowed him to repay his loans with Enron stock and, on that date, he made a partial repayment in the form of $2 million worth of Enron shares.[2049] Compensation Committee minutes indicate that the approval of the new repayment option was intended as evidence of compliance with the exemption from reporting under applicable securities laws.[2050] Mr. Skilling resigned from his position (then as Chief Executive Officer of Enron) on August 14, 2001. On September 15, 2001, he repaid in cash the remaining $2 million balance due on the loan.[2051] Mr. Skilling recalled that he paid accrued interest on the loan. According to Enron, Mr. Skilling still owes $88,679 of accrued interest and payment has been requested.[2052]

[2047] Jeffrey K. Skilling was appointed President and Chief Operating Officer of Enron Corp. on December 10, 1996. Prior to his appointment as Chief Operating Officer of Enron, Mr. Skilling served as the Chairman and Chief Executive Officer of Enron Gas Services Corp. Mr. Skilling entered into several loan transactions with Enron during that time: he received a $1.4 million loan in 1991 and another $100,000 loan in 1992. The 1991 loan was collateralized with pledged personal property. In 1993, Mr. Skilling repaid the principal and interest of both loans with the proceeds of a newly-issued nonrecourse debt in the amount of $1,606,719, which was collateralized with Enron stock options and phantom equity in Enron Gas Services. The loan was repaid in full on July 1, 1993. *See* 1993 and 1994 Enron Corp. Proxy Statements.

[2048] The 1999 Enron Corp. Proxy Statement indicates that the collateral given included Enron common stock, EOG stock and 1994 Deferral Plan benefits.

[2049] EC002680500. The 1999 Enron Corp. Proxy Statement indicates that he had paid the total amount of interest that accrued until September 1998 for a total of $215,664. According to the 2000 Enron Corp. Proxy Statement, the total accrued interest for 2000 was $126,747, which was paid by Mr. Skilling.

[2050] Minutes of the Meeting of the Compensation Committee, at 9 (May 3, 1999).

[2051] Enron Corp. Account Reconciliation Officers' Loans as of September 30, 2001, EC002680504.

[2052] EC002679852.

Other executive loans

Rebecca Mark

Rebecca Mark held numerous positions with Enron, including chairman and Chief Executive Officer of Enron International, Chairman and Chief Executive Officer of Azurix, and Chairman and Chief Executive Officer of Enron Development Corp.

Ms. Mark received two loans from Enron. First, Ms. Mark received a loan in the amount of $900,000 on May 7, 1997. The loan bore interest at the mid-term applicable Federal rate and was collateralized with 24,899 shares of Enron common stock.[2053] In May 1998, the entire principal of the loan plus the accrued interest, totaling $955,343, were forgiven.[2054] The 1999 proxy statement states that the loan forgiveness was "in consideration of Ms. Mark's increased responsibilities."[2055] The precise nature of these increased duties are not described.[2056]

Second, on May 4, 1998, Ms. Mark received a loan in the amount of $2.5 million.[2057] The loan bore interest at the short-term applicable Federal rate and was collateralized with Enron stock. In the beginning of 1999, $700,000 of the principal amount was forgiven due to Ms. Mark's performance in 1998. In February 1999, Ms. Mark repaid $550,000 on the loan.[2058] The remaining amount of $1.25 million as well as the accrued interest (in the amount of $171,099) was repaid by February 25, 2000.[2059]

[2053] 1998 Enron Corp. Proxy Statement, at 26. As of December 1997, accrued interest totaled $37,367. *Id.*

[2054] 1999 Enron Corp. Proxy Statement, at 25.

[2055] *Id.*

[2056] *Id.* Enron Corp. billed $450,000 of the loan amount to Enron International and amortized the remaining $450,000 plus the relevant portion of the accrued interest during 2000. *See* Account Reconciliation of Officer's Loans Chart as of December 31,2000 (EC001709350). It is noted on the chart that Enron Corp. would attempt to shift the remaining $450,000 to Water Co., and would write it off before year-end if it did not succeed.

[2057] According to the 1999 proxy statement, the loan was issued "due to revised vesting provisions that triggered constructive receipt for tax purposes." 1999 Enron Corp. Proxy Statement, at 25.

[2058] According to Enron, on the same date Ms. Mark paid $206,150 representing taxes on the $700,000 that was forgiven. EC002679704.

[2059] 1999 Enron Corp. Proxy Statement, at 25. (EC001709350).

Enron said that it reported both amounts forgiven as income on Ms. Mark's Form W-2.[2060]

Richard Kinder

Pursuant to his 1989 employment agreement, Richard Kinder received an advance of $3 million to purchase shares of Enron Corp. common stock,[2061] and a loan in the amount of $1.5 million. The loan and advance were to mature on February 8, 1999.[2062] In February of 1994, Mr. Kinder's employment agreement was renewed to provide that if he and Enron would "not be able to reach mutually satisfactory terms relating to his future employment," the loan and the advance would be forgiven.[2063] In November of 1996, Mr. Kinder entered into an agreement with Enron whereby he would resign from his position as an officer and director of Enron effective December 31, 1996, and would terminate his employment with Enron effective February 15, 1997. The outstanding principal and interest balances on his loan and advance -- totaling $3.8 million -- were forgiven as of February 7, 1997.[2064]

Rodney Gray

Rodney Gray received a loan from Enron in the amount of $250,000 on August 1, 1994. Enron Corp. common stock was pledged as collateral and Mr. Gray was responsible for payment of interest, which accrued at the applicable Federal rate.[2065] Mr. Gray terminated employment as an executive officer with Enron in November 1997. According to documents provided by Enron, Mr. Gray repaid the loan on August 24, 1999.[2066]

Clifford Baxter

Clifford Baxter received a loan from Enron in the amount of $200,000 on September 15, 1995. The loan bore interest at the short-term applicable Federal rate. According to the terms of the loan agreement as described in proxy materials, if Mr. Baxter remained employed by Enron

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[2060] EC002680476.

[2061] The stock was pledged as collateral. 1996 Enron Corp. Proxy Statement, at 21.

[2062] *Id.* at 21-22.

[2063] *Id.*

[2064] 1997 Enron Corp. Proxy Statement, at 25. A former member of the Board of Directors of Enron told the Joint Committee staff that Mr. Kinder had anticipated succeeding Mr. Lay as Chief Executive Officer, and that when that failed to occur, Mr. Kinder resigned.

[2065] *Id.* at 24.

[2066] EC002680449. According to the 1997 and 1998 proxy statements, Mr. Gray made interest payments of $15,426 in 1996 and $15,874 in 1997. 1997 Enron Corp. Proxy Statement, at 24; 1998 Enron Corp. Proxy Statement, at 26.

during March 15, 1996, and March 15, 1997, 50 percent of the loan would be forgiven on each date. In 1996, $100,000 of the principal was forgiven[2067] and in 1997 the remaining balance was forgiven.[2068]

Mark Frevert

Enron filings with the bankruptcy court indicate that Enron made a $2 million loan to Mark Frevert.[2069] Documents provided by Enron indicate that this loan was made in October 2001, the loan bore interest at the applicable Federal.[2070] According to Enron, the loan is still outstanding and repayment has been requested. The outstanding amount, including principal and interest is $2.093 million.

Mark Pickering

According to documents provided by Enron as well as interviews with Enron employees, Enron made a loan to Mark Pickering in connection with his relocation to the United States. It was explained that because Mr. Pickering had no credit in the United States, he was required to pay a substantial down payment on the purchase of a home and that Enron loaned him the money for this reason. The loan was made on June 13, 2001, for $400,000 and, according to Enron, is still outstanding.[2071]

David Oxley

According to information provided by Enron, a loan was made to David Oxley[2072] on August 15, 2001, in the amount of $500,000. The loan agreement provided that the loan was to

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[2067] 1997 Enron Corp. Proxy Statement, at 24-25.

[2068] 1998 Enron Corp. Proxy Statement, at 26-27. According to the 1997 and 1998 proxy statements, Mr. Baxter paid the accrued interest on the loan, totaling $6,000 in 1996 and $5,788 in 1997. 1997 Enron Corp. Proxy Statement, at 25; 1998 Enron Corp. Proxy Statement, at 27. While a loan to Mr. Baxter was described in proxy statements, in response to request for information made by the Joint Committee staff, Enron stated that current staff was unable to determine what loans were made to Mr. Baxter, and that there may have been two loans. EC002679704; EC002680476.

[2069] *In re Enron Corp.*, Case No. 01-16034, Statement of Financial Affairs, Exhibit 3b.2 (Payments to Insiders).

[2070] EC000752675.

[2071] EC002679704; EC002679766.

[2072] According to a services agreement entered into between Enron and Mr. Oxley on August 28, 2000, 2001, he was Vice President of Enron Europe Limited. EC002679832-844. Pursuant to an amendment to the services agreement dated November 28, 2001, his agreement was assumed by Enron North America and he was placed on the payroll of Enron North America. Assignment and Second Amendment Agreement, EX002679848.

be repaid within 120 days.[2073] On November 28, 2001, the services agreement between Mr. Oxley and Enron was amended to provide that the loan would be forgiven if: (1) Mr. Oxley remained employed by Enron until February 5, 2002; or (2) if earlier, Mr. Oxley were terminated involuntarily before February 5, 2002.[2074] The loan was forgiven on November 29, 2001.[2075]

Discussion of Issues

Although Enron had no formal policy regarding loans, there was a practice of making loans, particularly to key executives. Not counting the loans to Mr. Lay, Enron made loans to eight executives totaling over $17 million. Enron forgave over $6 million of these loans, including both principal and interest.

The loans to Mr. Lay stand out from the others by virtue of the total amount involved over time. The structure of his loans was also different. In other cases the loans, even if characterized as a line of credit, involved lending on single occasions, whereas Mr. Lay engaged in a series of transactions in which he borrowed, repaid, and borrowed again. As described above, the total amount withdrawn by Mr. Lay under his line of credit was over $106 million (over $77 million of which was in 2001 alone). During the period 1999-2001, Mr. Lay used stock to repay a portion of his loans; a total of over 2 million shares of Enron stock with a total value of $94.267 million was given to Enron as repayment for loans.

The loans made by Enron to employees raise both tax and nontax questions. From a Federal income tax perspective, Enron treated all these arrangements as loans for Federal tax purposes. That is, no amount was reported as income with respect to the loans, unless the loan was forgiven. A key issue raised by the various loans to Enron executives is whether certain loans should have been treated as compensation to the executive rather than a loan. The arrangements all carried the indicia of loans; there was generally a loan agreement and/or promissory note, interest was accrued (and in some cases paid), and in some cases there was collateral for the loan. Two aspects of the various loans raise the question of whether the loans were in fact compensation when entered into: (1) loan agreements that provide that the loan will be forgiven if the executive works for a specified period of time; and (2) forgiveness of loans (without an explicit forgiveness clause in the loan).

Two loans reviewed by the Joint Committee staff, one of Mr. Skilling's loans and a loan to Mr. Baxter, contained provisions providing that if the executive remained with Enron until a specified date, the loan would be forgiven.[2076] Mr. Baxter remained employed until the date specified in his agreement and, as a result, a $200,000 in indebtedness was forgiven. Mr.

[2073] Loan Agreement between Enron North America Corp. and David Oxley (EC002679827-831).

[2074] First Amendment to the Services Agreement, at 2 (EC002679845-847).

[2075] EC002680476; EX002679849.

[2076] As described above, Mr. Baxter's loan agreement provided for forgiveness in two stages.

Skilling did not remain with Enron until the date specified in his loan agreement, and he repaid the loan, with interest, after leaving Enron.

As described above, income results to the executive when a loan is forgiven. However, these loans raise the question of whether they were really in the nature of compensation for services and should have been treated as taxable compensation when entered into. It can be argued that the loan is to be satisfied solely from the performance of future services, and therefore is really compensation for services. From a factual standpoint, at the time the loan was made, the arrangement is not unlike the pre-bankruptcy bonuses paid by Enron in November 2001, which required the employee to repay the bonus, with a 25 percent penalty, if the employee did not remain with Enron for a certain period of time. These bonuses were treated by Enron as compensation and were subject to withholding.

In other cases, Enron forgave loans to executives when the loan agreement did not require forgiveness. Loans to Ms. Mark and Mr. Kinder were of this type. In these cases, the question is whether the forgiveness was contemplated at time of the agreement, which would cast doubt on the intent of the parties to enter into a loan. In order for these arrangements to be considered compensation, it would have to be shown that it was the understanding of the parties that repayment was not in fact anticipated.

In addition to tax issues raised, the loan transactions also raise questions of corporate governance. In particular, some view the use of loans, particularly when substantial amounts are involved over time or in particular instances, as a use of corporate funds for personal purposes. From this perspective, some argue that such loans are inappropriate. This view is reflected in the prohibition on executive loans contained in the Sarbanes-Oxley Act.

The use of stock to repay loans also raises corporate governance issues. Some commentators have argued that Enron executives used stock to repay loans in order to take advantage of exceptions to securities laws reporting requirements, thereby allowing the executives to defer reporting on sales of Enron stock during the months before the Enron bankruptcy. As described above, the loan agreements for Mr. Lay and Mr. Skilling were amended in 1999 to allow for payment with the use of stock; the changes were specifically structured to come within the reporting exceptions.

Recommendations

The Sarbanes-Oxley Act contains a prohibition on executive loans. If this prohibition had been in effect in prior years, it is likely that the loans reviewed by the Joint Committee staff in this case would not have been made. Thus, the Joint Committee staff is not recommending further legislative changes at this time.

4. Purchase and reconveyance of Kenneth L. Lay's annuity contracts

Present Law

Taxation of annuity contracts

In general

Present law provides favorable tax treatment for annuity contracts held by individuals. While no deduction is allowed for the purchase of an annuity contract, income credited to an annuity contract (i.e., "inside buildup") generally is not currently includible in the gross income of the owner of the contract. The extent to which payments received under the contract are includible in gross income depends on when the payments are received and the taxpayer's investment in the contract.[2077]

In general, for amounts received as an annuity, an "exclusion ratio" is provided for determining the taxable portion of each payment.[2078] The portion that represents recovery of the taxpayer's investment in the contract is not taxed. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Each annuity payment is multiplied by the exclusion ratio, and the resulting portion of each payment is treated as nontaxable recovery of the investment in the contract. Once the taxpayer has recovered his or her investment in the contract, the entire amount of all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract.

Amounts not received as an annuity generally are included in income if received on or after the annuity starting date. If amounts not received as an annuity are received before the annuity starting date, such amounts generally are included in income to the extent allocable to income on the contract (i.e., as income first).

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59-1/2, made after the owner dies or becomes disabled, made in the form of certain periodic payments, or that satisfies certain other requirements.

[2077] Sec. 72. Section 72 uses the term "investment in the contract" in lieu of the general tax notion of basis. Investment in the contract is defined (as of the annuity starting date) as the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount already received under the contract (to the extent it was excludable from income).

[2078] Special rules apply to variable annuity contracts. Treas. Reg. sec. 1.72-4(d)(3).

Annuities held by nonnatural persons

In general, if an annuity contract is held by a person that is not a natural person, such as a corporation, then the income on the contract is treated as ordinary income currently received or accrued during the taxable year. Thus, under this rule, no deferral is permitted to the holder of the contract. The contract is not treated as an annuity contract for Federal income tax purposes (except with respect to the insurance company issuing the contract).[2079]

Sale or disposition of annuity contracts

In general, a sale or disposition of an annuity contract is subject to the normally applicable gain recognition rules. That is, the seller of the contract recognizes gain to the extent that the amount received for the contract exceeds his or her investment in the contract. A number of courts have held that gain on the sale of an annuity contract is taxed as ordinary income to the seller.[2080] In general, if an annuity contract is transferred by an individual for less than full and adequate consideration, the individual is treated as receiving the difference between the cash surrender value of the annuity over the investment in the contract as an amount not received as an annuity.[2081]

Receipt of property for services

Property transferred in connection with the performance of services generally is includible in gross income of the person performing the services for the year in which the service provider's right to the property is either transferable or is not subject to a substantial risk of forfeiture.[2082] The amount includible is the excess of the fair market value of property received in connection with the performance of services over the amount, if any, paid for the property.

[2079] Sec. 72(u). For purposes of this rule, the holding an annuity contract by a trust or another entity as an agent for a natural person is not taken into account. Section 72(u) provides several narrow exceptions to the rule of inclusion in the case of an annuity contract that: (1) is acquired by the estate of a decedent; (2) is held under certain types of retirement plans or arrangements; (3) is a qualified funding asset for a structured settlement arrangement; or (4) is purchased by an employer upon termination of certain types of retirement plans and meets certain other requirements.

[2080] *First National Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962); *Roff v. Commissioner*, 304 F.2d 450 (3rd Cir. 1962); *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960).

[2081] Sec. 72(e)(4)(C).

[2082] Sec. 83. Under a special rule, if property is either nontransferable or is subject to a substantial risk of forfeiture when transferred, the service provider may elect within 30 days to apply section 83 as of the time of the transfer.

The person for whom the services were performed is entitled to a deduction equal to the amount includible in the service provider's gross income[2083] (subject to the $1 million cap on the deductibility of executive compensation).[2084] The deduction generally is allowable in the taxable year in which the amount is included in the income of the person performing the services. If the property is substantially vested upon transfer, the deduction is allowable in accordance with the method of accounting used by the taxpayer.[2085]

Factual Background

On September 14, 2001, the Compensation Committee of the Enron Board of Directors approved what the Committee minutes[2086] refer to as an "insurance swap transaction" as part of the compensation to be provided to Mr. Lay in connection with the resumption of his duties as Chief Executive Officer following the resignation of Mr. Skilling in August of 2001.[2087] According to documents provided by Enron, this transaction involved two annuity insurance contracts that had been purchased by Mr. Lay and his wife, one in each of their names. Mr. Lay's contract was purchased on September 30, 1999, and Mrs. Lay's contract was purchased on February 8, 2000. The contracts were to mature after approximately 30 years. As stated in the contracts, the initial premium made on each of the contracts was $2.5 million.[2088]

Under the transaction,[2089] Enron purchased the annuity contracts from the Lays for $5 million each (a total of $10 million)[2090] and also agreed to reconvey the annuity contracts to Mr.

[2083] Sec. 83(h).

[2084] Sec. 162(m).

[2085] Treas. Reg. sec. 1.83-6(2).

[2086] Minutes of the Meeting of the Compensation and Management Development Committee, September 14, 2001, at 4. EC2 000026740-41.

[2087] Mr. Skilling became Chief Executive Officer in February 2001. Prior to that time, Mr. Lay was both Chairman of the Board and Chief Executive Officer. When Mr. Skilling became Chief Executive Officer, Mr. Lay retained the title of Chairman.

[2088] Mrs. Lay's insurance contract is EC 000897921-50. Mr. Lay's is EC 000897964-99. Other internal Enron documents indicate that the amount of the initial investment was $5 million for each contract. "Inter Office Memorandum to Annuity Contracts, Liquidation for Compensation - Tax Issues, September 25, 2001," EC 002680472.

[2089] Documents regarding the transaction were executed by the Lays and Enron on September 21, 2001. Purchase, Sale, and Reconveyance Agreement, EC 000752808-814.

[2090] Information provided to Joint Committee staff indicated that Mr. Lay and Mrs. Lay each had a $5 million basis in their respective contracts. However, it is not clear from reviewed documents whether the Lays made payments in addition to the initial $2.5 million payments.

Lay if he remained employed with Enron through December 31, 2005.[2091] If Mr. Lay were to leave Enron prior to that date, reconveyance still would take place on the occurrence of one of four events: (1) retirement with the consent of the Board; (2) disability; (3) involuntary termination (other than a termination for cause); or (4) termination for "good reason."[2092] If Mr. Lay were to leave Enron prior to December 31, 2005, for a reason other than those provided, then Enron would have no further obligation to Mr. Lay with respect to the annuity contracts. The agreement regarding the transaction also provided that if either of the Lays died while Enron owns the contracts and continues to have a potential obligation to reconvey them to Mr. Lay, Enron will pay all proceeds received under the contracts to Mr. Lay if the decedent is Mrs. Lay and to Mr. Lay's estate if he is the decedent.

At the September 14, 2001, meeting, the Compensation Committee was presented with two different possible transactions involving the annuity contracts.[2093] The first alternative was the one adopted by the Committee. The second was the same as the first, except that the contracts would be purchased for their current market value (for a total of $4.691 million for both contracts combined). Both alternatives indicated that the Lays' basis in the contracts was $5 million each (for a total of $10 million) and that the current floor value of the policies was a total of $11.240 million. The presentation included a comparison of the each alternative with providing Mr. Lay with additional Enron stock, in terms of issues for Enron (deductibility of the payment, dilution to common shares outstanding, and taxes) and issues for Mr. Lay (liquidity at various time frames and vesting).

In addition to the material presented at the Compensation Committee meeting, the Committee requested a letter from Towers Perrin regarding the transaction. The letter is dated November 2, 2001, and states that it reflects discussions with Enron that occurred prior to the date of the Committee meeting.[2094] The letter indicates that the transaction grew out of a desire

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[2091] Technically, only one of the annuity contracts would be reconveyed. The contract originally owned by Mrs. Lay would be not be reconveyed to her but conveyed to Mr. Lay. The term a "reconveyence" is used here because that is how the transaction is described in the relevant agreements.

[2092] "Good reason" is defined by reference to Mr. Lay's employment contract, and generally refers to a constructive termination by reason of the occurrence of certain events, such as a change in his duties or a material reduction in salary without his consent.

[2093] Attachment to Minutes of the Meeting of the Compensation and Management Committee, (Sept. 14, 2001). Committee meeting minutes indicate that this analysis was presented by employees of Enron, and was prepared in consultation with lawyers at Vinson & Elkins and others. Mr. Lay was present while the proposed transaction was being discussed, but was reported as not present when the decision to go forward with the transaction was made. Minutes of the Meeting of the Compensation and Management Committee, at 4 (EC 2000026740) (Sept. 14, 2001).

[2094] Letter from Charles E. Essick, Principal, Towers Perrin to Dr. Charles A. LeMaistre (Nov. 2, 2001). EC 000897960-EC 000897961.

by Enron to provide an incentive for Mr. Lay to remain with Enron for a period of years. Members of the Compensation Committee also indicated in interviews with the Joint Committee staff that the motivation for the transaction was to provide a retention device. The documents executed in connection with the transaction also state that Mr. Lay's services have been and are expected to be of substantial value to Enron and that Enron wishes to encourage Mr. Lay to remain in the employment of Enron.

The Towers Perrin letter states that a retention incentive typically is handled by issuing restricted stock, but that Mr. Lay had indicated that he currently had large holdings in Enron stock and wanted more liquidity. The letter makes a number of points with respect to the transaction. First, the letter states that the transaction, while involving a current cash flow drain for Enron, will be beneficial to Enron overall because the $10 million payment to the Lays for the contracts is less than the current net present value floor value of the contracts of $11.240 million. That is, the letter indicates that the fair value of the contract is more than $10 million. Second, the letter states that the feature of the arrangement which allows Mr. Lay to earn the contracts back over four years is similar to the way a restricted stock award would be structured and thus should serve as a similar retention device.[2095] Third, the letter recommends that because the arrangement is in lieu of restricted stock, the $10 million value of the payment to Mr. Lay should be subtracted from future stock or stock option awards that would otherwise be granted to Mr. Lay over the next four years (at a rate of $2.5 million per year).[2096] Finally, the letter states the understanding that an alternative structure that was suggested was to pay Mr. Lay a cash signing bonus and to purchase his annuity, but not his wife's. The letter concludes that the structure adopted by the Committee is preferable to this alternative because it provides a meaningful retention incentive.

As of January 23, 2002, Mr. Lay was no longer with Enron. Thus, whether he is entitled to have the annuity contracts reconveyed to him depends on whether his termination meets the requirements as set forth in the agreement with the Enron. It is unclear whether the contracts have been or will be reconveyed to Mr. Lay. During the course of interviews, the Joint Committee staff was informed by counsel for former Compensation Committee members that the issue of whether Mr. Lay was entitled to receive the annuity contracts given the terms of his departure was under review by Enron and various legal counsel. At the time of publication, Enron stated it was unable to give the Joint Committee staff any further information regarding the status of the annuity contracts and whether they had been or would be reconveyed to Mr. Lay.

[2095] The letter refers to Mr. Lay as being able to "earn back the annuities over 4 years." This phraseology implies that Mr. Lay earned the contracts back ratably over the 4-year period, much as restricted stock might vest over a period of years. However, under the terms of the purchase, sale, and reconveyance agreement, Mr. Lay had no rights with respect to the annuity contracts unless he stayed through December 31, 2005 (or was terminated before then for one of the stated reasons).

[2096] The letter states that the Compensation Committee agreed to this reduction. However, the minutes from the meeting at which the transaction was approved do not mention this transaction. Thus, it is not clear whether this was the intent of Enron at the time.

The Joint Committee staff submitted written questions to Mr. Lay's counsel, Piper Rudnic, regarding his compensation arrangements. As part of these questions, the Joint Committee staff asked if the annuity contracts had been reconveyed to Mr. Lay (or if they would be) and, if they had been reconveyed, when this occurred. Mr. Lay's counsel did not respond directly to the question, but stated that "We are not in a position to give a legal opinion about the current status of the annuity contracts." They also stated their understanding that the characterization of Mr. Lay's termination for purposes of severance benefits was still under review.

Discussion of Issues

The purchase and reconveyance arrangement involving the Lays' annuity contracts can be analyzed both from the perspective of whether it would accomplish the stated objective of the arrangement, and from a Federal income tax perspective.[2097]

As described above, the stated purpose of the arrangement was to provide an attractive retention package to Mr. Lay upon his resumption of duties as Chief Executive Officer. The total range of options considered by Enron is not clear, but appears to have included (1) giving Mr. Lay a $5 million cash bonus, and purchasing and possibly reconveying one of the Lays' annuity contracts to Mr. Lay, and (2) the issuance of restricted stock. The first alternative would have provided a retention incentive but arguably not as significant an incentive as the arrangement Enron approved, because the value of the conditional benefit under the first alternative was less (i.e., the value of one annuity contract versus the value of both the annuity contracts). The use of restricted stock, an arrangement frequently used by Enron, would provide a retention incentive, but was not attractive to Mr. Lay because of his interest in more liquidity in his financial portfolio. Thus, the purchase and reconveyance arrangement provided liquidity to Mr. Lay, as well as serving as a more significant retention incentive.

In addition to other perceived benefits, from a tax perspective, use of the annuity purchase and reconveyance arrangement had advantages both for Enron and Mr. Lay when compared to other arrangements considered by Enron. The tax effects can be analyzed separately for the purchase aspect of the transaction and the reconveyance.

The purchase of the annuity contracts had current tax advantages for Mr. Lay compared to payment of a cash bonus (or any arrangement including a cash bonus). If he had been paid a cash bonus, the amount of the bonus would have been currently includible in gross income and subject to employment taxes. On the other hand, Mr. Lay would recognize gain on the sale of the annuity contracts to Enron only to the extent the amount received exceeded the Lays' basis in the contracts.

[2097] The focus of the Joint Committee staff review is Enron, not individuals. Thus, examination of the Federal tax consequences to the Lays arising from this transaction is beyond the scope of this review. Some general discussion is provided in order to give a full picture of the transaction.

Viewing the tax consequences of the purchase of the annuity contracts compared to payment of a cash bonus from Enron's perspective, as a practical matter, no deduction would be allowable with respect to either type of transaction. Enron would not be entitled to a deduction for the amount of the cost of the contracts; the amount paid would be basis in the contracts. If Enron paid a cash bonus, given Mr. Lay's total compensation package, the bonus would not be deductible due to the $1 million dollar cap on deductibility of compensation of certain executives.[2098] A key difference, however, is that if a cash bonus had been paid, Enron would be liable for its share of employment taxes;[2099] no employment taxes would be due as a result of the purchase of the annuity contracts. Another important difference is that, as a nonindividual holder of annuity contracts, Enron would be required to include in income each year the amount of the income on the contracts. This income inclusion would apply as long as Enron held the contracts. Thus, from Enron's perspective the current tax consequences of the annuity purchase and reconveyance arrangement were less favorable than the payment of a cash bonus or the payment of restricted stock.

The use of restricted stock would have provided some tax advantage to Mr. Lay compared to an arrangement involving a cash bonus, depending in part on the specifics of the arrangement. In general, restricted stock is includible in gross income when no longer subject to a substantial risk of forfeiture. Thus, for example, if Enron had granted Mr. Lay $10 million of restricted stock that vested over four years, the value of one fourth of the stock would be includible in income in each year (and subject to employment taxes). This is more favorable to Mr. Lay from a tax perspective than a current payment of $10 million, but less favorable than the annuity purchase arrangement agreed to by Enron which would result in income in excess of basis.

If restricted stock had been used, Enron theoretically would have been entitled to a compensation deduction when the stock was includible in Mr. Lay's income. However, as with a cash bonus, the deduction likely would be limited by the $1 million cap on deductibility of executive compensation.

With respect to whether Enron treated the purchase properly from a tax perspective, a key issue is whether Enron paid fair market value for the contracts. If Enron paid the Lays more than the fair market value for the contracts, then the question would arise as to whether the excess of the amount paid over such value was disguised compensation. If so, Enron would have had employment tax obligations.[2100] According to documents provided by Enron, three different purchase price alternatives were presented to the Compensation Committee: (1) a total of $4.692 million, which was described as the market value of the contract investments; (2) a total of $10 million, which was described as the Lays' basis in the contracts; and (3) a total of $11.240

[2098] Sec. 162 (m).

[2099] There is no dollar cap on the amount of compensation subject to the Hospital Insurance (Medicare) portion of employment taxes.

[2100] There also could be tax consequences for the Lays.

million, which was described as the net present value floor value of the annuities (i.e., the minimum amount the annuities were expected to be worth at maturity).[2101]

While the documents supplied by Enron do not clearly indicate a fair market value, the net present value floor value appears to represent the current value of the future payments in the policy. If this is accurate, the amount paid by Enron did not exceed the fair market value of the contracts, and there would be no question as to whether some amount should have been treated as taxable compensation.

If the annuity contracts are reconveyed to Mr. Lay, then the fair market value of the policies should be treated as compensation by Enron for reporting purposes, and would be subject to withholding and employment taxes. Enron's deduction would be limited by the $1 million cap on the deduction of executive compensation.[2102]

5. Split-dollar insurance arrangements

Present Law

Background

Overview

The term "split-dollar life insurance" refers to splitting the cost and benefits of a life insurance contract. The cost of premiums for the contract often is split between two parties. One party typically pays the bulk of the premiums, and is repaid in the future from amounts received under the contract. The other party often pays a small portion of the premiums, but has the right to designate the recipient of the bulk of the benefits under the contract. This type of arrangement transfers value from one party to the other party.

Split-dollar life insurance arrangements have been used for several purposes. A principal use has been by employers to provide low-cost life insurance benefits or to provide funds for other compensatory benefits (such as nonqualified deferred compensation) for employees on a tax-favored basis. Split-dollar life insurance arrangements are also used in other contexts. For example, such an arrangement can be used to fund a buy-sell agreement between shareholders or owners of a business, or to provide estate liquidity (sometimes with a trust as the owner of the contract).

The type of life insurance generally used in a split-dollar life insurance arrangement is referred to as whole life insurance. This does not refer to the period for which the insurance contract is in effect, but rather, to the fact that the contract has a "cash value," as well as providing a death benefit upon the death of the insured person. The cash value arises because the premiums paid to the insurer for the contract are invested, and some of this investment income is

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[2101] Attachment in the Minutes of the Compensation and Management Committee, at 7-8 (Sept. 14, 2001). EC 000026744 - EC 000026750.

[2102] Sec. 162(m).

credited to the contract. The amount of the future death benefit payable under the contract is funded both by premium payments and by investment earnings on the premium payments. The amount of the cash value at any point in time generally is the sum of the premiums paid plus the earnings on premiums that are credited to the policy, reduced by the cost of death benefit coverage for the current period, fees, and other charges imposed by the insurer. The amount of the cash value generally is zero or small at first, and increases over the duration of the contract.

The cash value of a whole life insurance contract may be borrowed or withdrawn by the contract holder (reducing the amount that will be paid as a death benefit under the contract). A whole life insurance contract can be contrasted with a term life insurance contract, which pays a death benefit upon the death of the insured person, but has no cash value. Under a term life insurance contract, the death benefit coverage applies only for a set term (e.g., one year or five years), and the premium payments are set at a level to fund the death benefit only during that period. The contract holder does not have the right to borrow or withdraw cash under a term life insurance contract, because it has no "cash value."

Methods for splitting the cash value and death benefits of a life insurance contract

The benefits that are split under a split-dollar life insurance arrangement generally are the death benefit (the amount paid upon the death of the insured person) and the cash value (which includes the earnings under the contract). Because the arrangement is by contract, the parties can split these features of the life insurance contract in whatever manner they agree upon. Over the past 50 years, a variety of split-dollar life insurance products have been developed.

One form of split-dollar life insurance arrangement is known as the endorsement method. Under this arrangement, as applied, for example, between an employer and an employee, the employer is the owner of the contract and pays the bulk of the premiums. The employee generally is the insured person, and pays a smaller amount of the premiums. The employer endorses over to the employee the right to designate the beneficiary of the death benefit under the contract. The employer's premium payments are repaid from the cash value of the contract or from the death benefit when the insured employee dies. Under some arrangements, ownership of the contract is turned over, or "rolled out," to the employee at a contractually agreed time, such as upon retirement, after the employer has recouped its premium payments.

Another common type of split is referred to as the collateral assignment method. Under this arrangement, as applied, for example, between an employer and an employee, the employee (or sometimes a trust he or she establishes) owns the policy and pays the premiums with amounts loaned by the employer, assigning the life insurance contract as collateral for the loans. The employer has the right to the portion of the cash value of the contract funded by its premium loans, but the employee (or trust) has the right to designate the beneficiary of the death benefits. The employee (or trust) may also have the right to the portion of the cash value of the contract that exceeds the employer's share of the cash value, if any.

Other types of splits, in which ownership of the cash value, the right to death benefits, or both, are split between the parties (e.g., between the employer and employee (or trust)), are also possible. Arrangements in which the cash value is split between the parties are sometimes referred to as equity split-dollar arrangements. Another variation, sometimes referred to as a

reverse split-dollar arrangement, is created when the owner of the contract and its cash value is the employee; the employee pays premiums with amounts loaned or reimbursed by the employer. The employee endorses or assigns to the employer the right to the death benefit under the contract, and perhaps also a portion of the cash value.

Tax treatment of split-dollar life insurance arrangements between employer and employee

Transfers of property to employees

Under present law, compensation of an employee generally is included in the employee's income when it is received (or constructively received). If property is transferred to a person in connection with the performance of services, the fair market value of the property (reduced by the amount, if any, that is paid for the property) generally is included in income at the time the interest in the property is transferable, or is not subject to a substantial risk of forfeiture (whichever is sooner).[2103]

Life insurance

Present law provides that no Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup"). Amounts paid by reason of the death of the insured under the contract ("death benefits") are also generally excluded from income of the recipient.[2104]

Other favorable rules apply to amounts paid out or borrowed under a life insurance contract. Distributions from the contract prior to the death of the insured generally are taxed only to the extent they exceed the taxpayer's investment in the contract; that is, the distributions are first treated as tax-free recovery of the investment in the contract, and then the excess is included in income.[2105]

[2103] Sec. 83. The rules of section 83 are discussed in greater detail in Parts III.C.1. and III.C.2.

[2104] Sec. 101(a). An exception is provided to this general rule of exclusion for death benefits, in the case of a transfer of a life insurance contract for valuable consideration. The amount of the death benefit includible in the beneficiary's income under this exception is the amount that exceeds the premiums and other consideration paid for the contract by the transferee. However, this rule of inclusion does not apply in certain cases, including when the transfer is to the insured or to a corporation in which the insured is a shareholder or officer. Sec. 101(a)(2).

[2105] Sec. 72. These favorable distribution rules do not apply to certain types of high-initial-premium policies (those funded more rapidly than seven annual level premiums); for those contracts, known as modified endowment contracts, distributions (and loans) are treated as income first, then tax-free recovery of investment in the contract.

Present law provides that no deduction is allowed for premiums on any life insurance contract if the taxpayer is directly or indirectly a beneficiary under the contract.[2106]

1960s rulings: cost of current term insurance protection

Until 2001, IRS guidance as to the Federal income tax treatment of split-dollar arrangements was limited. In the 1960s, the IRS published rulings[2107] providing that the amount includible in an employee's income under a split-dollar insurance arrangement is the cost of current term insurance protection (less the amount, if any, paid by the employee). Any policyholder dividends paid to, or benefiting, the employee are also includible in income.

In determining the cost of current term insurance protection, the employee may use either the cost as determined under an actuarial table known as the "P.S. 58 table," or the insurer's published rates for one-year term life insurance coverage. This election arguably permitted the parties to the arrangement to choose the lower rate for determining the amounts includible in the employee's income, or the higher rate for determining the employer's share (as in a reverse split-dollar arrangement).

Notice 2001-10: loan or compensation

In January 2001, the IRS issued Notice 2001-10.[2108] It provided interim guidance for the tax treatment of split-dollar life insurance, including types of split-dollar life insurance arrangements between an employer and employee in which the employee has an interest in the cash value of the contract (equity split-dollar arrangements) that were not addressed by the 1960s rulings. The IRS has issued subsequent guidance that continues to apply the general concepts of Notice 2001-10.

Notice 2001-10 provided that the IRS generally would accept the parties' characterization of a split-dollar life insurance arrangement in either of two ways. The first way is to treat the employee as the owner of the contract, and treat the employer's payments for premiums as loans to the employee. Foregone interest on the loans is included in the employee's income under the rules of present law.[2109]

The second way is to treat the employer as owning the contract by reason of paying its share of premiums. The employee includes compensation income equal to the value of the life insurance protection. This approach is similar to the requirement under the 1960s rulings that the cost of current insurance protection be included in income. Notice 2001-10 also specifically provided that the present-law rules taxing transfers of property to employees[2110] apply to split-

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[2106] Sec. 264(a)(1).

[2107] Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12.

[2108] 2001-5 I.R.B. 459, Jan. 9, 2001.

[2109] Sec. 7872.

[2110] Sec. 83.

dollar life insurance arrangements in which the employer transfers the cash value of the life insurance contract to the employee. If the contract is "rolled out" to the employee, he or she would generally include the cash value in income at that time.

Notice 2001-10 provided a new table, Table 2001, to replace the P.S. 58 table for valuing the cost of current life insurance protection. The Notice also provided that, after 2003, taxpayers would no longer be permitted to choose to determine the value of current life insurance protection by using the insurer's lower published premium rates (as under the 1960s rulings). Rather, if an insurer's published premium rate were used for this purpose, it would have to be a premium rate at which the insurer regularly sells term insurance (so long as the insurer does not more commonly sell standard-risk term insurance at higher premium rates).

Notice 2002-8

A year after Notice 2001-10 was issued, it was revoked by Notice 2002-8.[2111] Notice 2002-8, however, applies the general concepts of the earlier Notice, and provides that Table 2001 generally applies for valuation purposes for arrangements entered into after January 28, 2002 (the date Notice 2002-8 was issued). It also provides that for valuation purposes under arrangements entered into after January 28, 2002, the taxpayer may continue to choose the insurer's lower published premium rates; however, for such arrangements, after 2003, these rates must be rates at which the insurer regularly sells term insurance (not just published rates).

Notice 2002-8 specifically provides that the proposed regulations addressing the Federal tax treatment of split-dollar life insurance arrangements will be effective for arrangements entered into after the date of publication of final regulations.

Proposed split-dollar life insurance regulations

In general.--The IRS issued proposed regulations on split-dollar life insurance arrangements on July 5, 2002.[2112] The proposed regulations provide guidance on the income, employment, and gift tax treatment of split-dollar life insurance arrangements. Somewhat like the earlier notices, the proposed regulations generally provide two mutually exclusive regimes for taxing split-dollar arrangements, one taking an economic benefit approach,[2113] and the other applying loan treatment.[2114]

A central feature of the proposed regulations is to treat one party as the owner of the policy, even if more than one party has an interest in the policy. Whether the split-dollar arrangement comes under the economic benefit approach or the loan approach generally depends

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[2111] 2002-4 I.R.B. 398.

[2112] REG-164754-0, July 5, 2002. Regulations are proposed under Code sections 61, 83, 301, 1402, 7872, 3121, 3231, 3306, and 3401.

[2113] Sec. 61.

[2114] Sec. 7872 (or secs.1271-1275, if the loan is not below-market).

on which party is considered the owner. The loan approach generally applies if the party who is not the owner is making payments (premiums) and is reasonably expected to be repaid from the contract's cash value or death benefits. Otherwise, the economic benefit approach generally applies for income, employment, and gift tax purposes.

The preamble to the proposed regulations states that the economic benefit approach generally will govern endorsement split-dollar arrangements, and the loan approach generally will govern collateral assignment split-dollar arrangements.[2115] Special rules provide that the economic benefit approach always applies to a split-dollar arrangement in connection with the performance of services if the service provider's only benefit is current life insurance protection (a "non-equity" split dollar arrangement).[2116] The economic benefit approach applies to certain "non-equity" collateral assignment arrangements (if the employee or donee is the listed owner of the contract), as well as to endorsement arrangements (the employer or donor is the listed owner).

The proposed regulations would be effective for arrangements entered into after the final regulations are published in the Federal Register. However, taxpayers may rely on the proposed regulations if all parties treat the arrangement consistently.

Owner of the contract.–Generally, under the proposed regulations, the owner named in the contract is treated as the owner or, if more than one is listed, the first one is treated as the owner.[2117] An employer is treated as the owner if the employee's only benefit at any time is current life insurance protection (no cash value or possible future ownership of the contract, for example).

Split-dollar life insurance arrangement defined.–The proposed regulations define a split-dollar life insurance arrangement broadly, with especially inclusive definitions in the case of arrangements between service providers and recipients, and between corporations and shareholders.[2118]

Economic benefit approach.–Under this approach, the value of economic benefits under the life insurance contract is treated as being transferred from the contract owner to the nonowner (reduced by any consideration paid by the nonowner to the owner). The tax

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[2115] REG-164754-0, preamble at 11 (under the heading mutually exclusive regimes), July 5, 2002.

[2116] Prop. Treas. Reg. 1.61-22(b)(3)(ii). The economic benefit approach also applies to a split-dollar arrangement between a donor and donee (e.g., a life insurance trust) if the donee's only benefit is the value of current life insurance protection.

[2117] However, if multiple listed owners each have an undivided interest in every right under the contract, the contract is treated as two or more separate contracts that are not part of a split-dollar arrangement. Prop. Treas. Reg. sec. 1.61-22(c)(1).

[2118] Prop. Treas. Reg. sec. 1.61-22(b)(2).

consequence of the transfer depends on the relationship of the owner and nonowner;[2119] in the employment context, compensation for services.

The proposed regulations distinguish between equity split-dollar (in which the nonowner also has a right to some or all of the cash value of the contract), and non-equity split-dollar (in which the nonowner has no such right and has only the right to current insurance protection).

In the non-equity split-dollar arrangement, the nonowner includes in income (and also in wages for employment tax purposes) the cost of current insurance protection. Unlike under the 1960s rulings, the proposed regulations provide that the amount of current insurance protection is measured as the excess of the average death benefit under the contract over the total amount payable to the owner (including outstanding policy loans). The cost of this is determined as the amount of current insurance protection times the "premium factor" published by the IRS in separate guidance.[2120]

In the equity split-dollar arrangement, the nonowner is also required to include in income (and for employment tax purposes) the value of any interest in the contract– for example, the value of any interest in the cash value of the contract provided during the year. [2121]

Under the economic benefit approach, in the event of transfer of a contract by the owner to a nonowner (a "rollout" of the contract by the employer to the employee), the fair market value of the contract is included in the nonowner's income (less any portion on which he has already paid tax). In the service provider context, applicable present-law rules[2122] permit deferral of income inclusion (and also the employer's deduction) if the transferee's rights in the contract are not yet substantially vested.

Loan approach.–Under the loan approach, the owner and nonowner are treated as borrower and lender, respectively, if the nonowner (e.g., employer) paying premiums is reasonably expected to be repaid from the contract's cash value or death benefits. If the loan does not provide sufficient interest, then interest is imputed under the rules of section 7872. In general, such interest is not deductible by the borrower, but is includible in the income of the deemed lender in the arrangement. If sufficient interest is provided for, then the general rules for debt instruments apply (including OID rules). The proposed regulations provide rules for treatment of term, demand, and contingent payment split-dollar loans.

[2119] E.g., depending on the relationship, the arrangement may be a payment of compensation, dividend distribution under section 301, gift under the gift tax rules, or other transfer. Prop. Treas. Reg. sec. 1.61-22(d)(1).

[2120] Prop. Treas. Reg. sec. 1.61-22(d)(2). This separate guidance had not yet been published as of February 5, 2003.

[2121] The proposed regulations do not provide specific guidance for determining the value of the includible economic benefit. Prop. Treas. Reg. 1.61-22(d)(3)(ii).

[2122] Sec. 83.

Guidance on valuation

After the issuance of the proposed regulations, the IRS issued further guidance, Notice 2002-59, specifically on valuation of benefits under certain types of reverse split-dollar life insurance arrangements.[2123] This Notice provides that the IRS will challenge the use of high current term insurance rates, prepayment of premiums, or other arrangements to understate the value of benefits under the life insurance policy that are to be included in income in a reverse split-dollar life insurance arrangement.

Factual Background

Overview of Enron's split-dollar insurance arrangements

Enron entered into split-dollar life insurance arrangements with three of its top management: Mr. Lay, Mr. Skilling, and John Clifford Baxter.[2124]

Enron entered into two split-dollar life insurance arrangements with Mr. Lay.[2125] Enron entered into a split-dollar arrangement with Mr. Lay on April 22, 1994, with respect to a life insurance contract with a face amount of $30 million.[2126] Mr. Lay's position was chairman and chief executive officer of Enron Corp.[2127] Enron entered into another split-dollar arrangement with Mr. Lay on December 18, 1996. The face amount of the life insurance contract under the 1996 agreement was $11.9 million.

Another split-dollar life insurance agreement with Mr. Lay for $12.75 million of life insurance coverage was later approved by the Compensation Committee of the Board of Directors on May 3, 1999, at Mr. Lay's request, to trade out his Executive Supplemental Pre-Retirement Death Benefit under the Houston Natural Gas Corporation Executive Supplemental

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[2123] Notice 2002-59, 2002-36 I.R.B. 1, Aug. 16, 2002.

[2124] Enron's split-dollar arrangements with employees appear to be individualized, rather than part of a larger plan or arrangement to enter into split-dollar arrangements with employees.

[2125] Appendix D contains Enron's split-dollar life insurance agreements with Mr. Lay.

[2126] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 143.

[2127] Mr. Lay had been chairman and chief executive officer since February 1986. Enron Form 10-K for 1996, as filed with the Securities and Exchange Commission.

Benefit Agreement.[2128] Although Enron purchased the life insurance contract in 2000, Enron and Mr. Lay did not enter into the split-dollar arrangement.[2129]

Mr. Skilling entered into a split-dollar arrangement with Enron on May 23, 1997, with respect to an $8 million life insurance contract.[2130] Mr. Skilling's position was then president and chief operating officer of Enron Corp.[2131] Mr. Skilling said in an interview with Joint Committee staff[2132] that his insurance broker noticed Mr. Lay's split-dollar arrangement in proxy materials issued by Enron, and the broker suggested that Mr. Skilling should ask Enron to enter into a similar agreement with him.

Mr. Baxter's split-dollar arrangement with Enron was dated January 26, 2000, for $5 million of life insurance coverage. At that time, Mr. Baxter's position was chairman and chief executive officer of Enron North America Corp.[2133]

Specific split-dollar arrangements

Split-dollar arrangements with Mr. Lay

1994 arrangement. On April 22, 1994, Enron entered into a split-dollar arrangement with Mr. Lay and the KLL & LPL Family Partnership, a Texas limited partnership.[2134] KLL and LPL are the initials of Mr. Lay and his wife, Linda. The life insurance contract covered the joint lives of Mr. Lay and his wife, Linda. The life insurance contract had a face amount of $30 million[2135]

[2128] Agenda Item No. 8(d), Split Dollar Policy, EC 000752761, and Minutes, Meeting of the Compensation and Management Development Committee of the Board of Directors, Enron Corp., May 3, 1999, EC 000752759-EC 000752760.

[2129] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 12.

[2130] Appendix D contains Enron's split-dollar life insurance arrangement with Mr. Skilling.

[2131] Mr. Skilling took this position in January, 1997. Enron Form 10-K for 1996, as filed with the Securities and Exchange Commission.

[2132] Interview of Mr. Skilling by Joint Committee on Taxation staff on November 13, 2002.

[2133] Enron Form 10-K for 2000, as filed with the Securities and Exchange Commission.

[2134] Appendix D contains the Split Dollar Life Insurance Agreement (dated April 22, 1994) (EC 000752803 - EC 000752807) and the Collateral Agreement (dated April 22, 1994) (EC 000752801 - EC 000752803).

[2135] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 143.

and was issued by Transamerica Occidental Life Insurance Company. The arrangement was a "collateral assignment," whereby the family partnership was the owner of the contract, but Enron agreed to pay each of the nine annual premiums of $280,265. The family partnership assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the policy to secure the repayment of amounts Enron paid as premiums. The family partnership agreed not to withdraw, surrender, borrow against, or pledge as security for a loan any portion of the cash value of the policy.

The agreement provided that upon Mr. Lay's death while the agreement remained in force, Enron would be entitled to receive, from the death benefit proceeds, the amount of the premiums that Enron had paid. The beneficiary designated by the family partnership would be entitled to the balance of the death benefit proceeds. Enron would not be entitled to recoup its premium payments in the event of Mr. Lay's death after the termination of the agreement.

The 1994 agreement would be terminated by: (1) payment to Enron of the amount of premiums it had paid; (2) surrender of the life insurance contract; (3) death of the second of Mr. Lay and his wife, Linda, to die; or (4) 30 days after the ninth anniversary of the date the contract was issued or upon Mr. Lay's retirement from Enron, whichever is later. If the split-dollar agreement is terminated by the passage of nine years or Mr. Lay's retirement, Enron relinquishes the right to recoup its premium payments (unlike the other terminating events).

1996 arrangement.–Effective December 13, 1996, Enron entered into a similar "collateral assignment" split-dollar arrangement with Mr. Lay and the same family trust.[2136] The life insurance contract had a face amount of $11.9 million, and was also issued by Transamerica Occidental Life Insurance Company.[2137] The family partnership was the owner of the contract, but Enron paid each of the five annual premiums of $250,000. The family partnership assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the policy to secure the repayment of amounts Enron paid as premiums. The family partnership had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

The agreement provided that upon Mr. Lay's death, Enron would have the right to receive $1.25 million of the death benefit (the total of the five annual premiums of $250,000), or the amount of premiums paid by Enron to date if Mr. Lay died before all five premiums were paid. The balance of the death benefit under the life insurance contract would be paid to the beneficiaries under the contract, as designated by the family partnership.

The 1996 agreement could be terminated by the family partnership at any time during Mr. Lay's life by a lump sum cash payment to Enron of $1.25 million (or, if less, the amount of premiums Enron had paid by the time Mr. Lay's employment terminated). In addition, the

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[2136] Appendix D contains the Split Dollar Agreement (dated December 18, 1996) (EC 000752792 - EC 000752798). The agreement stated that it was to be effective as of December 13, 1996.

[2137] The effective date of the life insurance contract was October 14, 1996.

agreement would be automatically terminated by bankruptcy, receivership, dissolution, or cessation of business of Enron, or by mutual written agreement of the parties. In the event of an automatic termination, the family partnership could acquire Enron's interest in the life insurance contract by paying to Enron, within 60 days of the terminating event, the amount of the aggregate premiums Enron had paid (less any outstanding debt incurred by Enron that is secured by the policy). Alternatively, Enron could enforce its right to be repaid the amount of the premiums it had paid.

Split-dollar arrangement with Mr. Skilling

On May 23, 1997, Enron entered into a split-dollar arrangement with Mr. Skilling and the trustee of the Jeffrey Keith Skilling Family 1996 Trust.[2138] The trustee of this trust was Mark David Skilling. The life insurance contract had a face amount of $8 million, and was issued by Massachusetts Mutual Life Insurance Company.[2139] The arrangement was a "collateral assignment," whereby the Skilling family trust was the owner of the contract, but Enron paid most of the five annual premiums of $115,250 for each of the five years 1997 – 2001.

The trustee of the Skilling family trust agreed to pay a portion of the annual premium (amounts between approximately $4,400 and $7,600) for each of the five years.[2140] The agreement provided that these amounts were "equal to the annual cost of current life insurance protection on the life of the employee [Mr. Skilling], measured by the Insurer's current published minimum premium rate for standard risks."[2141] Enron agreed pay the balance of each of the five annual premiums. The Skilling family trust assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the contract to secure the repayment of amounts Enron paid as premiums. The Skilling family trust had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

The agreement provided that upon Mr. Skilling's death, Enron would have the right to receive a portion of the death benefit in cash equal to the aggregate premium payments made by Enron. The balance of the death benefit under the life insurance contract would be paid to the beneficiaries under the contract, as designated by the trustee of the Skilling family trust.

The agreement could be terminated by the trustee of the Skilling family trust at any time during Mr. Skilling's life upon written notice to Enron by a lump sum cash payment to Enron in the amount of the aggregate premiums Enron had paid. In addition, the agreement would be

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[2138] Appendix D contains the Split Dollar Agreement (dated May 23, 1997) (EC 000752568 - EC 7525574), the Assignment of Life Insurance Policy as Collateral (dated June 25, 1997, effective as of May 23, 1997) (EC 000752563 0 EC 000752566), and the Jeffrey K. Skilling Split Dollar Premium Payment Schedule (EC 000752567).

[2139] The effective date of the life insurance contract was May 23, 1997.

[2140] Jeffrey K. Skilling Split Dollar Premium Payment Schedule, EC 000752567. Appendix D contains this document.

[2141] Split Dollar Agreement at 2 (dated May 23, 1997) (EC 000752569).

automatically terminated by bankruptcy, receivership, dissolution, or cessation of business of Enron, by termination of Mr. Skilling's employment with Enron for any reason, by failure of the trustee of the Skilling family trust to pay its portion of the premium (unless Enron agreed to pay), or by mutual written agreement of the parties. In the event of an automatic termination, Mr. Baxter's trust could acquire Enron's interest in the life insurance contract by paying to Enron, within 60 days of the terminating event, the amount of the aggregate premiums Enron had paid (less any outstanding debt incurred by Enron that is secured by the policy). Alternatively, Enron could enforce its right to be repaid the amount of the premiums it had paid.

Split-dollar arrangement with Mr. Baxter

On January 26, 2000, Enron entered into a split-dollar arrangement with Mr. Baxter and his insurance trust, of which Margo Baxter was trustee. The life insurance contract had a face amount of $5 million, and was issued by Transamerica Occidental Life Insurance Company.[2142] Under the terms of the agreement, the arrangement, like Enron's other split-dollar arrangements, was a "collateral assignment," whereby Mr. Baxter's trust was the owner of the contract, but Enron paid the annual premium of $50,565. Mr. Baxter's trust assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the policy to secure the repayment of amounts Enron pays as premiums. Mr. Baxter's trust had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

The agreement provided that upon Mr. Baxter's death, Enron would have the right to receive a portion of the death benefit in cash equal to the aggregate premium payments made by Enron. The balance of the death benefit under the life insurance contract would be paid to the beneficiaries under the contract, as designated by Mr. Baxter's trust.

The agreement could be terminated by Mr. Baxter's trust at any time during Mr. Baxter's life by a lump sum cash payment to Enron in the amount of the aggregate premiums Enron had paid. In addition, the agreement would be automatically terminated by bankruptcy, receivership, dissolution, or cessation of business of Enron, or by mutual written agreement of the parties.[2143] In the event of an automatic termination, Mr. Baxter's trust could acquire Enron's interest in the life insurance contract by paying to Enron, within 60 days of the terminating event, the amount of the aggregate premiums Enron had paid (less any outstanding debt incurred by Enron that is secured by the policy). Alternatively, Enron could enforce its right to be repaid the amount of the premiums it had paid.

Subsequent developments

Enron filed for bankruptcy under chapter 11 on December 2, 2001. Bankruptcy of Enron was one of the events giving rise to automatic termination of the split-dollar arrangements with

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[2142] The effective date of the life insurance contract was January 26, 2000.

[2143] Unlike the agreement with Mr. Skilling, the agreement with Mr. Baxter was not automatically terminated upon the termination of his employment with Enron.

Mr. Lay, Mr. Skilling, and Mr. Baxter. Mr. Baxter died on January 25, 2002.[2144]

Discussion of Issues

Enron's split-dollar life insurance arrangements with Mr. Lay, Mr. Skilling, and Mr. Baxter were entered into between 1994 and 2000, before the issuance of the series of recent IRS guidance starting with Notice 2001-10 in January, 2001. Under the limited guidance issued by the IRS prior to Notice 2001-10, the cost of current term insurance protection would be includible in income of the owner of the life insurance contract (less the amount paid by the owner).[2145] Enron would not be permitted to deduct the premiums.[2146]

Under the two split-dollar life insurance arrangements with Mr. Lay and the arrangement with Mr. Baxter, Enron paid the entire amount of the premiums under the life insurance contracts. The portion of this premium that constituted the cost of current term insurance protection would have been includible in income by the employee.

Under Mr. Skilling's arrangement, the Skilling family trust paid a portion of each annual premium under the life insurance contract, while Enron paid the balance of the annual premium. The terms of the split-dollar agreement provide that the amounts paid by the Skilling family trust are intended to constitute the full cost of current insurance protection, based on the insurer's "published minimum premium rate for standard risks." Under the 1960s rulings, taxpayers were permitted to choose to determine the amount includable in income on this basis. Because the Skilling family trust, rather than Enron, paid this portion of the premiums, no amount would have been includible in income. Each of the five annual premiums on the $8 million life insurance contract was $250,000, but the "cost of current insurance protection" was determined to be an amount between $4,400 and $7,600 each year. This disparity in amount illustrates the valuation issues that arise from permitting the use of insurers' "published" premium rates to set the amount includable in an employee's income.

[2144] His death was alleged to be a suicide. Paul Duggan and Lois Romano, *Enron Official Shaken In Days Before Suicide*, Washington Post, Feb. 9, 2002, at A1.

[2145] Examination of the Federal tax consequences of the split-dollar life insurance arrangements to the individual Enron employees is beyond the scope of this Report. Some general discussion is provided in order to illustrate the issues relating to the tax treatment of split-dollar life insurance arrangements into which Enron entered.

[2146] Section 264(a)(1) provides that no deduction is allowed for premiums on any life insurance contract if the taxpayer is directly or indirectly a beneficiary under the contract. Prior to amendment in 1997, the rule provided that no deduction was allowed for premiums on a life insurance contract covering any officer or employee, if the taxpayer is directly or indirectly a beneficiary under the contract. Enron generally had the right to recoup all of its premium payments from the death benefits paid by the life insurance contracts, by the terms of the split-dollar life insurance arrangements. The premium deduction denial rules are discussed in more detail in Part Three, section IV of this Report, relating to company-owned and trust-owned life insurance.

Enron employees' split-dollar insurance arrangements were entered into prior to the issuance of the 2002 proposed regulations. Further, the regulations are in proposed form, and would become effective generally for arrangements entered into after the date final regulations are published. However, if the rules of the proposed regulations applied, the tax treatment probably would be conceptually similar to the treatment under the pre-Notice 2001-10 letter rulings published by the IRS, in that the value of the economic benefit would be includible in income. However, the analysis of whether to apply this approach or the proposed regulations' loan approach would be new, and the process of determining the amount of this cost would differ from under prior law.

Under the proposed regulations, the tax treatment of the non-equity collateral assignment split-dollar arrangements that Enron entered into with Mr. Lay, Mr. Skilling and Mr. Baxter would likely be subject to the "economic benefit" approach. The proposed regulations provide a special rule that the economic benefit approach always applies to a split-dollar arrangement in connection with the performance of services if the service provider's only benefit is current life insurance protection (a "non-equity" split dollar arrangement). Because the partnership and the trusts that were the owners of the contracts in these collateral assignment arrangements did not have the right to borrow or otherwise gain access to the cash value of the life insurance contracts,[2147] the contracts would be treated as non-equity split dollar arrangements under the proposed regulations. In this circumstance, the proposed regulations would provide that the owner of the contract[2148] would include in income the cost of current insurance protection. Valuation of this cost would be an issue, as the proposed regulations do not provide new guidance.[2149]

Alternatively, if the arrangements were subject to the loan approach under the proposed regulations, they would be treated as loans of each premium payment made by Enron. The borrower under this analysis would be the person deemed to be the owner of the life insurance contracts.[2150] The foregone interest on these deemed loans would be included in the income of the partnership or trust.

[2147] Under each agreement described, the employee's family partnership or trust had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

[2148] Under the proposed regulations, the owner may be the partnership or trust. However, in the employment context, it could be argued that attribution or look-through to the employee would be appropriate, because the income is in the nature of compensation for his services.

[2149] Notice 2002-8 provides that until final regulations are published, the P.S. 58 rates, or the insurer's lower published premium rates for standard risks as permitted under the 1960s rulings, may be used to determine the value of current life insurance protection for split-dollar life insurance arrangements entered into before January 28, 2002.

[2150] Under the proposed regulations, the owner may be the Lay family partnership, the Skilling family trust, or Mr. Baxter's trust, respectively.

The enactment of the Sarbanes-Oxley Act of 2002, relating to corporate governance, has raised the issue of whether a split-dollar life insurance arrangement between and employer and an employee is characterized as a loan, for purposes of that Act's prohibition of certain loans to executives.[2151] The resolution of that question is not necessarily related to whether the arrangement is characterized as a loan, or otherwise, under Federal tax rules.[2152]

Until the issuance of Notice 2001-10 in 2001, the IRS had issued very little guidance on split-dollar life insurance since the 1960s. During this period, the use of split-dollar life insurance became more widespread, and variations on the product proliferated. In the absence of guidance, some taxpayers may have taken a variety of positions as to the includibility in income of benefits under the arrangements, and as to the timing or amount of items that are includible. From a tax policy perspective, taxpayers' failure to include in income the appropriate value of an economic benefit received by an employee from an employer indicates a need for guidance as to the proper tax treatment of split-dollar life insurance arrangements.

More recently, since 2001, the IRS has issued far more detailed guidance, both as general statements published in Notices, and as more specific rules published as proposed regulations. In addition, the IRS has superceded the previous valuation table, known as the P.S. 58 table, and supplanted it with Table 2001 for new split-dollar arrangements. The effect has been to treat the economic benefit received in a split-dollar life insurance arrangement more like other economic benefits received by employees, specifying the tax treatment in greater detail than previously in an area in which practices that may not accurately measure income had become increasingly common.

Recommendations

Requiring taxpayers to include in income the economic value of the benefit received in a split-dollar life insurance arrangement (or to treat the arrangement as a loan, if that treatment reflects the nature of the transaction) is consistent with the goal of the income tax system to accurately measure income. The Notices and proposed regulations generally serve the tax policy goal of improving accurate income measurement in the case of split-dollar life insurance arrangements. The Joint Committee staff recommends that guidance relating to split-dollar life insurance should be finalized.

[2151] Sarbanes-Oxley Act of 2002, sec. 402, Pub. L. No. 107-204. The Sarbanes-Oxley Act is discussed in more detail in Part Four, section III.C.3., relating to employee loans.

[2152] Postal, *Will SEC Exempt Split-Dollar From Ravages Of Sarbanes-Oxley Loan Rules?*, Insurance Chronicle, Jan. 13, 2003, at 1.

6. Limitation on deduction of certain executive compensation in excess of $1 million

Present Law

In general

Present law allows a deduction for ordinary and necessary business expenses, including a reasonable allowance for salaries and other compensation for personal services actually rendered.[2153] The reasonableness standard has been used primarily to limit payments by closely-held companies in cases in which nondeductible dividends may be disguised as deductible compensation. The reasonableness standard has rarely, if ever, been applied in the context of compensation paid to an employee of a large publicly held corporation, where the question of whether a payment is really a return to capital is generally not an issue.

Under present law, compensation in excess of $1 million paid by a publicly held company to the company's "covered employees" generally is not deductible.[2154] Covered employees are the chief executive officer and the four other most highly compensated employees of the company as reported in the company's proxy statement.

Subject to certain exceptions, the deduction limitation applies to all otherwise deductible compensation of a covered employee for a taxable year, regardless of the form in which the compensation is paid, whether the compensation is for services as a covered employee, and regardless of when the compensation was earned. The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of a nonqualified stock option, the deduction is normally taken in the year the option is exercised, even though the option was granted with respect to services performed in a prior year.

Certain types of compensation are not subject to the deduction limitation and are not taken into account in determining whether other compensation exceeds $1 million. With respect to compensation paid to Enron executives, the most relevant exception to the deduction limitation is for performance-based compensation. In general, performance-based compensation is compensation payable solely on account of the attainment of one or more performance goals and with respect to which certain requirements are satisfied, including a shareholder approval requirement.[2155]

[2153] Sec. 162(a)(1).

[2154] Sec. 162(m). The $1 million limit is reduced by any amount of excess parachute payments that are not deductible for the year (as determined under sec. 280G). The deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

[2155] In addition, the following types of compensation are not subject to the deduction limitation and are not taken into account in determining whether other compensation exceeds $1 million: (1) compensation payable on a commission basis; (2) payments to a tax-qualified retirement plan (including salary reduction contributions); and (3) amounts that are excludable from the individual's gross income (such as employer-provided health benefits). In addition,

Performance-based compensation: In general

The deduction limitation does not apply to any compensation payable solely on account of the attainment of one or more performance goals, but only if: (1) the performance goals are determined by a compensation committee of the board of directors of the publicly held company which is comprised solely of two or more outside directors; (2) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such compensation; and (3) before payment of such compensation, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.[2156]

Compensation generally does not satisfy the requirements for performance-based compensation if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. However, compensation does not fail to be performance-based merely because the compensation may be paid upon death, disability or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not satisfy the requirements of the exception.[2157]

Performance goal requirement

Preestablished objective performance goal

In order to qualify for the exception for performance-based compensation, the compensation must be paid to the covered employee pursuant to a preestablished objective goal. A performance goal generally is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually establishes the goal.[2158] A performance goal is considered objective if a third party having knowledge of the relevant facts could determine whether the goal is met.[2159]

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under a transition rule, compensation is not subject to the limitation and is not taken into account in determining if other compensation exceeds $1 million if the compensation is payable under a written binding contract in effect on February 17, 1993, and at all times thereafter before such compensation is paid and which was not modified thereafter in any material respect before such compensation is paid. Sec. 162(m)(4).

[2156] Sec. 162(m)(4)(C).

[2157] Treas. Reg. sec. 1.162-27(e)(2)(v).

[2158] In no event will a performance goal be considered to be preestablished if it is established after 25 percent of the period of service (as scheduled in good faith at the time the goal is established) has elapsed. Treas. Reg. sec. 1.162-27(e)(2)(i).

[2159] *Id.*

The term performance goal is broadly defined. A performance goal can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. Treasury regulations provide that such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs. A performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion). A performance goal does not include the mere continued employment of the covered employee. Thus, for example, a vesting provision based solely on continued employment does not constitute a performance goal.[2160]

A preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained. A formula or standard is objective if a third party having knowledge of the relevant performance could calculate the amount to be paid to the employee. In addition, a formula or standard must specify the individual employees or class of employees to which it applies.[2161]

Discretion

The terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the performance goal. A performance goal is not discretionary merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal. That is, negative discretion to reduce the amount payable to a covered employee is generally permitted, as long as such discretion does not result in an increase in the amount payable to another employee. A formula or standard is not considered discretionary merely because the amount of compensation to be paid upon attainment of the performance goal is based on a percentage of base pay or salary and the dollar amount of the salary is not fixed at the time the performance goal is established if the maximum dollar amount to be paid is fixed at that time.[2162]

Changes in the timing of payments can affect the amount being paid and thus raise the question of whether the change involves impermissible discretion. As described below, Treasury regulations provide guidance on what types of timing changes are or are not considered increases in the amount payable.[2163]

If compensation is payable upon or after the attainment of a performance goal, and a change is made to accelerate the payment of compensation to an earlier date after the attainment of the goal, the change will be treated as an increase in the amount of compensation unless the

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[2160] *Id.*

[2161] Treas. Reg. sec. 1.162-27(e)(2)(ii).

[2162] Treas. Reg. sec. 1.162-27(e)(2)(iii)(A).

[2163] Treas. Reg. sec. 1.162-27(e)(2)(iii)(B).

amount of compensation paid is discounted to reasonably reflect the time value of money. If compensation is payable upon or after the attainment of a performance goal, and a change is made to defer the payment of compensation to a later date, any amount paid in excess of the amount that was originally owed to the employee will not be treated as an increase in the amount of compensation if the additional amount is based either on a reasonable rate of interest or on one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of a specific investment (including any decrease as well as any increase in the value of an investment).[2164]

If compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be treated as an increase in the amount of compensation. Thus, for example, if the terms of a stock grant provide for stock to be transferred after the attainment of a performance goal and the transfer of the stock also is subject to a vesting schedule, a change in the vesting schedule that either accelerates or defers the transfer of stock will not be treated as an increase in the amount of compensation payable under the performance goal.[2165]

Stock option and stock appreciation rights

Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the performance goal requirement if: (1) the grant or award is made by the compensation committee; (2) the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and (3) under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.

Conversely, if the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (e.g., in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is considered performance-based compensation.[2166] The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the applicable requirements.

[2164] *Id.*

[2165] *Id.*

[2166] Treas. Reg. sec. 1.162-27(e)(2)(vi). Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent that may be payable, provided that payment of the dividend equivalent is not made contingent on the exercise of the option.

Compensation attributable to a stock option or stock appreciation right does not satisfy the requirements of the exception for performance-based compensation to the extent that the number of options granted exceeds the maximum number of shares for which options may be granted to the employee as specified in the plan.[2167]

Outside director requirement

The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director:

- Is not a current employee of the publicly held corporation;
- Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;
- Has not been an officer of the publicly held corporation; and
- Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.[2168]

Specific rules apply in determining whether a director falls within any of these categories.[2169]

[2167] If an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan. *Id.*

[2168] Treas. Reg. sec. 1.162-27(e)(3)(i).

[2169] For example, the determination of whether an individual was an officer of the publicly held corporation is based on the facts at the time that the individual is serving as a member of the compensation committee. A director is not precluded from being an outside director solely because the director is a former officer of a corporation that was previously within the affiliated group of the publicly held corporation but is no longer within the group when the individual is serving on the compensation committee. As another example, specific rules apply, including certain rules disregarding de minimis remuneration, in determining whether and when the individual is receiving remuneration from the publicly held corporation in a capacity other than as a director. Treas. Reg. sec. 1.162-27(e)(3)(ii) - (viii).

Shareholder approval requirement

In general

The material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid. The shareholder approval requirement is not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders.[2170]

The material terms that must be disclosed to shareholders include: (1) the employees eligible to receive compensation; (2) a description of the business criteria on which the performance goal is based; and (3) either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained (except that, in the case of a formula based, in whole or in part, on a percentage of salary or base pay, the maximum dollar amount of compensation that could be paid to the employee must be disclosed).[2171] To the extent not otherwise specifically provided in Treasury regulations, whether the material terms of a performance goal are adequately disclosed to shareholders is determined under the same standards as apply under the Securities Exchange Act of 1934.[2172]

Eligible employees

Disclosure of the employees eligible to receive compensation need not be so specific as to identify the particular individuals by name. A general description of the class of eligible employees by title or class is sufficient.[2173]

Business criteria

Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10 percent, the 10-percent figure is a target that need not be disclosed to shareholders. However, in that case, disclosure must be made that the bonus plan is based on an earnings-per-share business criterion. In the case of a plan under which employees may be granted stock options or stock appreciation

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[2170] Treas. Reg. sec. 1.162-27(e)(4)(i).

[2171] *Id.* The disclosure requirement may be satisfied even though information that otherwise would be a material term of a performance goal is not disclosed to shareholders if the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation. Treas. Reg. sec. 1.162-27(c)(4)(iii)(B).

[2172] Treas. Reg. sec. 1.162-27(e)(4)(v).

[2173] Treas. Reg. sec. 1.162-27(e)(4)(ii).

rights, no specific description of the business criteria is required if the grants or awards are based on a stock price that is not less than current fair market value.[2174]

Compensation payable under a performance goal

Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any employee during a specified period. If the terms of the performance goal do not provide for a maximum dollar amount, the disclosure must include the formula under which the compensation would be calculated. Thus, for example, if compensation attributable to the exercise of stock options is equal to the difference in the exercise price and the current value of the stock, disclosure would be required of the maximum number of shares for which grants may be made to any employee and the exercise price of those options (e.g., fair market value on date of grant). In that case, shareholders could calculate the maximum amount of compensation that would be attributable to the exercise of options on the basis of their assumptions as to the future stock price.

Other rules

Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. If, however, the compensation committee has authority to change the targets under a performance goal after shareholder approval of the goal, material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal.[2175]

The material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval.[2176]

Factual Background

Statement of Enron policy regarding deduction limitation

Since the enactment of the $1 million deduction limitation,[2177] Enron has expressed the intent to structure certain compensation arrangements to qualify as performance-based

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[2174] Treas. Reg. sec. 1.162-27(e)(4)(iii).

[2175] Treas. Reg. sec. 1.162-27(e)(4)(vi).

[2176] Treas. Reg. sec. 1.162-27(e)(4)(vii).

[2177] The $1 million deduction limitation was enacted in 1993, effective for amounts that would otherwise be deductible for taxable years beginning on or after January 1, 1994. Pub. L. No. 103-66, sec. 13211(a) (1993).

compensation not subject to the $1 million limit. The 1994 Enron Corp proxy statement contains this initial statement regarding the limitation:[2178]

> [The deduction limitation], enacted in 1993, generally disallows a tax deduction to public companies for compensation over $1 million paid to the company's Chief Executive Officer and four other most highly compensated executive officers, as reported in the proxy statement. Qualifying performance-based compensation will not be subject to the deduction limit if certain requirements are met. Enron intends to structure the performance-based portion of the compensation of its executive officers (which currently consists of stock option grants, certain restricted stock grants, performance unit grants and annual incentive awards) in a manner that complies with the new statute, including presentation of each of these plans to stockholders for approval. Occasionally, Enron may grant restricted stock for specific reasons which would not qualify as performance-based.

Subsequent annual proxy statements continued to indicate the general intent to structure most, but not necessarily all, compensation arrangements so as to meet the requirements for performance-based compensation. For example, the proxy statement for the annual shareholder meeting in 2001 contains the following statement as part of the "Report from the Compensation and Management Development Committee Regarding Executive Compensation:"[2179]

> Section 162(m) of the Internal Revenue Code, as amended (the "Code"), generally disallows a tax deduction to public companies for compensation over $1,000,000 paid to a company's CEO and four most highly compensated executive officers, as reported in its proxy statement. Qualifying performance-based compensation is not subject to the deduction limit if certain requirements are met. Enron has structured **most** aspects of the performance-based portion of the compensation for its executive officers (which includes stock option grants, performance units, and performance based annual incentive awards) in a manner that complies with the statute. The Amended and Restated Enron Corp. 1991 Stock Plan, the Amended and Restated Performance Unit Plan, and the Enron Corp. Annual Incentive Plan were presented to and approved by shareholders at the 1999 [sic], 1995 and 1999 Annual Meetings of Shareholders, respectively.[2180] (emphasis added)

[2178] 1994 Enron Corp. Proxy Statement, at 11.

[2179] 2001 Enron Corp. Proxy Statement, at 16.

[2180] Similar statements were included in previous proxy statements. For example, the 2000 proxy statement contained the same language, except that dates given as to when shareholder approval was obtained are different. The 2000 proxy contains the following dates of shareholder approval: 1994, 1997, and 1999 for approval of the Amended and Restated 1991 Stock Plan; 1994 and 1995 for approval of the Amended and Restated Performance Unit Plan; and 1994 and 1999 for the Annual Incentive Plan. 2000 Enron Corp. Proxy Statement, 15.

Other proxy statements clarify which portions of the 1991 Stock Plan were intended to qualify as performance-based compensation (as Amended and Restated Effective May 4, 1999). For example, the 1999 proxy contains the following: [2181]

> [E]nron believes that the income generated in connection with the exercise of stock options granted under the 1991 Stock Plan should qualify as performance-based compensation and, accordingly, Enron's deductions for such compensation should not be limited by [the deduction limitation]. The 1991 Stock Plan has been designed to provide flexibility with respect to whether restricted stock awards will qualify as performance-based compensation under [the deduction limitation]. Enron believes that certain awards of restricted stock under the 1991 Stock Plan will so qualify and Enron's deduction with respect to cash awards should not be limited by [the deduction limitation]. However, certain awards of restricted stock and all awards of phantom stock units will not qualify as performance-based compensation and, therefore, Enron's compensation expense deductions relating to such awards will be subject to the ... deduction limitation. [2182]

Shareholder approval

In general

As noted in the proxies, three plans, the 1991 Stock Plan, the Performance Unit Plan, and the Annual Incentive Plan[2183] were submitted for shareholder approval (and subsequently approved) so that compensation provided under these plans would qualify as performance based. As discussed in more detail below, with respect to certain plans, Enron initially took the position that the plans would be considered performance-based even if the plans would be effective absent shareholder approval. Treasury regulations made clear that this was not the case.[2184]

[2181] 1999 Enron Corp. proxy statement, at 16. Similar statements were included in other proxy materials. *See, e.g.*, 2001 Enron Corp. Proxy Statement, at 32.

[2182] The terms of the 1991 Stock Plan (as Amended and Restated Effective May 4, 1999), which the 1999 proxy describes, distinguished between restricted stock (secs. 5.2(i)-(v) of the Plan), performance-based restricted stock (sec. 5.2(vi) of the Plan), and phantom stock units (sec. 5(vi) of the Plan). According to these plan provisions only the performance-based restricted stock is specifically designed to qualify for the performance-based exemption to the deduction limitation.

[2183] The 1991 Stock Plan and the Performance Unit Plan are discussed in more detail in Part III.C.2., above. The Annual Incentive Plan is discussed in Part III.B.2., above.

[2184] Treas. Reg. sec. 1.162-27(e)(4)(i).

1991 Stock Plan

The 1991 Stock Plan initially was approved by the shareholders in 1991. Amendments to the Plan 1991 Stock were presented to the shareholders in 1994, including amendments determined necessary by Enron to meet the requirements for performance-based compensation under the deduction limitation.[2185] The 1994 proxy materials state that shareholder approval of the amendment was required so that certain awards under the 1991 Stock Plan would qualify as performance-based compensation under the compensation deduction limitation.[2186]

The proxy materials do not state what happens if the amendment is not approved by the shareholders, and the 1991 Stock Plan amendment submitted with the proxy materials is silent on the issue. The only reference to an effective date in the amendment is the following:

"NOW, THEREFORE, the Plan is amended as follows:

"1. The plan name will be changed to 'ENRON CORP. 1991 STOCK PLAN (AS AMENDED AND RESTATED EFFECTIVE MAY 3, 1994),' and the Plan shall be restated to incorporate this and all prior amendments."[2187]

An amended and restated 1991 Stock Plan was submitted to shareholders for approval in 1997. The plan submitted for approval says that it is effective upon approval of the shareholders.

The 1991 Stock Plan (as Amended and Restated Effective May 4, 1999) was again submitted for shareholder approval in 1999, and again (as Amended and Restated Effective May 1, 2001) in 2001. These versions of the 1991 Stock Plan provided that it is not effective unless shareholder approval is obtained.[2188]

Performance Unit Plan

The Performance Unit Plan was initially presented for approval by the shareholders for the purpose of meeting the requirements for performance-based compensation under the deduction limitation in 1994. The proxy materials in 1994 stated that, if shareholder approval

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[2185] The amendments were also submitted to the shareholders in order to comply with an exemption under the short-swing profit recovery provisions of the applicable securities laws. 1994 Enron Corp. Proxy Statement, at 31.

[2186] 1994 Enron Corp. Proxy Statement, at 31.

[2187] 1994 Enron Corp. Proxy Statement, Exhibit C. The Joint Committee staff was unable to obtain a copy of the 1991 Stock Plan as originally adopted; it is possible the Plan had separate effective date provisions.

[2188] Sec. 9 of the Enron Corp. 1991 Stock Plan (as Amended and Restated Effective May 4, 1999); sec. 9 of the Enron Corp. 1991 Stock Plan (as Amended and Restated Effective May 1, 2001). The Plans are included as Exhibit B of the 1999 and 2001 Enron Corp. Proxy Statements.

was not obtained, the Performance Unit Plan would continue but payments made on or after January 1, 1994, would not be deductible by Enron.[2189] The Performance Unit Plan document submitted with the proxy did not contain a provision conditioning the effectiveness of the Plan on shareholder approval.

An amended and restated Performance Unit Plan was presented for approval by the shareholders in 1995. The amended and restated Performance Unit Plan was substantially the same plan that was approved in 1994. Proxy materials explain that the Performance Unit Plan was being resubmitted to shareholders in order to comply with the requirements of the compensation deduction limitation. The proxy states that Treasury Regulations under the compensation cap, issued after the proxy materials had been finalized, made it clear that compensation was not performance based if it would be paid regardless of whether the terms are approved by the shareholders. The Performance Unit Plan presented in 1995 provided that, if shareholder approval was not obtained, the Plan would not be continued and grants made in 1994 and 1995 would be cancelled. The proxy materials state that, "Upon further guidance from legal counsel after consultation with the Internal Revenue Service, the clarification contained herein now complies with the Internal Revenue Service's interpretation of this provision."[2190] In addition, the Performance Unit Plan document provided with the 1995 proxy materials expressly provides that:

> Upon approval by the stockholders of the Company at the 1995 annual meeting, the Plan shall be considered effective for Performance Periods beginning on or after January 1, 1994. In the event that the Plan is not approved by the stockholders of the Company at the 1995 annul meeting, all Performance Units granted prior to such meeting with respect to Performance Periods beginning on or after January 1, 1994, shall be cancelled without the payment of any amount to the holders thereof and no Performance Units shall thereafter be granted under the Plan.[2191]

Annual Incentive Plan

The Annual Incentive Plan was initially presented for approval by the shareholders for the purpose of meeting the requirements for performance-based compensation under the deduction limitation in 1994. The 1994 proxy materials state that, if the requisite shareholder approval is not obtained, the Annual Incentive Plan will continue, but payments made on or after January 1, 1994, will not be tax deductible if compensation to executives exceeds $1 million.[2192] However, the Annual Incentive Plan document provides that "Upon approval by the stockholders

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[2189] 1994 Enron Corp. Proxy Statement, at 28.

[2190] 1995 Enron Corp. Proxy Statement, at 27.

[2191] Section X.G. of the Enron Corp. Performance Unit Plan (As Amended and Restated Effective May 2, 1995), the Plan is included as Exhibit A to the 1995 Enron Corp. Proxy Statement.

[2192] 1994 Enron Corp. Proxy Statement, at 30.

of the Company at the 1994 Annual Meeting, the Plan shall be considered effective as of January 1, 1994," indicating that the Plan would not be effective unless approved by the shareholders.[2193]

A new Annual Incentive Plan was presented for shareholder approval at the 1999 annual meeting. The proxy materials for this meeting state that approval of the shareholders is required in order for the payments from the Plan to be tax deductible as performance-based compensation and that the Plan will not become effective unless approved by the shareholders.[2194] The Annual Incentive Plan document submitted with the proxy materials provides that "upon approval by the shareholders of the Company at the 1999 Annual Meeting, the Plan shall be considered effective as of January 1, 1999."[2195]

Role of the Compensation Committee

Composition of the Committee

During the period of the Joint Committee staff review, the Compensation Committee consisted of a chairman, Charles A. LeMaistre, and three or four other directors. In 1993, 1994, and 1995, the other members of the Compensation Committee were Robert A. Belfer, John H. Duncan, and Joe H. Foy. In 1996, Mr. Foy and Mr. Belfer were replaced by Norman P. Blake and Robert K. Jedicke. Frank Savage joined the Compensation Committee at the end of 1999.

The 1997 proxy states that changes were made in the composition of the Compensation Committee in order to comply with the requirements of the $1 million deduction limitation.[2196] The proxy does not describe the precise reason for the change. As discussed above, in order to meet the requirements for performance-based compensation, the compensation must be approved by a committee consisting of at least two outside directors. Thus, it appears probable that the change was related to this requirement.

1991 Stock Plan

The 1991 Stock Plan provides that the plan is to be administered by a committee of the Board of Directors of Enron Corp. designated by the Board and composed of not less than two nonemployee directors, as defined in Rule 16b-3 of the Securities Exchange Act of 1934. The Compensation Committee acted as the administrator of the 1991 Stock Plan. The 1991 Stock

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[2193] Sec, XIV of the Enron Corp. Annual Incentive Plan. The Plan is included in as Exhibit B to the 1994 Enron Corp. Proxy Statement.

[2194] 1999 Enron Corp. Proxy Statement, at 29.

[2195] Sec. XIV of the Enron Corp. Annual Incentive Plan. The Plan is included as Exhibit A to the 1999 Enron Corp. Proxy Statement.

[2196] 1997 Enron Corp. Proxy Statement, at 15-16.

Plan[2197] provides that, subject to applicable law and the terms of the 1991 Stock Plan, the Committee has the sole power, authority and discretion to:

- Designate participants,
- Determine the types of awards to be granted to a participant,
- Determine the number of shares to be covered by or with respect to which payments, rights, or other matters are to be calculated in connection with awards,
- Determine the terms and conditions of any award,
- Determine whether, to what extent, under what circumstances and how awards may be settled or exercised in cash, Enron Corp. common stock, other securities other awards, or other property, or may be canceled, forfeited, or suspended, determine whether, to what extent, and under what circumstances cash, shares, other securities, other awards, other property, and other amounts payable with respect to an award under the Plan shall be deferred either automatically or at the election of the holder thereof or of the Committee,
- Interpret, construe, and administer the Plan and any instrument or agreement relating to an award made under the Plan,
- Establish, amend, suspend, or waive such rules and regulations and appoint such agents as it shall deem appropriate for the proper administration of the Plan,
- Make a determination as to the right of any person to receive payment of an award or other benefits,
- Except for awards made to persons subject to Section 16 of the Securities Exchange Act of 1934, delegate to individuals in specified officer positions of the company the authority to make and issue awards for a specified number of shares subject to the terms and provisions of the Plan,[2198] and
- Make any other determination and take any other action that the Committee deems necessary or desirable for the administration of the Plan.

The Plan provides that a majority of the Committee constitutes a quorum and that the acts of a majority of the members present at any meeting at which a quorum is present or acts approved in writing by all members of the Committee are considered acts of the Committee.[2199]

Performance Unit Plan

The Performance Unit Plan provides that the Compensation Committee of the Board of Directors[2200] is responsible for the administration of the Plan. The Compensation Committee is

[2197] Except as otherwise described, Plan provisions are included in both the 1999 and 2001 Restatements of the 1991 Stock Plan.

[2198] This provision was not in the 1999 Restatement of the 1991 Stock Plan.

[2199] The authority of the Committee to make plan amendments was added in the 2001 restatement; it was not in the 1999 restated Plan.

[2200] In some years, the Compensation Committee was called the Compensation and Management Committee.

granted certain specific authority under the Plan, as described below, and also has such other powers and authority necessary or proper for the administration of the Plan, as determined from time to time by the Compensation Committee. Notwithstanding that the Compensation Committee is the Plan administrator, day-to-day administration of the Plan is the responsibility of the Vice President of Human Resources, who in carrying out such day-to-day administrative activities is acting as the Committee's delegate. The Compensation Committee may also delegate to any person designated by the Compensation Committee any power or duty granted to it under the Plan. The Compensation Committee may adopt such rules for the administration of the Plan as it deems necessary.

As part of the specific authority granted to the Compensation Committee under the Performance Unit Plan, the Committee is responsible for designating, in its sole discretion, which eligible employees will receive an award of performance units for the year. Prior to the Compensation Committee making its designation, the Office of the Chairman of the Company is to present a nomination list to the Compensation Committee of those eligible employees, if any, recommended to the Committee for consideration as recipients of performance units. The Performance Unit Plan provides that the Compensation Committee is to make its designation after "giving due consideration to the nomination list." The Compensation Committee is not bound by the nomination list, and may include any, all, or none of the eligible employees on the nomination list and may include other eligible employees as the Compensation Committee considers appropriate. The Compensation Committee is to provide each designated eligible employee with a written notice of any performance units granted to the employee during the year. The Committee also determines, in its sole discretion, the number of performance units to be granted to any eligible employee, subject to the terms of the Plan.

The Compensation Committee is to maintain, or is to cause to be maintained, accounts reflecting each participants interest in the Performance Unit Plan. The Compensation Committee has the authority, in its discretion, to determine whether benefit payments with respect to performance units are made in cash, Enron Corp. common stock, or both.

The Plan provides that the Board, or the Compensation Committee acting on behalf of the Board, may amend or modify the Performance Unit Plan at any time and in any manner, except that no change in any grant previously made may be made which would impair the rights of the recipient of a grant without the consent of the recipient. In addition, no amendment may be made without the approval of stockholders if the amendment would:

- Change the class of eligible employees who may be designated to receive an award under the Performance Unit Plan,
- Change the criteria used to determine the adjusted value to a performance measure other than total shareholder return,
- Change the schedule used to determine adjusted value,
- Increase the maximum grant of performance units that any eligible employee may receive in a year, or
- Otherwise modify the material terms of the Performance Unit Plan.

Annual Incentive Plan[2201]

The Compensation Committee of the Board is responsible for administering the Annual Incentive Plan and has a variety of duties and responsibilities under the Annual Incentive Plan. It has the sole discretion to: (1) interpret the Annual Incentive Plan; (2) approve preestablished, objective annual performance measures; (3) certify the level to which the performance measures were attained prior to any payment under the Annual Incentive Plan; (4) approve the amount of awards made under the Annual Incentive Plan; and (5) determine who is to receive any payment under the Annual Incentive Plan. The Annual Incentive Plan provides that decisions of the Compensation Committee are conclusive and that the Compensation Committee shall have no liability for any action taken or decision made in good faith relating to the Annual Incentive Plan or any award made under the Annual Incentive Plan.

The Annual Incentive Plan as approved by shareholders in 1994 provided that the Compensation Committee was to establish annually an award fund, expressed as a percentage of after-tax net income, prior to the beginning of the year (or such later date as permitted under applicable law). The Annual Incentive Plan as restated in 1999 provides that the maximum annual award fund is five percent of recurring after-tax net income of Enron and eligible employees are limited to Section 16 officers. Recurring after-tax net income means after-tax net income subject to downward adjustment by the Compensation Committee in its sole discretion for what it considers unordinary or nonrecurring items of after-tax net income and other items or events, including, but not limited to, financial impact on Enron resulting from changes in law and/or regulations pertaining to Federal taxes imposed on corporations.

The maximum permitted individual target award under the 1994 Plan was one-half of one percent (.5 percent) of the after-tax net income of Enron. The 1999 Annual Incentive Plan provides that, for eligible participants subject to the deduction limitation (and officers subject to section 16 of the Securities Exchange Act), the Compensation Committee is to establish an individual target award level, expressed as a percentage of recurring after-tax net income. The maximum individual target award level that can be established under the Annual Incentive Plan is one percent of the recurring after-tax net income of Enron.

Under the 1999 Annual Incentive Plan, the Compensation Committee is to verify the actual recurring after-tax net income of the Company, if any, and the resulting award fund, taking into consideration any downward adjustments that the committee may make at is sole discretion. The Compensation Committee then determines which participants will receive payments under the Plan, and the amount of such payments. Discretionary upward adjustment of the actual award level above the target aware level is not allowed.[2202]

[2201] Unless otherwise indicated, this description is based on the 1999 Annual Incentive Plan.

[2202] The Compensation Committee had similar responsibilities under the 1994 Annual Incentive Plan.

The 1994 Annual Incentive Plan provided that the Compensation Committee has the authority to modify or terminate the plan at any time, except that, without prior approval of the shareholders, no amendment may be made that would: (1) change the class of participants eligible to receive awards under the plan. (2) base the award on a performance measure other than after-tax net income. (3) base the award fund on a performance measure other than recurring net after-tax income. (4) increase the maximum individual target award level under the plan, or (5) modify any other material terms of the plan. The 1999 Annual Incentive Plan contains similar authority, except that, consistent with plan terms in effect at the time, provides that the Compensation Committee cannot change the total fund to an amount greater than five percent of recurring after-tax net income or base an award on a performance measure other than net after-tax income without the consent of the shareholders.

Information from third-party consultants

In 1998, Towers Perrin was asked to provide information regarding how other companies address the $1 million deduction limitation. Towers Perrin provided a letter which was presented to the Compensation Committee at the February 9, 1998, meeting.[2203] The report says that in May 1997, Towers Perrin conducted a survey of 275 companies regarding annual incentive plan design issues. The survey showed that about 45 percent of the survey participants have sought shareholder approval of their annual incentive plans because of the deduction limitation. Towers Perrin suspected that this was relatively low because many companies either do not have cash compensation in excess of $1 million for covered employees or manage the deduction limitation by deferring compensation in excess of $1 million. The latter technique was reportedly used by about 10 percent of surveyed companies.

Towers Perrin did not have data regarding how companies structure annual incentive plans to comply with the deduction limitation, but stated that it was their understanding that companies often establish a "soft" incentive funding target for covered employees which makes it likely that the total amount the company desires to pay such employees will be within the cap. Towers Perrin explained that this is done because the deduction limitation permits bonuses to be less than the shareholder-approved target.

Towers Perrin reported that they conducted a survey in August 1997 of 150 large U.S. companies. This survey showed that annual bonuses for management employees represent from two percent to 10 percent of after-tax profit, with a median of five percent. They suggested that, if a company were attempting to leave room for a reduction in the target amount, it would be common to set the funding pool approved by shareholders somewhat above these levels.

Towers Perrin also described a second approach of having shareholders approve the maximum dollar payouts to individuals under the Plan, with a laundry list of possible performance measures that can be used. The compensation committee could then select the performance measures to be used under the Plan each year, subject to the dollar limits. Towers Perrin commented that this approach would give the Compensation Committee considerable

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[2203] Letter from Towers Perrin to Vice President, Compensation and Benefits, Enron Corp., (April 21, 1998). EC000104240 - EC000104241.

latitude, but that some shareholder groups recommend against approval of this type of Plan because the standards of performance are not revealed.

As described above, Enron adopted an approach that gave an overall target based on after-tax net earnings.

Other actions of the Compensation Committee

Proxy statements included an annual report from the Compensation Committee. These reports typically discussed the overall Enron philosophy regarding executive compensation and the activities of the Compensation Committee regarding executive compensation, including the methods for determining appropriate levels and components of executive compensation.[2204] In years since the enactment of the $1 million deduction limitation, this report has included a section regarding compliance with the deduction limitation. As reflected above, this portion of the report typically stated the intent to structure certain compensation arrangements in order to meet the exception to the $1 million limitation for performance-based compensation.[2205]

Despite the apparent attention paid by the Compensation Committee to the deduction limitation, as reflected in Compensation Committee meetings and reports, one member of the Committee interviewed by the Joint Committee staff indicated that he was not aware that there was such a limitation.

Data

Table 26, Table 27, and Table 28, below, show the aggregate amount of total compensation, performance-based compensation, additional deductible compensation, and nondeductible compensation for Enron's covered employees for 1998, 1999, and 2000.

[2204] *See, e.g.*, 1999 Enron Corp. Proxy Statement, at 13-16.

[2205] 1994 Enron Corp. Proxy Statement, 12; 1995 Enron Corp. Proxy Statement, at 14-15; 1996 Enron Corp. Proxy Statement, at 13-14; 1997 Enron Corp. Proxy Statement, at 15-16; 1998 Enron Corp. Proxy Statement, at 15; 1999 Enron Corp. Proxy Statement, at 16; 2000 Enron Corp. Proxy Statement, at 15; 2001 Enron Corp. Proxy Statement, at 16.

Table 26.–Application of $1 Million Deduction Limitation for 1998
(Millions of Dollars)

Employee	(1) Total Compensation	(2) Performance-Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation [(4)=(1)-(2)-(3)]
Employee 1	14.942	13.570	1.0	.372
Employee 2	8.214	3.336	1.0	3.878
Employee 3	16.700	2.148	1.0	13.552
Employee 4	8.651	1.884	1.0	5.767
Employee 5	Information not provided by Enron	Information not provided by Enron	Unknown	Information not provided by Enron
Total*	48.505	20.937	4.0	23.568

*Details may not add to totals due to rounding.

**Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of $1 million.

Table 27–Application of $1 Million Deduction Limitation for 1999
(Millions of Dollars)

Employee	(1) Total Compensation	(2) Performance-Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation [(4)=(1)-(2)-(3)]
Employee 1	48.478	47.058	1.000	.420
Employee 2	54.322	48.680	1.000	4.642
Employee 3	7.204	2.832	1.000	3.372
Employee 4	6.874	6.517	.357	0
Employee 5	7.324	6.484	.839	0
Total*	124.202	111.572	4.100	8.434

*Details may not add to totals due to rounding.

** Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of $1 million.

Table 28.–Application of $1 Million Deduction Limitation for 2000
(Millions of Dollars)

Employee	(1) Total Compensation	(2) Performance-Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation
Employee 1	105.990	104.376	1.000	614.153
Employee 2	81.988	66.894	1.000	14.094
Employee 3	29.897	30.022	0.0	0.0
Employee 4	21.427	18.631	1.000	1.796
Employee 5	21.597	21.077	.520	0.0
Total*	260.899	241.00	.520	16.504

*Details may not add to totals due to rounding.

**Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of $1 million.

The amounts shown in these tables are from information provided by Enron to the IRS in connection with the IRS' review of Enron's tax returns for 1998, 1999, and 2000. The information was provided in response to specific questions regarding the deduction limitation. The Joint Committee staff has compared this information with other information provided by Enron to the IRS and the Joint Committee staff, as well as proxy information. This comparison yielded a number of inconsistencies that stem from a variety of sources. In some cases Enron has provided information which was later modified by Enron, in other cases there are internal inconsistencies with the information provided, and in other cases it is difficult to reconcile various pieces of information. These inconsistencies may raise questions as to the accuracy of the information provided. For example, seemingly straightforward and simple information such as the job title of a particular individual varies between proxy statements and information provided to the IRS. In one case, shown on Table 28, performance-based compensation of an individual was more than the individual's total compensation.

Some of the inconsistencies discovered could have a significant impact on the amount of compensation subject to the $1 million cap. As shown in Table 28, above, based on information provided by Enron to the IRS, in 2000, the top-five highest paid officers received total compensation of $261 million. However, based on information relating to total the highest paid 200 employees for 2000 provided by Enron to the Joint Committee staff, the five highest paid employees received compensation of over twice that amount--$573 million.[2206] On the top-200 list for 2000, the highest paid employee is listed as having the title Chairman and Chief Executive Officer of Enron (the list does not include names) and as having total compensation of $169 million. This amount of compensation does not correspond to any amount provided to the IRS for 2000.

[2206] The information relating to the highest paid 200 employees provided by Enron to the Joint Committee staff for 1998 through 2001 is in Appendix D to this Report.

In interviews with the Joint Committee staff, IRS personnel also indicated that they had discovered inconsistencies with information provided by Enron and expressed difficulty in obtaining complete compensation information. The IRS attributed this, in part, to Enron's recordkeeping system. According to the IRS, Enron personnel stated to the IRS that Enron did not maintain a centralized file for each executive reflecting total compensation for that executive.

The IRS informed the Joint Committee staff that, as part of its examination of Enron's returns for 1998, 1999, and 2000, it is investigating discrepancies of this nature. The Joint Committee staff has not attempted to duplicate this work. While the information provided below may not be completely accurate, it is the best information available.

Discussion of Issues

The $1 million limitation on the deductibility of certain executive compensation does not appear to have had a substantial impact on either the amount of compensation paid by Enron or the structure of its compensation arrangements.

Table 29, below, shows total compensation, performance-based compensation, additional deductible compensation, and nondeductible compensation for 1998 through 2000. This is the combined information contained in Table 26, Table 27, and Table 28.

Table 29–Application of $1 Million Deduction Limitation for 1998-2000 (Millions of Dollars)

Year	(1) Total Compensation of Covered Employees	(2) Performance-Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation
1998	48.5	20.9	4.0	23.6
1999	124.2	111.6	4.2	8.4
2000	260.9	241.0	3.5	16.5
Total 1998-2000*	433.6	373.5	11.7	48.5

* Details may not add to totals due to rounding.

**Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of $1 million.

It appears evident that the existence of the $1 million deduction limitation had no effect on the total compensation provided to Enron executives. Based on information provided by Enron to the IRS, as shown in Table 29, above, total compensation for the top-five executives for 1998-2000 was $433.6 million.[2207]

[2207] Enron also paid compensation in excess of $1 million to many employees not subject to the deduction limitation. The information regarding the top-200 most highly compensated employees provided by Enron to the Joint Committee staff indicates that 46 employees, 93

Enron intended certain of its compensation arrangements to qualify as performance-based for purposes of the deduction limitation, and treated substantial amounts of compensation as meeting this requirement. Based on information provided by Enron to the IRS, as shown in [link to table 4], above, performance-based compensation for 1999 and 2000 was comparable, 90 percent and 92 percent, respectively. In those years, seven percent and six percent, respectively, of total compensation of covered employees was not deductible. In the case of certain individuals, the amount of performance-based compensation was so great compared to total compensation that less than $1 million of compensation was potentially subject to the deduction cap.

For 1998, however, performance-based compensation was only 43 percent of total compensation of covered employees, and 49 percent of the total compensation of covered employees was not deductible. This is due in large part to the compensation provided to two covered employees. The nondeductible compensation for those two employees was 82 percent of the total nondeductible compensation of all five covered employees. Seventy-six percent of the total compensation for those two employees was not deductible.

Although Enron treated substantial amounts of compensation as performance-based, the $1 million deduction limitation does not appear to have had a significant impact on the overall structure of Enron's compensation arrangements. The arrangements that Enron considered to provide performance-based compensation were generally utilized prior to the enactment of the deduction limitation. Enron made certain modifications to its compensation arrangements in order to meet the Code's definition of performance-based compensation; however, these modifications were generally limited to relatively minor changes needed to meet the requirements rather than changes to the overall structure of its compensation arrangements. For example, in the case of bonuses, the Compensation Committee was advised by its outside consultants to establish a high enough "soft" target that could be approved by the shareholders so that whatever level of bonuses Enron ultimately paid would be within the target and thus would not fail to be performance based. It is possible that certain arrangements might not have been submitted for shareholder approval had this not been required in order to meet the requirements for performance-based compensation.

The Compensation Committee was required to take certain actions in order for compensation to qualify as performance-based. A review of the Compensation Committee minutes indicates that the deduction limitation was discussed from time to time, and the role of the Compensation Committee with respect to approval of performance targets was mentioned.[2208] In addition, the annual report of the Compensation Committee in proxy statements discussed the deduction limitation. While the deduction limitation was discussed in Compensation Committee meetings, it appears that more time was spent on broader compensation issues, such as overall

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employees, and all 200 top-paid employees received compensation in excess of $1 million in 1998, 1999, and 2000 and 2001, respectively. This information is included in Appendix D to this Report.

[2208] *See, e.g.*, Minutes of the Meeting of the Compensation Committee, at 2 (Feb. 9, 1998).

compensation targets. One former member of the Compensation Committee interviewed by the Joint Committee staff indicated he had no knowledge of the deduction limitation and did not remember it ever being discussed. This may be an indication that the limitation was not a significant concern for Enron.

The existence of the $1 million deduction limitation did not prevent Enron from paying nondeductible compensation. From 1998 through 2001, $48.5 million of nondeductible compensation was paid to covered employees.[2209]

Another aspect of the deduction limitation that can be observed from the review of Enron is the discrepancy between the operation of the limitation, which is based on generally applicable tax rules, and compensation as reported in Federal proxy statements. Proxy statements include a summary compensation table for covered employees (referred to as "named officers" under the securities laws) as well as other information regarding executive compensation.

Because of timing differences and other factors, compensation as reported for proxy purposes can vary significantly from compensation subject to the $1 million deduction limitation. For example, because the deduction limitation applies when amounts would otherwise be deductible, compensation may be taken into account for purposes of the limitation at a different time that it is reported for proxy purposes. Restricted stock is an example of such a timing difference. For proxy purposes, the value of restricted stock is shown in the year the stock is granted,[2210] whereas restricted stock is taken into account for purposes of the deduction limitation when it is includible in income, i.e., as it vests. Salary and certain other compensation that is deferred may also be reported at a different time for proxy purposes than when it is taken into account under the deduction limitation. Income attributable to the exercise of stock options is also treated differently for proxy reporting purposes and tax purposes.

The securities laws requiring that certain compensation information be reported in the proxy statement and the Federal income tax laws have different purposes. Thus, each set of laws may appropriately treat items of compensation differently in order to accomplish their respective purposes. However, the difference in the treatment may cause confusion for persons who are attempting to determine the amount of nondeductible compensation from publicly available sources; it is not possible to make this determination based on proxy information.

The IRS is reviewing the application of the $1 million deduction limitation to Enron for the years 1998 through 2001. Determining whether the requirements for performance-based compensation were in fact met involves extensive, labor intensive factual determinations. The Joint Committee staff has not attempted to duplicate the efforts of the IRS. Issues that would need to be addressed include an analysis of the total compensation of covered employees, terms of all plans and arrangements and individual compensation agreements, examining materials provided to shareholders for approval, and determining whether the Compensation Committee took required actions with respect to the compensation. As described above, there are a number

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[2209] *See* Table 29, above.

[2210] *See e.g.*, 1998 Enron Corp. Proxy Statement, at 20.

of inconsistencies in the information provided by Enron regarding compensation, making the examination more difficult in this case.

Recommendations

The Joint Committee staff believes that the $1 million deduction limitation is ineffective at accomplishing its purpose, overrides normal income tax principles, and should be repealed. The concerns reflected in the limitation can be better addressed though laws other than the Federal tax laws.

The $1 million deduction limitation reflects corporate governance issues regarding excessive compensation, rather than issues of tax policy.[2211] It is often difficult for tax laws to have the desired effect on corporate behavior.[2212] Taxpayers may simply choose to incur the adverse tax consequences rather than change their behavior. In Enron's case, due to the existence of net operating losses, the denial of the deduction may not have been an issue.

In Enron's case, the $1 million deduction limitation appeared to have little, if any, effect on the overall level of compensation paid to Enron executives or the structure of compensation arrangements. To the extent that performance-based compensation is viewed as being a preferable form of compensation, some may argue that the $1 million limitation was effective in the Enron case, because such a large part of compensation was structured to be performance-based. However, as noted above, the deduction limitation did not appear to be a motivating factor in the structure of Enron's compensation and the arrangements that it treated as performance-based (or similar arrangements) generally predated the enacted of the limitation. In addition, some may question whether the compensation was truly performance based, particularly given Enron's financial decline; to the extent the limitation affected Enron's compensation arrangements, it may have merely placed more emphasis on the desire to increase reported earnings.[2213]

[2211] H.R. Rep. No. 103-111, at 646 (1993).

[2212] Another example of tax laws that are aimed at corporate governance issues are the golden parachute rules that limit the compensation that may be paid to certain employees due to the change of control of a company. Sec. 280G. Failure to comply with these rules results in a denial of the deduction to the company and the imposition of a 20 percent excise tax, payable by the employee. Sec. 4999. Commentators generally observe that the golden parachute rules have done little to affect the amount of compensation payable upon a change of control. Rather, the rules are often thought of as providing a road map as to how to structure compensation arrangements. It is not uncommon for employment agreements to provide that, in the event the employee is subject to the excise tax, the tax will be paid by the company, with a gross up to reflect the income tax payable as a result of the employer's payment of the tax.

[2213] *See* Part I. of Part One of this Report.