

**ENRON: THE JOINT COMMITTEE ON TAXATION'S
INVESTIGATIVE REPORT**

HEARING

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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FEBRUARY 13, 2003
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ENRON: THE JOINT COMMITTEE ON TAXATION'S INVESTIGATIVE REPORT

THURSDAY, FEBRUARY 13, 2003

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:07 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Nickles, Snowe, Thomas, Bunning, Baucus, Breaux, and Bingaman.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. We really have two items today. First is our organization meeting, and then we have this very important hearing on Enron Corporation. There is also a members briefing going on where all members are supposed to be. Obviously, the four of us that are here were not at that briefing on another matter.

So what I want to do, if and when we get a sufficient number of people to do our formal organization, we are going to stop the hearing, turn to the committee's business, and I think we can do that very, very quickly. Nobody needs to leave the room or anything. Anybody in the audience can stay. We will do that quickly, then return to the hearing.

I want to thank everybody for being here today. I think that we have a very important subject before us. Most importantly, almost a year since were inquiries were first made by the Joint Tax Committee, so a long period of time, has gone into this work that we are going to hear today.

I believe that you are about to witness a shocking event in the history of American corporate tax policy and American corporate financial accounting. We are going to have the veil torn off of the world of tax shelters and the world of manipulation of accounting.

The report reads like a conspiracy novel, with some of the Nation's finest banks, finest accounting firms, and some of our best attorneys working together to prop up the biggest corporate farce of the century. Enron was a house of cards, and the cards are the schemes that we will hear about today.

The Joint Tax Committee report provides us a wealth of information. Much of this information has never been seen before, not only by the public, but also the IRS and other government agencies.

It includes tax return information, opinion letters from law firms, internal documents, accounting firm correspondence, shelter pro-

motional material, and, most importantly, internal Enron documents laying out how the scheme of deception played out.

Not only will we gain a fuller understanding of tax shelters, and also of accounting gimmicks, but we are provided with a complete story of the people and the professionals working behind the scenes to make all this happen.

The Joint Tax Committee report names names and it does not pull any punches in telling us about the law firms, accounting shops, and investment bankers that were promoting and aiding Enron in all of these activities.

The conclusion is very troubling, as you might see in one example here: show me the money. By the way, Project Steele is not misspelled.

Anyway, “show me the money” is in that catch-phrase on an internal Enron document for just one shelter. It is clear that this is what it is all about, this one example, but many others that could be put up there: money, money, money.

Money above honesty and financial accounting, money above tax return compliance, money above professional and business ethics, money above common sense. Money, money, money.

I am reminded that back in the 1980’s there was a popular phrase that came to us from Wall Street. The phrase was: “Greed is good. Greed cuts through and clarifies.”

Now, the irony is that, in this case, greed actually obscured. Greed actually hid the real substance of the business of Enron. The substance is that there was not much substance. All of the artifices were designed to make something appear real that was not real.

Enron viewed its tax shop goal in line with this general goal I just described. That is, the tax shop was designed and was managed with the objective of noncompliance with its responsibilities under the Tax Code. Instead, Enron viewed its tax shop as it’s profit center, where complexity was an ally and bending the rules was a partner in a search for more paper gains.

In addition to bending the rules, there appears to be a culture of wining and dining amongst the small community of people that helped drive these deals. One small, but telling, example is the Banker’s Trust—one of the participants in this dance of shelters—who takes Enron’s Director of Tax Research for what was termed “The Potomac Capital Investment Corporate Conference.”

The details can be found starting on B-203 of the report, but let me just highlight what the conference was all about. Fly to Boca Raton, and Sunday night is casino night. Then starting on Monday, it is your choice of golf, tennis, fishing, then a golf clinic, and, finally, a reception dinner cruise.

The next day, the real work starts with your choice of golf, tennis, fishing, leisurely lunch, and finally a reception dinner.

To wind down the last day of the conference is more golf and tennis. Obviously, no amount of lipstick is going to make that pig look very pretty.

The Joint Committee report describes in detail the structures used by Enron to avoid tax and to inflate earnings. Many of these schemes are not well-known, and their publication this very day could provide a road map for others to follow.

So, as a matter of public policy, I want to be very clear so that these things don't return to haunt us in the future. Today, February 13, 2003, will be the effective date for any legislation we offer to shut down these tax schemes or anything like any of them.

Today's date will not move, it will not slip. Senator Baucus and I are unified on this point. And we do not care if it takes 5 years to get the legislation passed, this date will hold.

So to all lobbyists here and elsewhere, I would like to have you write that date down, February 13, 2003. If a company does an Enron-type deal after today, I do not want you to come to me whining that we are not being fair. Just serving notice so that all the lawyers, all the accountants, and all the investment bankers that profit so handsomely from these deals know that you are on notice.

Now, in addition to Enron's tax and accounting the Joint Tax report gives equal time to the important issue of executive compensation and employee benefits. Somehow, it seems to go from bad to worse. I find it very stunning that a Fortune Top 10 company was wholly incapable of answering simple questions about how much executives received in pay.

Further, the Enron board seems unaware of its most basic responsibilities, its most basic duties of protecting the shareholder. In addition, I think this Joint Tax report provides new details of a jaw-dropping amount of executive compensation and benefits.

I will just mention what does not meet the smell test. That is, Enron had 200 executives, each of whom was being paid over a million dollars while they ran the company to bankruptcy, leaving thousands of dedicated employees, as we know, high and dry.

These employees helplessly watched their retirement savings go down the drain when the company's stock tanked from more than, as you know, \$90 a share in 2000, to 34 cents a share in January of 2002.

Again, we happen to be able to benefit, as policymakers, from the Joint Tax providing an enormous amount of documents detailing executive compensation and employee benefits.

Finally, Joint Tax has much to say of findings and recommendations from their work. The Joint Tax also raises serious concerns about the ability of the IRS to ever find out about these transactions.

These findings and these recommendations deserve serious consideration, and will surely inform this Finance Committee as it compares this current corporate tax shelter legislation against abuses listed in this report.

Now I would like to make one last point, and it is more of a personal one. We have a person we have all known for maybe two decades for me, or at least a decade and a half, Lindy Paull, sitting before us. This is her appearance for the last time as Chief of Staff of the Joint Tax Committee.

I think it is really a tribute to her that she is going out with a report that will cause great shock waves, felt among professional people on K Street and elsewhere.

I would like to thank you, Lindy, for all of your dedication, all of your hard work, not only at the Joint Tax Committee, but as I previously indicated, we have had a relationship here as your pro-

fessional work on the Finance Committee. Your dedication and knowledge will be greatly missed.

I also recognize that your staff has spent nearly a year, as I indicated in the beginning of my remarks, on this report, and have, for the last few weeks been at this report and this study day and night in, most importantly, preparing for this important hearing.

These men and women on your staff who serve on this project have done so, I think, at great personal sacrifice that we never give enough thanks for. The travel and demands of this tax has kept them away from family and other loved ones.

Yet, they have continued to meet the needs of Congress, while at the same time pursuing one of the ugliest and most complicated financial disasters of recent times.

I would ask for members' indulgence while I take a moment to name the dedicated staff primarily responsible for the investigation: Mary Schmitt, Sam Olchyk, Carolyn Smith, Ray Beeman, Nikole Clark, Robert Gutwald, Brian Meighan, David Noren, Cecily Rock, Carol Sayech, Ron Schultz, Allison Wielobob.

In addition, we want to give thank-you to the Government Printing Office for getting this major report to us in time for this hearing. I thank all of you, and probably some that I did not name that needs thank-yous, and maybe Lindy can fill us in on all the other people that were involved in lesser roles in this job well done.

You have given us a very sobering report about corporate tax practices and executive compensation in modern America. I hope the transparency and the checks and balances of our system that this report highlights were non-existent return, and all corporate America benefits from it, and our economy surely is going to benefit from it.

Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

Ms. Paull, I echo the comments of the Chairman. You have always provided very candid advice to this committee, regardless of which side of the aisle was asking the question.

You are a testament to being a true professional and a good role model, I know, for the people who work over at Joint Tax, and for many other people who know you and work with you. This is a crowning achievement. I know the hours you put in, the weekends, the long days and nights.

I just thank you very, very much for your service to America, service to the Congress, and particularly to the two tax writing committees, and to all of us. Thank you very, very much. It is appropriate that Senator Grassley also mentioned the names of the Joint Tax staff who worked on this project, because I know how hard they have worked.

We have had many discussions, you and I, how hard Joint Tax staff work compared with some other organizations around here, and I deeply appreciate it.

As you know, it has been almost a year today that I and Senator Grassley asked you to conduct this investigation of Enron's tax returns.

We called on the Joint Committee because we believed that you had the expertise. You are Congress' resident tax law experts. We thought that you would know best how to proceed and advise us most thoroughly.

We also instructed the Joint Committee to review, as you know, Enron's pension and executive compensation programs, and we asked you to proceed carefully. This committee did not rush to judgment with respect to all the Enron matters. Rather, we thought it was just best to get the facts, and we asked you to do that. We thank you for what you have done.

Your report and findings, I think, will also provide countless benefits to lawmakers and to academics for years. There is so much information here. It will be pivotal, I think, to our efforts to restore public confidence in corporate America, and also to the voluntary nature of our tax system. There is much information here, and I think it will be very, very helpful.

All across the country, the story of Enron has undermined public confidence. It has also undermined business ethics, undermined confidence in our accounting system, our tax laws, as well as our pension laws.

The Joint Committee report shows that this erosion of confidence, certainly in this case, was warranted. Enron not only engaged in accounting gimmicks to boost stock prices, but Enron repeatedly abused the Tax Code.

And they had help from investment bankers, from lawyers, and from accountants. In transaction after transaction, these advisors helped Enron carry out its tax schemes with "opinion letters."

Now, opinion letters are supposed to serve as an independent counsel's assurance of the proper tax treatment for specific facts in a given transaction. Enron paid millions of dollars for these opinion letters.

Frankly, based on your committee's investigation, many of them may not be worth the paper they are written on. They were not independent. They were not what we all hope opinion letters are supposed to be.

The report also describes collusion among the advisors. They made sure that they kept their tax opinion writing business among themselves. Enron and its advisors conspired to mine the Tax Code for tax schemes, and they concealed the schemes in a complex maze of entities and transactions.

They ensured that no one, particularly the IRS, would ever discover what they were up to. In fact, I believe they added new meaning to the term "complexity," a new meaning to "obfuscation."

Last night when I read the executive report, I was just astounded at the complexity of these schemes. I very much agree with you in your recommendation that, in certain cases, some provisions should be repealed.

In fact, there was one that was so complex, I laughed when I read it. That, in itself, was enough evidence for me that it should be repealed, it was just so complex.

It is abundantly clear that the IRS was kept in the dark and they were out-manuevered. The lack of adequate disclosure rules, the lack of sufficient IRS enforcement resources clearly helped

Enron and its executives walk away with millions, and perhaps billions.

Just as the Congress has appropriated more money from the Securities Exchange Commission to enforce our securities laws, it is abundantly clear to me that we also have to appropriate many more dollars to the IRS so we can more effectively enforce our tax laws.

The Joint Committee's report raises serious concerns about corporate ethics and about the ethics of tax advisors. Where is the independence? Did these advisors meet their profession's code of ethics? In many cases, I think not. How much were they willing to let greed affect their judgment? I think, in too many cases.

The Joint Committee report also should serve as a wake-up call. The conduct of some advisors who call themselves professionals is inexcusable. At the same time Enron was engaged in this shameful conduct, senior executives were lining their pockets.

The company used schemes to juice earnings so their stock options skyrocketed. Enron executives rushed to the bank to take out their own deferred savings, while leaving employees holding an empty bag. The rank-and-file employees watched as a lifetime of savings in Enron's pension plan turned to dust.

Executives also got a free ride from the board of directors. The board was asleep at the wheel. According to the Joint Committee, it was anything but independent. They operated as a rubber stamp. The executives wrote their own compensation plans, as you report.

Ms. Paull, I look forward to hearing from you and learning the answers to some of the questions that all of us have. First, what role did the advisors play, their outside lawyers, accountants, and investment bankers? Was their conduct appropriate?

Second, was there collaboration among so-called independent advisors? That is, instead of providing checks and balances, were they more concerned about padding their own pockets and the pockets of their friends?

Third, what went wrong with Enron's pension plans? Last Congress, this committee reported out a bill to give rank-and-file employees more information to help them diversify. Is this enough?

Fourth, what about the interplay between executive compensation and the rank-and-file pension plan? The rank-and-file employees had their entire life savings invested in the pension plan, while at the same time Enron's executives had executive privilege, that is, their own protected pot of money.

Mr. Chairman, the Joint Committee's report provides the committee with a unique opportunity. I believe it is historic. I believe this report is going to be the genesis of some major changes in U.S. tax law.

I'm not wise enough to predict what those changes are going to be, but this is so revealing, that is, in the sense of how easy it is, and also the high probability, therefore, that many people are engaged in this and it's going to cause, I think, more than a ripple. It's going to cause some terrific, and I think profound, changes.

We now have an invaluable insight into corporate abuse of the Tax Code. I am more convinced than ever that the tax shelter legislation this committee approved last week must be enacted immediately. In fact, it must probably be improved upon.

The idea that someone suggests that tax shelters are not a problem is simply without merit, it is laughable. The committee's report puts that notion to rest.

Now, this report may be viewed by some as a road map for abusing the Tax Code. Anybody going through this report can say, aha! There is a new idea. Rest assured, this is not a road map. This is the end of the road.

The Joint Committee makes specific recommendations. Mr. Chairman, I look forward, with you, in developing additional legislation based on the report, and we should act without delay.

With that in mind, I strongly support the Chairman's statement that any legislation enacted to curb abuses such as those highlighted in this report must have an effective date of February 13, 2003, that is, today.

I look forward to hearing from you, Ms. Paull, and other witnesses. It is my judgment, Mr. Chairman, as I said, that this is the beginning.

There should be several other hearings, a series of hearings, and some later follow-up hearings to see how far we have progressed, or if we have progressed at all, in curbing these outrageous abuses.

The CHAIRMAN. Before we start the hearing, I would like to introduce the people who are at the table besides Ms. Paull.

We have Dr. George Plesko, assistant professor of Management, MIT, Sloan School of Management. Dr. Plesko has written extensively about tax book issues that are relevant for today's findings.

Second, we have Dr. Edmund Outslay, professor of Accounting and Information Systems, Michigan State. He has written about Enron and corporate income tax.

Next, we have Dr. James Seida, who is an assistant professor of Accountancy at the University of Notre Dame. He is a new father, and we thank you for your wife letting you come here on this particular date, considering it was just three or 4 days ago.

Finally, we have Ms. Kathryn Kennedy, associate professor of Law, John Marshall Law School, Chicago. She happens to be a graduate of a university in my State, Drake Law School, in Des Moines, Iowa.

She is director of both the Graduate Tax and Graduate Employee Benefit programs, and I think we are going to benefit from her knowledge of employees' compensation issues today.

Then Lindy Paull, I have already referred to. I will not go to any further introduction. Normally, we would go left to right. But obviously we are going to start with Lindy Paull to present the report. She will have 30 minutes to do that.

Then we would go from left to right the way you were introduced, and we will have 5 minutes for each person on the panel, although your entire statement, without your asking, if you want it, will be put in the record as you have submitted it.

Then we will go to questions, and they will be in the order that we normally do questions.

Ms. Paull?

**STATEMENT OF LINDY L. PAULL, CHIEF OF STAFF, JOINT
COMMITTEE ON TAXATION, WASHINGTON, DC**

Ms. PAULL. Thank you, Mr. Chairman and Senator Baucus. I very much appreciate your gracious comments. I have really been blessed to be able to serve Congress for 17 years, and will hopefully have the opportunity to serve you as an outside advisor as well. So, thank you very much. Thank you for the kind comments for our staff, who have really worked hard on this report.

I appreciate the opportunity to bring this report to you today. I hope that it will serve as a fruitful report for the purposes of many hearings and studies. I think it was an extremely unusual opportunity for our staff to be able to look inside one of the 10 largest companies in the United States and explore selected issues, obviously, in as much depth as we could.

We could not have done it without the cooperation of the company, so we appreciate that as well.

The report consists of these three volumes, which totals about 2,700 pages in total. The first volume is our Investigation Report. It is over 700 pages.

As the Chairman said, the report includes an extensive background of the company, an extensive discussion of tax motivated transactions, and an extensive discussion of compensation and pension arrangements of the company that are basically equally split.

It was certainly a Herculean task for our staff to do this over the last year, in addition to our regular and normal legislative duties, which was quite a busy year last year as well. So, I am grateful to our staff, and it has been an honor to work with them.

The second volume of the report contains two appendices, basically, a compilation of materials that were provided by the company related to the structure transactions that we go into. We obviously had boxes, and boxes, and boxes of information. We tried to put together a set of materials that is the most relevant and helpful to try to understand these very complicated transactions.

The third volume includes two appendices, one of which includes all of the tax opinions that relate to the transactions that we described. Then there is an additional set of appendices dealing with executive compensation and pension issues that back up some of the statements that we make in our report.

So, it is quite lengthy. It will take quite a while to get through all of this material, for those who are interested in studying it.

I, too, would like to thank the Government Printing Office, who was able to print this report on an extremely tight timeframe, and really was amazed that they were able to get it ready for you for this hearing, because we certainly had to come down to the wire in writing our report.

We selected, with the consultation of Senators Grassley and Baucus who asked us to do this work, a fairly specific set of issues to look at, the issues that deal with tax shelter arrangements, the offshore entities, and special purpose entities.

We also selected issues dealing with compensation arrangements of the employees, including the executive compensation arrangements, the tax qualified retirement plans, and with a special view to look towards what might have contributed to the loss of benefits by different categories of employees.

As I said, the company cooperated with us in our investigation. As a part of this report, they provided us with confidential information that they have agreed to allow to be publicly disclosed in an official report, hearing, or meeting of the committee, so that is what this report includes.

In doing our report, we reviewed all of the tax returns since 1985. Many tax returns are over 1,000 pages long. There are boxes and boxes. We reviewed 100 boxes of information that were supplied by the company, and about 40 boxes of information that were supplied by the Internal Revenue Service.

We conducted 46 interviews of current and former Enron employees, as well as some other individuals who had relevant information.

We traveled to Houston to conduct many of the interviews and to review documents and meet with the Internal Revenue Service.

We have done an extensive search of all kinds of materials that have been written on this company since the bankruptcy was filed, and the information leading up to it, including publicly-available information from the Securities Exchange Commission and the Bankruptcy Court, and some non-publicly available information from other agencies. So, I believe we did a very comprehensive job at conducting the investigation.

I will do my best to summarize this extensive report so that you get the gist of the report. But it certainly would be helpful that people study the report over the next few months and see what they think should be done about it.

We have our views on that, but obviously it would be useful to get the comments of many others to see what their views are as well.

Enron is a Houston-based energy and commodities trading company that is in bankruptcy. Prior to bankruptcy, it conducted business through approximately 3,500 domestic and foreign subsidiaries and affiliates, although some of those subsidiaries and affiliates were inactive. That means the subsidiaries were set up, but they were not involved in an active business.

Enron operated in diverse markets and it operated internationally. Enron was in a broad range of businesses.

In the year 2000, the year before bankruptcy, Enron's financial statement revenues exceeded \$100 billion. It was ranked seventh on the Fortune 100 list of largest companies. Enron had about 59,000 shareholders. It were widely owned. Enron had about 25,000 employees.

Just to step back a little bit, because a lot has been written about the number of foreign entities this company had, our examination found that, while there was approximately 1,300 foreign entities owned by this company, only about 250 of those entities were actually active. And we explained why there were so many inactive companies that were owned by this company. Roughly about 80 percent of the foreign entities were inactive, and that had to do with the way Enron went about bidding for jobs in the international marketplace.

When Enron went to bid for a power plant or something like that, or an investment overseas, it set up a whole set of companies.

But if most of their bids did not come to fruition, Enron just never unwound those companies.

So, we do have an extensive amount of data on that which has gotten a lot of media report. Some of Enron's companies were certainly set up in low- or no-tax countries. We found 441 entities set up in the Cayman Islands, but also most of those were inactive shells.

With respect to Enron's Federal income tax, here is when it gets a little confusing. While Enron's financial statements may have combined a lot of entities, the ones that are eligible for the consolidated tax return would be fewer in number.

So, it is hard to look at a financial statement that might be filed with the SEC and try to translate that into information for the tax return. So, we have a table that tries to give you an idea of the differences. You start with Enron's financial income and go down to what Enron reported on its tax return.

For Federal income tax purposes, we have a table in the report that has all of their income tax information back to 1985. But just looking for the last decade, from 1990 to 1995, Enron paid approximately \$325 million of Federal income taxes. For the period of 1996 to 1999, it paid no income taxes, which I think has been widely reported in the media.

And then for the last 2 years, Enron has paid about \$60 million of Federal income tax, which is before the Bankruptcy Court right now to determine whether or not they would be eligible for a refund of those taxes.

Also, just in short, Enron has been under audit since 1989 on a regular basis, so the Internal Revenue Service has had a team of auditors in there looking at examining their tax position for some time.

As I said, we do provide a reconciliation of the financial statement income to their taxable income, basically for the last 5 years. It is worthy to note, for example, that for 1996 through 1999, financial statement income was over \$2 billion, whereas, for tax purposes, Enron reported losses, not income, of about \$3 billion.

So, there is a big difference during that period between Enron's financial statement income and taxable income. Some of it is attributable to who you count in the group from the tax return standpoint, but much of it is attributable to various other items that we try to categorize and give you a summary of that in Table 2.

Let me turn, now, to the tax motivated transactions. This was a company that certainly had a tax department that grew during the 1990's. Enron was a tax-sensitive company.

Enron entered into, in the early 1990's, some transactions to manage its tax liability so that it could benefit from, for example, Section 29 tax credits. Enron also had other kinds of transactions it entered into to manage their tax liabilities.

The principal focus of our work was on 1995 and forward with respect to these tax motivated transactions. They entered into 12 very large transactions. When we stepped back from looking at these transactions, I think we would say that at the core of these transactions they were designed to permit Enron to take the position that the long-term tax benefits that were stemming from these

transactions would allow them to take the position that they generated financial statement income.

So I think it is worthy to note that the origin of these financial accounting benefits was the reduction in tax. That seems to be the sole origin of these transactions.

Our report takes each of these 12 transactions that were very, very complicated transactions and tries to develop a story about the transactions; how the transactions were developed, basically the fact that a promoter brought Enron the transaction, how Enron analyzed the transaction, and how it sought opinions with respect to how the transaction would be handled for tax purposes and accounting purposes, and then Enron did the necessary steps to implement the transactions, and who within the company approved the transactions, including many of the transactions approved by the board of directors.

We tried to categorize the transactions in a way to try to make sense out of them, because they all seemed a little bit different. We first categorized some transactions as solely raising corporate tax issues. The second group of transactions used partnerships to facilitate the tax benefits, so we focused on the transactions that had partnerships as the key of the transaction. Then we had some transactions that implicated international or certain financial products, types of tax rules. Then we also looked into corporate-owned and trust-owned life insurance arrangements and structured financing arrangements, including the kinds of financing that might yield debt for tax purposes and equity for financial statement purposes, and the commodity pre-paid transactions.

Irrespective of the structure and the types of special rules that might apply to the structure, Enron typically used one of two strategies to achieve the tax and financial statement benefits.

We had, I think, four transactions: Projects Tanya, Valor, Steele, and Cochise, which were designed to duplicate losses. In other words, they were designed to deduct the same loss twice for tax purposes.

Another set of transactions, Projects Tomas, Condor, Teresa, Tammy I, and Tammy II, were intended to shift basis from a non-depreciable asset to a depreciable asset.

A further transaction, Project Apache, was designed to generate tax deductions for what was, in essence, the repayment of principal on debt, which is generally not tax deductible.

In two transactions, Projects Renegade and Valhalla, Enron received a fee to serve as an accommodation party to another taxpayer who was entering into some transactions to derive these similar kinds of tax and financial benefits.

We have summarized, in a table that appears on page 10 of the report and page 8 of the testimony, the 12 transactions. The table looks like this, by project name, by the financial accounting income statement benefit that was derived from the beginning of the transaction through the end of last year, and then we list the project amount of financial statement income that would be derived over the duration of the transaction, and the same for the next two columns through 2001, and then the total projected tax savings. The table lists the promotor—that is, the party who brought the transaction to the company—who provided the primary tax opinion, and

the total fees paid to the advisors with respect to these transactions. I think the project fees are broken down further on a project-by-project basis in our report, but these are the aggregate of the fees.

I think when we stepped back and looked at this picture, we felt it was a pretty shocking picture. What we see here is, in essence, \$2 billion of tax and financial statement income. I think it is fair to characterize it as artificial. There is a very diminimus amount of assets that might have been purchased at some point, but diminimus. Much smaller than the fees that were paid.

These are, in essence, when you look to the heart of the transactions, transactions done with yourself to generate artificial tax benefits that led to artificial financial statement benefits. Enron paid \$88 million to promoters and other facilitators to help it do that.

As I said, the report has a detailed analysis of each one of these transactions. It really reveals a pattern of behavior showing that Enron deliberately and aggressively engaged in transactions that had little or no business purpose in order to obtain these favorable tax and financial accounting treatments.

It seemed that financial statement income became a paramount consideration for the company. Enron announced to the world that it was shooting for a target of a billion dollars of net income for the year 2000. That announcement came in 1996.

When the first of the two transactions came in 1995 and 1996, the transactions were intended to shelter a large capital gain. After that, as best as we can determine, most of the transactions were intended to produce financial statement benefits.

I think it is fair to say that Enron's management realized that tax motivated transactions could generate financial statement accounting benefits, and the tax department was looked to do that on a regular basis. In effect, the tax department was converted into an Enron business unit, complete with annual revenue targets. The tax department, in consultation with experts, then designed transactions to meet or approximate the technical requirements of the Tax Code, with the primary purpose of manufacturing financial statement income. The slogan "Show me the money," that is shown in the materials with respect to Project Steele exemplified this effort. However a bona fide business purpose, that is, a purpose that is other than to secure favorable tax and accounting treatment, was either lacking or tenuous in many of the transactions, and clearly was not the reason for the transaction.

Viewed in their entirety, the Enron structured transactions not only pushed the concept of business purpose to the limit—and really, in our view, beyond—but also highlighted several general issues about the nature of the tax system and a corporation's attitudes towards it.

Enron's behavior illustrates that a motivated corporation can manipulate highly technical provisions of the tax law to achieve significant, unintended benefits. Remarkable in many respects was Enron's ability to parse the law to produce a result that was contrary to the spirit of the law and not intended by Congress or the Treasury Department in the case of regulations.

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

Troubling was the lack of responsibility or independent assessment that some advisors showed in evaluating Enron's stated purpose. In one case, the materials that were provided to us indicated that an advisor who also issued the tax opinion was involved in manufacturing the business purpose. It would not be surprising if this kind of collusion existed in other transactions.

Enron also excelled at making complexity an ally. Many transactions use exceedingly complicated structures and were designed to provide tax benefits significantly into the future.

For any person who tried to review the transaction, even if you renewed the deal books that have all the transaction documents in it, there would be no easy way to understand the transaction. Rather, a reviewer would be required to parse details from a series of deal documents, make assumptions about parties' intents, and then try to apply what it thought the relevant rules were. In short, Enron had the incentive and the ability to engage in unusually complicated transactions in order to preclude meaningful review of them.

Corporations like Enron have an inherent advantage over the Internal Revenue Service. Enron structured its deals with the advice of sophisticated and experienced lawyers, investment bankers, and accountants. Assertions of attorney/client privilege hindered the ability of the IRS to obtain many of the most instructive of the documents, and that, in turn, impedes the ability of the IRS to effectively audit the transaction. Also, some transactions resulted in payment of some income tax in the early years, with significantly larger deductions to follow in later years. This kind of a pattern makes it less likely that the IRS will timely identify the transaction.

Just to sum up on this part of our report, Enron's aggressive interpretation of business purpose, cooperation of accommodation parties, the protections provided by tax opinions, the complex design of the transactions, all were factors that encouraged Enron to engage in tax motivated transactions.

Enron places the spotlight, again, on the general ineffectiveness of present law in regulating tax shelters. Tax shelters are, in many ways, a result of the ambiguity of complex provisions of law, lack of administrative guidance, and inconsistent interpretations of the law by courts. Tax shelters also involve the juxtaposition of unrelated incongruous tax provisions in a single transaction or a series of connected transactions. Taxpayers use these complexities to their advantage and perform a clinical assessment of the risks and benefits of engaging in a transaction, often concluding that there is low risk of effective enforcement, including a low risk of whether

or not there would ultimately be a penalty against the transaction, and they easily find that the benefits outweigh those risks.

Until the costs of entering into these kinds of transactions is substantially increased, corporations will continue to engage in transactions that violate the letter and spirit of the law.

With respect to these structure transactions, we have somewhere around 16, 17, or 18 specific recommendations that I am not going to get into here because they are technical. They are listed in our report.

We also had some more general findings and recommendations that I would like to highlight for you. The first one, just to play off of what I just said, is that the Joint Committee staff believes that stronger measures are necessary to discourage transactions that lack a non-tax business purpose or economic substance.

We also recommend that the attainment of financial statement benefits based solely on income tax savings should not be a valid business purpose for purposes of evaluating a transaction or arrangement under Federal income tax law.

The third item we would suggest is that tax law should not permit the use of accommodation parties such as employees, consultants, or advisors. The first two transactions used employees. Employees played a critical role for the transaction to work, and they were treated as an unrelated party under the tax law. In the other transactions, the promoters played the role of an accommodation party to make these transactions work. Our staff believes that there ought to be some severe penalties imposed on these accommodation parties—honestly, we had never seen this before—and on the taxpayer who utilizes the accommodation party.

I have already said, and just to say again in a summary fashion, we are concerned about the willingness of tax advisors to render opinions that rely on factual representation that the advisor knows, or has reason to believe, are incorrect, incomplete, or inconsistent with the facts. Many tax motivated transactions cannot occur without the complicity of a tax advisor who is aware of all the relevant facts, yet chooses to ignore them and instead relies on the taxpayer's purported factual representations. We pointed this out when we describe the actual transactions and point to the opinions and everything about that.

The fifth item we would suggest is that we are concerned that businesses are engaging in tax motivated transactions primarily to obtain financial accounting benefits. The accounting benefits result entirely from manipulation of the Federal income tax laws to create permanent book tax differences. We believe that, while this treatment is based solely on the Federal tax benefits, we are concerned—and this is not our area of expertise—that there may be certain aspects of the financial accounting rules governing accounting for income tax expense that need to be reviewed by the regulatory bodies, and we urge those bodies to look at that.

Another significant observation is that we are concerned about the use of multiple entities in connection with the tax motivated transactions. Coupled with the inherent complexity of these transactions and the delayed timing of the tax benefits, it is exceedingly difficult for the Treasury Department and the IRS to timely identify and properly evaluate these transactions. We think that, as a

preliminary step, that detailed disclosure of any tax motivated transaction needs to be done on a timely basis, irrespective of whether the transaction has immediate tax benefits.

We applaud the statement that was made by the Chairman and Senator Baucus today, that appropriate action will be taken effective as of today, because that is one of the unusual parts of this report. The report provides such a detailed analysis of complicated transactions, and it could serve as a road map to others to engage in these kind of transactions.

As I said, our report has more specific recommendations that I am not going to go into in detail here, but I would be happy to talk to you about in questions.

Now I would like to turn over to the pension and compensation section of the report. It is another very lengthy section of the report.

Just as an overview, Enron's compensation arrangements received considerable media attention in the aftermath of Enron's bankruptcy. Some of this attention focused on the broad-based retirement plans maintained by Enron that received special tax benefits. These are the qualified retirement plans. We looked into a variety of issues with respect to them.

For many Enron employees, the benefits provided under these plans were the primary source of retirement income. Of course, they have lost that source of income if their assets were invested in Enron stock, which there was a high concentration of that in this case.

So, just looking at the retirement plans, Enron maintained a lot of plans, but the three main plans were: an Employee Stock Ownership Plan, also known as an ESOP; the Enron retirement plan, which was a defined benefit plan but was modified to switch over to a cash balance plan in the mid-1990's; and the Enron savings plan, which is, in essence, a 401(k) plan.

The issues that we looked at concerning the qualified plans included the locking in of the value of the ESOP offset under the Enron retirement plan, which is a unique feature that the IRS has been looking at; the conversion of the Enron retirement plan into a cash balance plan; the investment of the Enron ESOP in Enron stock; the change in recordkeepers under the Enron savings plan that resulted in the black-out period in October and November of 2001 during which plan participants were not able to change their investments while the price of the Enron stock was falling.

We also looked into the reasons behind the level of investment in the Enron savings plan assets in Enron stock, and some allegations that were made by a former contract and full-time employee that payments were diverted from employee benefit plans to unrelated employee benefits.

In addition to the qualified retirement plan issues, we also focused a lot of attention on the various compensation arrangements of Enron, particularly those of officers and executives in the company.

Enron had a pay-for-performance compensation philosophy. Employees who performed well were compensated well. Enron's compensation costs for all employees, and especially for executives, in-

creased significantly over the years just immediately before the bankruptcy.

We have a table that shows the compensation of the top 200 highly compensated employees for 1998 through 2000, and we have it broken down between their base salary, bonus, stock options, restricted stock, and then a total amount. Just looking at the total amount, the top 200 employees received total compensation of \$193 million in 1998, and \$1.4 billion in 2000. So, you see a large increase in the total compensation in the last 3 years of the company. Most of that increase is attributable to stock options. You can see the column under stock options on page 26 of the testimony that shows stock options were about \$62 million in 1998, and over \$1 billion in 2000.

Another component of executive compensation is the non-qualified deferred compensation. We have a table on page 27 that shows the approximate amounts that were deferred by executives under the deferred compensation plan. Again, these were the top 200 executives, or top 200 paid employees of the company. In 1998, they deferred \$13 million of their compensation, in 2000 they deferred \$67 million. So, there was an increase there. In addition to that, there were significant distributions just before the bankruptcy of these monies. Fifty-three million dollars was taken out the 2 months before the bankruptcy filing, I think it was.

Senator BAUCUS. What was the bankruptcy date?

Ms. PAULL. December 2, 2001. This would have been the last few months before that.

As I noted, Enron did have a culture of having employees own Enron stock. There was stock-based compensation used as a principal form of compensation for executives, but it was also used as a form of compensation for employees, more generally. As I noted before, the deduction for compensation attributable to the exercise of non-qualified stock options increased by more than 1,000 percent from 1998 to 2000, so there was a significant increase in their tax deduction for that.

Also, just before the bankruptcy—and literally, this was just before the bankruptcy, a week or two before—two bonus programs were established, one for approximately 60 key traders and one for approximately 500 employees that the company had identified as critical for continuing the operations of Enron on a going-forward basis. In order to participate in the program, the employee had to agree to stay for 90 days. If the employee did not stay for 90 days, the employee would have to give the bonus back, plus 25 percent. The combined costs of that program, immediately, as I said, just weeks before the bankruptcy, was over \$100 million.

Enron also had some special arrangements for a small number of executives. In some cases, they were arrangements just for one employee. We had one executive who received a fractional interest in a jet aircraft. We had a few employees that received loans or lines of credit from Enron. Some employees had split-dollar life insurance arrangements. An unusual transaction was when Enron purchased two annuities from Kenneth Lay and his wife as part of a compensation package for 2001. And certain executives were allowed to exchange their interest in plans for large cash payments, or stock options, or restricted stock grants. There were, as I said,

for a limited number of executives, some fairly special arrangements.

Let me now just turn to some of our general observations with respect to the pensions and compensation and note that we probably have a dozen or so specific recommendations with respect to this area. I am not going to highlight all of those, but would just highlight a couple of our general findings.

But, first, as I said, Enron had a philosophy of pay-for-performance; those who performed well were paid well. There was a broad array of compensation arrangements for executives, including base pay, bonus, and long-term incentives.

The approval of the compensation packages for its executives rested almost entirely with internal management. Although the Compensation Committee of the Enron Board of Directors formally approved both the total amount of the compensation paid to executives in the form of such compensation, the Compensation Committee's approval generally was a rubber stamp of the recommendations made by Enron's management.

The lack of scrutiny of compensation was particularly prevalent with respect to Enron's very top executives, who essentially wrote their own compensation packages. We also would observe that there was really no indication that the Compensation Committee ever rejected a special executive compensation arrangement brought to the Committee.

I think one of the more difficult things that we had in this area, was that Enron did not seem to have a consistent or a centralized recordkeeping system with respect to compensation arrangements in general, and especially with respect to the top executives.

Enron could not provide us with documentation relating to any of the special compensation arrangements for the top executives. When we asked employees about these arrangements, employees who were responsible for compensation, they seemed to have no knowledge of certain aspects of the executives' compensation. The kinds of documentation or listings of people's compensation would vary from list to list. It was very difficult to make certain that we got the most accurate information, because it never seemed to be the same time every time we asked for it.

We would also note that Enron's heavy reliance on stock-based compensation, both with respect to executives and with respect to rank-and-file employees, certainly caused a significant financial loss when Enron's stock price collapsed. As part of the philosophy that a large portion of executive compensation should depend on shareholder return, Enron rewarded executives with huge amounts of stock options, restricted stocks, and bonuses tied to financial earnings. In addition, a strong company culture encouraging stock ownership by all employees led to high investments in Enron stock by employees through their 401(k) plan, the savings plan. When Enron's stock price plummeted, Enron's employees and executives lost millions of dollars in retirement benefits, through various compensation arrangements that employees had. Although some executives suffered very large losses that appeared to be stunning in amount, many executives also reaped substantial gains from their compensation arrangements. But the rank-and-file employees, in many cases, virtually lost all of their retirement savings, in es-

sence, because they believed the statements made by the top executives up to the very end that Enron was viable and the stock price would turn around.

As I said, we have probably a dozen or more specific recommendations. I would just highlight three areas that we would bring your attention to.

One area has to do with the high concentration of investment in Enron stock. That is an area that we hope the Congress would pay some attention to and focus on. At a minimum, plans should provide participants with investment education on a regular basis, especially if a person has a high concentration of an investment. The high concentration does not necessarily have to be in employer stock. It should be a red flag to a plan to give the participant more investor investment education.

I would just say, without getting into details, that we would hope that you would examine the non-qualified deferred compensation arrangements. Enron had executives that were exerting control, apparently, over their compensation by directing the investment of these deferred compensation arrangements, and then they actually could receive the money back just before bankruptcy. There is a question of whether the tax rules should be reviewed and restricted with respect to this whole area of deferred compensation.

Finally, we question the wisdom of the million dollar cap on the compensation deduction for certain employees, the very top employees, of the company. In the case of Enron, it did not appear to have any effect. Enron was able to qualify most of the compensation for a performance-based exception, and it was also a net operating loss company so it did not seem to care about the deductibility issue. So, the cap is really a corporate governance issue. It is really not a tax issue, and we would question the wisdom of keeping the cap in the Tax Code.

So with that, I have probably gone on way too long. But I hopefully gave you a flavor for what is covered in our report, and I would be pleased to answer any questions you may have now or later.

The CHAIRMAN. Thank you for being willing to answer questions. I want to go to our other four panelists.

Ms. PAULL. Right.

The CHAIRMAN. And, as I indicated, your entire statement will be put in the record. For Ms. Paull, there does not need to be any apology for taking a long time because you have just reported in a short period of time the work of a year. Also, there obviously will be hours and hours put into our review of that report, at least at the staff level.

[The prepared statement of Ms. Paull appears in the appendix.]

The CHAIRMAN. So I am going to start left to right, Dr. Plesko, Dr. Outslay, Dr. Seida, and then Ms. Kennedy.

STATEMENT OF DR. GEORGE A. PLESKO, ASSISTANT PROFESSOR OF MANAGEMENT, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Dr. PLESKO. Thank you.

Chairman Grassley, Ranking Member Baucus, and members of the committee, thank you for inviting me to testify today.

My charge this morning is to provide a context for the JCT report, and I will address three issues not specific to Enron, but which generally relate to the financial and tax reporting Enron firms face.

First, I will address differences in the accounting systems for financial and tax reporting. Second, I will discuss improvements that can be made in disclosure of tax information by publicly traded firms. Finally, I will briefly touch upon the administration's proposal for dividend relief as it relates to today's hearing, specifically the effect on firms' incentives to engage in tax-minimizing transactions.

The purpose of financial accounting is to yield information useful to investors and creditors in making decisions about firms. Financial accounting, while seeking to achieve comparability across firms and consistency within, does not require accounting rules to be implemented uniformly by each company. This is in contrast to the approach taken in much of the tax law, where uniformity in the accounting for economic events is required.

Beyond the different rules, firms face differing incentives for financial and tax reporting. As we have seen, managers have incentives to increase income reported to shareholders, while minimizing currently reported taxable income.

It is apparent from the academic literature and known transactions that neither tax, nor financial reporting considerations, consistently dominate the other.

Aggregate differences between the amount of income reported to shareholders and the fisc are significant. From 1996 to 1998, the dollar amount of the excess of pre-tax book income over tax income grew from \$92.5 billion to more than \$159 billion, an increase of 72 percent. In 1998, this difference equaled 24.2 percent of total tax net income.

While over this period tax net income fell slightly, pre-tax book income reported to shareholders grew 8.5 percent. The growth in these differences may largely be due to aggressive financial accounting rather than just tax minimization.

On January 2nd of this year, the Permanent Subcommittee on Investigations of the Government Affairs Committee released a report detailing four Enron transactions. Three were identified as leading to an overstatement of Enron's financial position and were not tax motivated. The fourth was designed to reduce Canadian taxes, but was reported as having no effect on U.S. tax liabilities.

But this leads to the second point, whether or not there are sufficient disclosures under the current system. Mr. Chairman, on July 8, 2002, you wrote the Treasury Secretary and the Chairman of the Securities and Exchange Commission asking about the potential benefits of additional disclosure.

My answer to the additional question you posed of whether sufficient tax information is already publicly available is, no, it is not. It does not appear to me that either tax authorities or investors have all of the information that could be made available about a firm's tax position, and major improvements would not be difficult to achieve.

At this point, I am not convinced full public disclosure of corporate returns is warranted, and recognize confidentiality concerns expressed about sensitive competitive information.

But I am convinced that more and better disclosure of tax information could be achieved with little or no administrative or economic cost to the firm.

Lillian Mills, of the University of Arizona, and I have outlined a proposal for substantial revisions to the Schedule M-1. Our proposed modifications provide for a more detailed reconciliation, anchored to the income numbers reported in a firm's 10-K.

In addition to improvements in tax administration, she and I conclude that any debate on public disclosure should begin with the idea of the Schedule M-1.

We argue that, potentially, the entire M-1 of each firm, each tax return filed, could be made publicly available as it contains information that others, such as the Financial Accounting Standards Board, have already deemed as important to the general public. The Joint Committee report provides this type of information for Enron, as was highlighted by Ms. Paull.

To close, let me briefly comment on how proposed changes in dividend taxation could affect tax-minimizing behavior. The general topic of dividend relief is outside the scope of today's hearing, but the argument has been made that the proposal will discourage companies from engaging in aggressive tax planning because lowering a company's tax bill will reduce the amount of tax-free dividends that can be paid to shareholders.

While this claim is qualitatively true, I think the quantitative effect is likely to be quite small. There are very strong economic arguments to be made for integrating corporate and individual taxes as part of a broad and fundamental tax reform. As we have just had detailed to us, distinctions between debt and equity invite complicated transactions to exploit one or the other characterization.

But we think about the goals of management as maximizing shareholder wealth through the maximization of either after-tax profits or cash flows, and we have already seen in the testimony so far about tax staffs being used as profit centers.

This theory, therefore, suggests that firms should consider the tax situations of their own investors, but there is no strong evidence that firms operate in such a manner. The market, however, solves this with participants making investments in opportunities that match their desires for taxable or tax-preferred returns.

Given that many will not benefit, or remain indifferent, and other aspects of the Code will not change, it seems to me that the incentive for managers to continue to seek to minimize taxes will continue largely unabated unless, as has already been pointed out, there are fundamental changes to the managerial compensation and incentives of these companies.

Thank you again for the opportunity to be here today, and I look forward to the further discussion of these issues.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Plesko appears in the appendix.]

The CHAIRMAN. Now, Dr. Outslay?

STATEMENT OF DR. EDMUND OUTSLAY, PROFESSOR, DEPARTMENT OF ACCOUNTING, THE ELI BROAD COLLEGE OF BUSINESS, MICHIGAN STATE UNIVERSITY, EAST LANSING, MI

Dr. OUTSLAY. Chairman Grassley, Ranking Member Baucus, esteemed members of the committee, I appreciate very much the opportunity to testify this morning on issues raised by Enron's tax returns and practices.

My testimony reiterates many of the points my colleague, Gary McGill, and I made in our recent Tax Notes paper entitled, "Did Enron Pay Taxes? Using Accounting Information to Decipher Tax Status."

The current attention focused on discrepancies between publicly traded corporations book and taxable incomes hearkens back to a similar period in the first half of the 1980's.

As a result of tax legislation enacted in the Economic Recovery Tax Act of 1981 particularly accelerated depreciation and safe harbor leasing, corporate tax payments and taxable income shrank dramatically relative to reported accounting problems.

In response, Congress closed several tax loopholes, such as the completed contract method of accounting. It enacted the corporate Alternative Minimum Tax. If you will remember, one of those AMT adjustments was a 50 percent add-back for the difference between book and taxable income, which proved to be both a nightmare and caused more earnings management.

As Ms. Paull mentioned, whereas tax planning strategies in the 1980's focused primarily on temporary differences, more recent tax planning strategies tend to focus on what we call permanent differences.

The most prominent strategies that create permanent differences include income shifting to low-tax jurisdictions, including corporate inversions, using non-qualified stock options to create tax, but not book deductions, and transactions that create tax credits or tax-exempt income, such as the corporate life insurance policies on rank-and-file employees.

The growth of these types of tax strategies reflects a shift in the manner in which companies view the role of their tax departments, as we just heard, moving them from cost centers, compliance-oriented, to profit-centers, bottom line-oriented.

Tax strategies that lower tax but not book income show up in a reduced book tax provision, thus increasing after-tax income and lowering the company's book effective tax rate.

Evidence of tax planning that has become an integral part of earnings management can be found in these annual Tax Efficiency Scoreboards published by journals such as CFO Magazine.

Our focus on Enron has been with regard to the current accounting rules dealing with the company's disclosure of its tax status. Estimates of Enron's most recent tax liability ranged from zero to \$112 million, and we found out this morning it was actually about \$60 million.

The exasperation expressed by analysts that accounting information lacks precision when it comes to discerning tax status of Enron or any other public company is not new.

As far back as 1986, my colleagues and I noted that "GAAP concerning accounting for income taxes and the related reporting re-

quirements are so difficult to comprehend, they are subject to varying interpretations which lead to extreme diversity in the treatment of similar transactions.”

Senator Grassley, when you asked whether sufficient tax information is already publicly available to determine a corporation’s tax status, we would say no. Some commentators have suggested that the solution is to make the entire corporate tax return public. As Ms. Paull mentioned, for multinational corporations, such a return can exceed several thousand pages.

Very few investors would have the patience to sift through such voluminous materials, and even if they did most would not be able to identify the specifics of the transactions that produced the reported information.

Academic researchers, on the other hand, would love such detailed information to be made publicly available, but such sunlight does not guarantee that a corporation’s activities would become more transparent.

But disclosure does not have to be an all-or-nothing proposition. An expanded income tax note along the lines George recommended would be a step in the right direction. Specific disclosure of the tax benefits from employee stock option exercises would make stop options more transparent.

A separate statement of U.S., State and local, and international income taxes paid in the current year should be mandatory. An alternative would be to make the first four pages of Form 1120 publicly available, although such information would not disclose the corporation’s international tax liability.

We would also like to see the deferred tax asset and liability balances in the incomes note tie out to the amounts reported on the balance sheet.

In summary, the issue as to whether Enron paid taxes opens debate on two fronts, both with the common theme of transparency.

Accounting and tax reports should not be a cat-and-mouse game to the public or to the government. I think the issue we are discussing is, what becomes the size of the bell to put on the mouse.

Moving from a hide-the-pea approach, which we currently have, to a needle-in-the-haystack approach, which we might get, could really actually have a perverse effect, producing less, rather than more, transparency.

Thank you for the opportunity to participate this morning, and we welcome further dialogue on these important issues.

The CHAIRMAN. Thank you, Dr. Outslay.

[The prepared statement of Dr. Outslay appears in the appendix.]

The CHAIRMAN. Now, Dr. Seida?

**STATEMENT OF DR. JIM A. SEIDA, ASSISTANT PROFESSOR,
MENDOZA COLLEGE OF BUSINESS, UNIVERSITY OF NOTRE
DAME, NOTRE DAME, IN**

Dr. SEIDA. Thank you for the opportunity to be part of today’s hearing. I would like to make several comments regarding tax shelters, tax disclosure, and specifically on Enron.

With respect to tax shelters, apparently it is difficult for some tax shelter promoters and business managers to determine when a

tax shelter crosses the line from a legitimate and ethical tax planning device to an abusive tax shelter. Without guidance of where this line is or where it should be, the line of demarcation will probably continue to drop.

On this slippery slope, one shelter will be compared to another in terms of its legality. There needs to be a line to evaluate what is acceptable and what is not acceptable with respect to tax shelters. Legislation may be the only way to establish this line.

However, we also must ensure that U.S.-based firms are not placed at a competitive disadvantage due to the U.S. income tax system.

With respect to tax disclosure, a common theme in the testimony by Professors Plesko and Outslay is that it is difficult to accurately estimate a corporation's taxable income from publicly available financial statement information, and that tax disclosure should be improved.

A simple improvement, is to require a corporation to disclose its U.S. taxable income. Requiring the disclosure of U.S. taxable income might allow outsiders to better assess the extent to which a corporation uses tax shelters to reduce taxable income and/or aggressive accounting methods to increase reported earnings.

Since corporate managers generally have incentives to report higher financial accounting income and lower taxable income, one income measure can be used to evaluate the other.

While differences may not necessarily indicate abusive tax sheltering or aggressive financial reporting, large differences should result in additional scrutiny of the reported income numbers.

Since large differences could raise a red flag, management would have an incentive to voluntarily explain material items responsible for the difference. Thus, the required disclosure of taxable income has the potential to reduce both abusive tax sheltering and aggressive financial reporting.

What is interesting in the case of Enron, is that the tax disclosures did suggest that Enron was not paying much tax and that taxable income was negative, despite reporting positive book income.

The reported U.S. tax net operating loss carryforward, disclosed as part of Enron's financial statements, suggest that Enron's cumulative U.S. taxable income over the 4-year period 1996 to 1999 was (referring to the Joint Committee on Taxation's report on Enron) negative \$2.9 billion, which seems consistent with the report.

Over the same period, Enron's reported pre-tax book income was nearly \$2.9 billion. Thus, the cumulative difference over the 4 years between the taxable income and the book income was approximately \$5.8 billion, a negative \$2.9 billion taxable loss and a \$2.9 billion positive pre-tax profit.

This difference does not appear to be explained by foreign income that is not subject to U.S. tax and deductions related to stock options. It is not clear what is responsible for this large divergence between financial accounting and tax accounting measures of income.

Given Enron's large U.S. tax losses, it had little incentive to further reduce U.S. taxable income. Thus, it seems likely that this

large divergence between current taxable income and financial accounting income is due to aggressive financial reporting.

Several questions follow. Why did this large divergence between tax and financial accounting income, computed with publicly available data, not raise a red flag?

Would the disclosure of taxable income improve investor ability to detect abusive tax shelters and aggressive financial reporting? If Enron's taxable income was disclosed more prominently, would Enron's aggressive financial reporting practices have been detected sooner?

In Enron's case, the estimated taxable income figures paint a considerably different picture than the reported financial accounting income figures do. Given what we know about Enron, it is not surprising that it paid very little in taxes. Thank you.

The CHAIRMAN. Thank you, Dr. Seida.

[The prepared statement of Dr. Seida appears in the appendix.]

The CHAIRMAN. Ms. Kennedy?

STATEMENT OF PROFESSOR KATHRYN J. KENNEDY, ASSOCIATE PROFESSOR, THE JOHN MARSHALL LAW SCHOOL, CHICAGO, IL

Ms. KENNEDY. Thank you, Chairman Grassley, Ranking Member Baucus, distinguished members of the committee. Thank you for this opportunity.

Like you, I have not had an opportunity yet to review the Joint Committee on Taxation's full report, but I am familiar with the terms of the Enron deferred executive compensation plans, and with abuses that have been occurring in this area.

My purpose in this testimony is twofold: to outline for you some of the abuses that we have seen in executive deferred compensation arrangements, and to offer proposed legislation to eliminate these abuses. Attached to my testimony are proposed legislative changes to Sections 61 and 83 of the Internal Revenue Code, and proposed regulatory changes to ERISA.

In order for an executive to avoid any current taxation on deferred compensation, two of the Internal Revenue Code rules must be satisfied, that of constructive receipt and that of economic benefit.

The constructive receipt rules of Section 61 tax the individual if he/she has any control over the timing of the income. Unfortunately, since 1978, Treasury has been under a moratorium with respect to issuing constructive receipt rulings.

In contrast, the economic benefit theory of Section 83 focuses on whether the taxpayer has any economic benefit in property from the employer. The Service has long regarded that an employer's unfunded and unsecured promise to pay deferred compensation is not property.

However, the Service has affirmed the use of trusts, such as rabbi trusts, to provide protection for executives against an employer's later change of heart or change of control, provided the assets remain subject to the claims of the creditors.

While there is not a moratorium on the Service's ability to issue guidance under Section 83, it has refused to issue guidance on any-

thing outside the model trust language. This policy, coupled with the 1978 moratorium, has made conditions ripe for abuse.

So what abuses are we seeing in this area? First, the list of distributable events. Like qualified plans, most non-qualified plans provide for a distribution of benefits upon certain events: retirement, disability, death.

However, we are seeing an expansion of this list, an expansion that even goes to employer bankruptcy or insolvency. Clearly, such a feature, coupled with the rabbi trust, virtually insulates the executive from any risk at all. So, I recommend that Congress explicitly document the distributable events that may be used under a non-qualified deferred compensation plan.

Second, with respect to subsequent elections, many of these plans are permitting participants to change their original election regarding when and how benefits will be paid.

While the Treasury has prohibited this, the courts have permitted it. Therefore, I recommend Congress focus on this area and require at least a minimum of a 1-year advance or 2 years' advance requirement for insiders.

Third, we are seeing in-service distributions being permitted under these plans, either through a hardship withdrawal or a non-hardship withdrawal that is subject to a "haircut." Some of these plans have been extremely lenient in their definition of hardship and have set haircut provisions at 5 percent, or even lower.

I recommend that Congress add hardship to the list of distributable events, but define that term very narrowly. And, as to the haircut penalty, certainly if the penalty is sufficiently large, it does impose a substantial risk of forfeiture. But, as we have seen in the Enron situation, I recommend to Congress that they affirm any use of haircut provisions only to non-insiders.

Lastly, the modification of rabbi trusts. Rabbi trusts can be successfully used under Section 83 to secure an executive's benefit under a non-qualified plan against subsequent change of ownership of the employer or subsequent change of heart by future management.

However, we are seeing an expansion of this list to include employer declining health, even bankruptcy or insolvency. I recommend Congress limit these triggering events solely to change of control or change of heart.

In addition, we are seeing rabbi trust assets move offshore as another way of providing greater security to executives, to the detriment of creditors. I recommend that Congress state that such offshore arrangements will be property under Section 83.

How should Congress proceed? I urge Congress to take the lead and specify in the Code the applicable constructive receipt and economic benefit rules that should govern these plans.

I also recommend that Congress direct the Secretary of Labor, through its regulations, to subject these plans to similar reporting and disclosure rules that are applicable to qualified plans.

Thank you.

[The prepared statement of Ms. Kennedy appears in the appendix.]

Senator BAUCUS. Thank you, Ms. Kennedy.

Ms. Paull, if I am reading Table 3 on page 10 of your report correctly, under the last column it lists promoter fees. It looks like Enron agreed to pay about \$88 million in project fees for 12 transactions, and that seems like an awful lot of money.

So my question is, what did Enron buy? What was the net result of paying those fees? What did they get out of it? I would like to address not only the transaction and the artificial gain, but also whatever business purpose gain.

Ms. PAULL. Well, as I mentioned before, that table puts together in one place really the core of the transactions. Enron basically structured these transactions to create \$2 billion of tax benefits, which would have led to \$2 billion of, over time, financial statement benefits.

Our review of the transactions found that they were mostly internal machinations. We could not find any assets that were purchased or any wealth that was built for the company. That is what they bought for these fees.

Senator BAUCUS. Right.

Also, could you expand a little more on your point that the tax department was a profit center, what that was, and what that implies?

Ms. PAULL. The tax department, over time, as it succeeded in producing some significant transactions, began to get targets for producing transactions that would yield financial accounting benefits.

In our appendix, we have a series of presentations that were regularly made to the higher ups with respect to what they were doing. They were reporting on, in essence, their success, and we suspect they were rewarded in an appropriate way.

Senator BAUCUS. Now, given what you have discovered, how easily could other major corporations and their accountants, their lawyers, their investment bankers, and so forth, structure some of these same arrangements?

That is, for financial statement purposes, they show great income, great gain, but for tax purposes, particularly, I guess, the tax is deferred to sometimes a later date, or the taxes are reduced. How easily can other companies, theoretically, do this?

Ms. PAULL. Well, it took a long time for Enron to pick the transactions. Enron looked at a lot of transactions and picked these. So you had to be large and you had to have the resources to be able to analyze and implement very complicated transactions.

It was not a cookie-cutter kind of a deal. But, as far as we could tell, there was a relationship with a select number of advisors who brought Enron these kind of transactions, helped facilitate as a party in some aspects of the transactions to make them work.

I would think that it was not unique, but we do not know how widespread it would be. But you would have to be pretty sophisticated to engage in these kind of transactions.

Senator BAUCUS. But my guess is that there are sophisticated lawyers and accountants in other parts of the country besides Texas.

Ms. PAULL. Well, they were not all from Texas, if you take a look at the list.

Senator BAUCUS. Where were they from?

Ms. PAULL. This was a big company and they had the resources.
 Senator BAUCUS. I am just curious. Most of their lawyers were from where, and their accountants were from where?

Ms. PAULL. They were either in the northeast or in Texas.

Senator BAUCUS. All right.

In your Table 3 on page 10, the report does not break down who is receiving the lion's share of the fees, whether it is accountants, lawyers, or promoters. Could you give us some indication of who received most of the fees?

Ms. PAULL. Well, we do break down the fees on a project-by-project basis. I believe the lion's share of the fees go to the promoters.

Senator BAUCUS. Just looking at all this together, what kind of surprised you the most about all this, and generally what is the most effective way for us to deal with this, assuming that these kinds of transactions are probably reoccurring someplace? It is probably not the norm, but there is probably enough of it someplace in the country to warrant—

Ms. PAULL. I hope it is not the norm.

Senator BAUCUS. We hope it is not the norm.

Ms. PAULL. We do not know.

Senator BAUCUS. But let us assume that these kinds of transactions are probably occurring somewhere else. What surprised you the most about all this? What is your overall impression? Just basically, what do we have to do?

Ms. PAULL. I think we were just shocked by the ability of the company to produce these kind of results with the complicity of other folks who were willing to go along with them. There was no business purpose to these transactions other than to generate these artificial tax benefits which led to financial statement benefits.

We know there is a lot of legitimate, bona fide tax planning going on out there every day of the week with businesses, but we were just shocked to see these transactions with, in our view, the business purpose really not there.

In order to attack the transactions, as I said before, you have got to get in there. The business propose test is a facts and circumstances analysis. We had access to documents that showed end games that were ignored, in essence, intended outcomes that were ignored in giving the up-front opinion, for example. That would have changed the result.

Another shocking thing to us was that while the tax opinions were assuming one set of facts, the accounting opinions were assuming that outcome in order to be able to record these tax benefits as a financial statement benefit.

So, really, honestly, it was eye-opening for our staff to take a hard look at what these transactions really were about. I do not think there is any magic bullet to fixing this.

Senator BAUCUS. What about more public disclosure, as suggested by some of the panelists?

Ms. PAULL. I think there has to be a whole array of solutions here. More public disclosure in probably several areas ought to be looked at, but that is not a tax thing. I think we raised the issue, but we do not go into it very much.

We think more tax disclosure would be helpful. We also think, as I mentioned before, a very tough penalty on taxpayers is needed to change the cost benefit analysis of going into these transactions. Hopefully, maybe the accounting folks will take a look at their rules, too. I mean, I think it is a whole array. There is no one silver bullet to fix this.

Senator BAUCUS. Thank you, Mr. Chairman.

The CHAIRMAN. I wanted to apologize to Ms. Kennedy. I was called down to the committee room down the hall to help make a quorum in Judiciary. I may have to be called back one more time, but in the meantime, I would ask questions.

Ms. Paull, your report tells a story about how the Enron structured transactions came about in very broad terms. Would you walk us, kind of, through that process?

Ms. PAULL. Yes. Basically, a transaction would be brought to either the finance department, treasury department of the company, or the tax department.

The tax department would look at the transaction, which would be a fairly complicated transaction, so they needed people who were capable of analyzing the transaction. If the tax department thought this was a transaction that might be viable for the company, then they would see if they could get, in essence, a "should" level opinion, which means that the taxpayer should prevail.

Then the tax department would seek approval for entering into the transactions, and then they would enter into an engagement with the promoters and implement the transaction.

The CHAIRMAN. I would like to refer to Table 3, page 10 of your report. It shows that during the years 1995 to 2001, Enron reported \$651 million in accounting income, all of which comes from questionable tax benefits.

The "show me the money" diagram, that would be B-177 of Volume 2 of the report, talks about how Project Steele was to earn \$132.8 million of the pre-tax operating income. So the question is the significance of that term "operating income," as opposed to other types of accounting income.

Ms. PAULL. Well, operating income is the kind of income that the market analysts use to try to evaluate what the worth of a company is, and it has a direct bearing on basically market values of the company. So, being able to produce—as two of our transactions, at a minimum, did—operating income is a really significant factor in the marketplace.

The CHAIRMAN. All right. I would like to turn to an accounting issue for you, Ms. Paull. The report states that Enron did many of these questionable transactions to generate accounting income and do it right now based on future tax deductions. Is this a tax problem or is it something that other agencies should be concerned with, or maybe it could be both?

Ms. PAULL. Well, at its core it is a tax problem, because at its core it is structuring a transaction that is supposed to yield tax benefits that, as Dr. Outslay said, is a permanent tax difference.

When a transaction results in those kinds of benefits, then it translates into financial statement benefits. So I have to say, at its core, it is a tax issue. But I think our recommendation, in general, is that the accounting bodies should take a look at the FAS-109

Statement of Accounting for Income Taxes and evaluate whether or not they think they are getting the right result, too.

The CHAIRMAN. It might be all right if one or the other four panelists might want to comment on that from your experience.

Dr. OUTSLAY. I think Ms. Paull does pinpoint the trend that we have seen in the last decade in terms of how tax strategies are marketed and becoming much more of an accounting-oriented marketing strategy as opposed to sort of just simply looking at cash flows and tax benefits.

So I think that, given that we were only able to sort of observe what Enron reported, at least until today, on the financial statements, our frustration has been in trying to sort of determine exactly what kinds of strategies produce these sort of accounting results. In some of the tax benefits that we think should be reported in the income tax note end up getting put in other accounts.

So, I think it is fairly, I do not know about easy, but there are ways that you can sort of camouflage some of these things, that they do not actually appear where you think they should appear. So, I would support improved disclosure. Again, you could do that through the SEC or SX-149, or something like that.

Ms. PAULL. Also, Mr. Chairman, I forgot to mention that one of the issues—because I think the accounting profession struggled with this—is that these tax benefits that are derived well into the future are not present valued for this purpose.

I do not know that we know how to advise anybody on that, but that is another one of the disconnects that is going on here. Enron was recording financial statement benefits in earlier years based on tax benefits that are going to be derived in later years, and there is no accounting for the present value notion either.

The CHAIRMAN. Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman. Thank you for having the hearings.

Thank all the witnesses, and especially Lindy Paull, for the good work that you and your staff have done on this. Thank you for your great service on the Joint Committee. I have always enjoyed working with you, even when you did not give me the cost analysis that I was looking for, which occurred every now and then.

It seems to me that, in looking over the report and listening to the testimony, that what we have is that, instead of drilling for oil and gas, Enron was drilling the Tax Code, looking for ways to find more and more tax shelters. They were very successful in that regard.

To put it in perspective, an individual janitor in Louisiana making \$10,000 a year was paying more in Federal income taxes in 1996, 1997, 1998, and 1999 than the Enron Corporation was making billions of dollars of revenues.

Now, if that janitor asked me, what in the world is going on, I would probably have to tell him, well, you did not have a good tax lawyer. Maybe if he had, he could have found a way to have zero tax liabilities like Enron did.

The question is, however, is there anything that you all came up with in the analysis and the investigation that indicated that anything Enron was doing was illegal as opposed to just drilling the Tax Code for existing loopholes and tax shelters?

Ms. PAULL. I do not know what you mean by illegal. In a criminal sense, we did not pursue any avenue that may have had a law enforcement organization interested in it. So, if there was an avenue where there was a possibility of a law enforcement agency involved, we did not pursue the matter.

Senator BREAUX. Well, did anything strike you as being in that area that perhaps was more than just mining the Tax Code, but going further than that?

Ms. PAULL. Well, I would just have to say, we would hope that these transactions ultimately would not produce the benefits that Enron was hoping to get from them. So, in our view, these are inappropriate benefits that Enron was seeking to achieve.

I do not know if you want to call it illegal or not. We would hope that if it got down to it and a court looked at it, the court would agree that this result should not happen under the Tax Code.

Senator BREAUX. Were there examples of collusion between the Enron Corporation and the tax advisors and/or tax attorneys in structuring these deals, or were they at arm's length in the cases that you all looked at?

Ms. PAULL. Well, we have some instances where we would question the independence of some of the advisors. We would say, at a minimum, that they turned a blind eye to some critical facts that would be outcome-determinative under the tax law.

Senator BREAUX. Were there any examples that you all ran across where the tax advisors had the opportunity to benefit from the transaction that they, themselves, were advising on the propriety of?

Ms. PAULL. We did have some indication of that, in one case. In other words, somebody wrote all over one of the documents in here that, the firm that is giving the tax opinion, some of the partners in the firm would be investing in an entity to make it a viable entity, meeting the requirements under the Tax Code. There is a document indicating that the partners of this law firm who was giving the tax opinion would participate in the transaction. In the end, they did not, as far as we know, participate.

Senator BREAUX. It has been suggested, somewhat strangely, I think, that one way to prevent Enron-type problems in the future would be to eliminate corporate dividend tax.

I guess the theory is, if you have less money in the corporation you will have less opportunities to steal, which is sort of a novel way of looking at it.

I mean, is there any evidence that, if we had not had the double taxation on corporate dividends, that somehow all of this would not have occurred?

Ms. PAULL. Well, first of all, for 1996 through 1999, Enron did not pay corporate income tax.

We could barely get our report done. We have not tried, for example, to evaluate the tax shelter legislation the committee just approved to see whether it hits the mark or not with respect to the Enron transactions. We have not been able to evaluate something like that.

Certainly, we could get back to you. But I do not think dividends from that company, at least during some of these periods, would even qualify because they are not subject to double tax.

Senator BREAUX. I know my time is up. But, for the record, during the years 1998, 1999, 2000, and 2001 when these types of transactions were occurring, Enron was, in fact, declaring dividends.

The argument that somehow if we did not have a double taxation on dividends, the corporation would declare dividends and somehow not misuse the money, I think, is something that just stretches anyone's imagination.

Thank you.

The CHAIRMAN. I think I will follow up with the very question he asked, but not ask it again, and not ask it of Ms. Paull. But just kind of as Senator Breaux put the question out, would any of the panelists want to comment on that?

Dr. PLESKO. If I may, I touched on that at the end of my testimony. I think it depends on how you would structure the dividend relief. In the context, for example, of the current proposal, I think what you have to do is step back and say, what managers do is maximize shareholder value. That is what they are supposed to do.

How do they do that? They do that by maximizing the after-tax cash flow that they have for their shareholders. So if you look at the ways in which you would incorporate the individual investors' thoughts into the process of do they want dividends or not, to the extent that you have preferences for long-term capital gains, which is deferred and at a rate lower than the current corporate rate, I am not sure I would want the corporation I am investing in to pay 35 cents now if I could get capital gains taxation on that at a much later date at 20 percent.

Second, in the current context, most of my personal equity holdings are through tax-deferred accounts. Whether they pay dividends, in that situation the only taxes, the incentive I have for that corporation, is just keep the share price high, and the paying of dividends is, again, not going to affect me.

If the tax law change is such that all of that income will eventually be tax-free anyway, then I am not going to be getting any additional benefit from those dividends being paid out to be tax-free. I am much better off with the company still minimizing the amount of taxes it pays.

I think, fundamentally, if you look at what the Code does, if a firm is faced with the possibility of being able to reduce their taxes, the incentive structure we have within the firm for compensation and everything else says, maximize your after-tax profits.

I have a hard time understanding what firms would do otherwise. I do not see firms, for example, all of a sudden deciding to forego accelerated depreciation because to forego accelerated depreciation means we can have higher current taxes, and therefore pay greater dividends out.

There is a reason why firms take advantage of those things, because it has a cash flow effect. I do not think that we are going to see major changes in the cash flow effects that will be facing the firm.

The CHAIRMAN. I do not want to prolong anything. I have got other questions. But if anybody else wanted to comment, I would not cut you off.

[No response.]

The CHAIRMAN. All right. I will go on then.

I want to bring up something that I would like to have brought up last summer as part of the Sarbanes-Oxley bill. That is an amendment that I could not offer, under the procedures of the Senate, at that time.

I would like to list these amendments and ask whether they would have been effective in combatting the abuses at Enron if these proposals had been in effect.

I will do these one at a time and ask for a response. An amendment to establish an independent oversight auditor within the Securities and Exchange Committee to conduct spot check auditing of externally audited financial statements.

Can any of you respond to that? You can tell me it is a crazy idea. You are not going to offend me. I just want some reaction. Because we know we have a problem here. Sarbanes-Oxley was about some of these problems. I just wondered if that would—

[No response.]

The CHAIRMAN. All right. Then there is no reaction. We will strike that one off the list.

Dr. OUTSLAY. Well, I would say that a lot of the attention Enron got was from using what were called special purpose entities, off-balance-sheet financing and accounting.

The FASB now has a new exposure draft, and they're called variable interest entities. That may have come up in an audit. Whether or not they were, in fact, complying with the FASB rules with regard to those off-balance, that may have come up in something like that.

The CHAIRMAN. Let me move on, because I have two more of those examples.

Another one would have been an amendment to prohibit public auditors from rendering an audit opinion on the financial statement effects of any tax shelter arrangements that the auditing firm sells to an audit client.

Dr. OUTSLAY. Well, here again, I think you would have to be very specific. I think that has been sort of the issue that you are dealing with with these tax shelter regulations, is what is a tax shelter?

So, for example, if you define a tax shelter, in one sense, as producing a book tax difference of \$10 million or something like that, then they have really broadened what is considered sort of a tax shelter, and it certainly would have limited the types of opinions that you would have allowed these auditors to actually have given.

Ms. PAULL. Mr. Chairman, on that last point, the first transaction was brought to the company by Arthur Andersen. I believe, in that particular transaction, Andersen not only did the tax opinion, but they did the audit opinion. Or the accounting advice. I am not sure if it rose to the level of opinion. The second transaction was the same kind of arrangement. So that proposal would have had an effect on the first two transactions here, basically, just so you know.

The CHAIRMAN. Then the last one before I call on Senator Baucus. This is getting back to the amendments of last summer.

An amendment that would have clarified that bonuses and other high-dollar compensation of corporate directors and wrongdoers

could be brought back into a bankruptcy estate when a company declares bankruptcy.

Ms. PAULL. There was a lot of that going on here, obviously. So I do not know what the criteria the Bankruptcy Court would use for that, but there certainly were a lot of high-paid people. In fact, the top 200 compensated employees in the year 2000, the year before bankruptcy, all made over a million dollars in this company.

The CHAIRMAN. All right. Ms. Kennedy, does this not fall into your area of expertise?

Ms. KENNEDY. Yes. I think the Bankruptcy Court already has the jurisdiction. For payments made within the last year of bankruptcy, you can void those transactions and get back that money.

The CHAIRMAN. Yes. My staff reminds me that we wrote this amendment with that into consideration, so we would have allowed the court to go back more than one year.

Ms. KENNEDY. That would have to be written into the Code then.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Ms. Paull, this is, I think, in your investigation.

Ms. PAULL. I am sure it is.

Senator BAUCUS. This is the structure of the Project Cochise, as of January, 1999. Actually, I did not put up Teresa, which is even more complicated. This is Cochise.

Ms. PAULL. We actually tried to put in our report the most simplified of the diagrams they gave us, too, because there are more than this.

Senator BAUCUS. What is going on here? Can you explain it? [Laughter.] Last night I looked at it and I tried, and I really did not get very far. Can you explain it?

Ms. PAULL. This is one of the transactions that, after all is said and done, we end up with basically what has been known in the tax profession as duplication of loss transaction, whereby you are going to deduct the same loss for tax purposes twice.

That was the whole purpose behind this transaction and it was, in essence, a transaction between the company, most of it with itself, and the promoter, Bankers Trust.

Senator BAUCUS. All right. Well, obviously, this is fairly complex.

Ms. PAULL. Very complex.

Senator BAUCUS. And, as you said, there are other transactions which are even more complex, or as complex.

Ms. PAULL. Yes.

Senator BAUCUS. How many such transactions?

Ms. PAULL. Well, the ones that we were made aware of and that we describe in the report that are of this kind of nature were 12. Twelve transactions were planned, 11 were actually implemented.

The twelfth transaction was ready to be implemented, but then Enron filed for bankruptcy. They are, in magnitude, very large transactions. Maybe there were other transactions. But these were the big, large transactions.

Senator BAUCUS. Yes. I saw a chart, but I do not have it in front of me. But, basically the average size of these transactions was what? I saw the chart, but I have forgotten.

Ms. PAULL. Well, the benefits were \$2 billion for 12 transactions.

Senator BAUCUS. Right. Right.

Ms. PAULL. So, pretty big.

Senator BAUCUS. Now, there were opinion letters, were there not, accompanying these transactions?

Ms. PAULL. Right.

Senator BAUCUS. Who wrote them? Say, Cochise. Project Cochise.

Ms. PAULL. On Cochise?

Senator BAUCUS. Yes.

Ms. PAULL. McKee, Nelson, Ernst & Young wrote the tax opinion for the Cochise transaction.

Senator BAUCUS. And how much were they paid for that opinion?

Ms. PAULL. I think it is in here, and I think it is around a million dollars. We broke down the fees in the report. Yes. It is about a million dollars that Enron paid for the tax opinion.

Senator BAUCUS. But I am told here that fees for Project Cochise were about \$16 million. The King & Spalding firm was involved. Oh, this is Teresa.

Ms. PAULL. No, no. I think the bulk of the fees, as we had mentioned before, went to the promoter.

Senator BAUCUS. Right.

Ms. PAULL. So the tax opinion fee was about a million dollars. And, honestly, I think the person who was involved in this transaction changed firms. We may not know exactly which firm actually received the fee, but the advisor was the same.

Senator BAUCUS. What can you say about the quality of the opinion?

Ms. PAULL. Well, we were disappointed in this particular opinion.

Senator BAUCUS. Why? What were some of the reasons?

Ms. PAULL. Once again, I think that we were disappointed in the sense that the opinion failed to analyze a very important Code section, an anti-abuse Code section, Section 269, in any detail. I think they referred to it in a footnote, or something like that.

Senator BAUCUS. So, that is not well done?

Ms. PAULL. We think it was a significant issue.

Senator BAUCUS. What appears was not understood, poor quality, as opposed to the legal opinion, and/or how much of it was an assumption of the facts which were not checked out?

Ms. PAULL. Again, this is another one of the opinions where it seemed to us that the so-called end result of the transaction, the way the transaction would be unwound or Enron would exit from the transaction, was given short shrift, as if maybe it would happen, maybe it would not, when it was actually what was intended. That would affect the outcome of the opinion as well.

Senator BAUCUS. As I recall in your executive summary, you began with some limitations that you faced. That is, you talked to people who would voluntarily give information. If they did not voluntarily give it, you had no subpoena power.

Would you just go through some of it, just to give a flavor of the scope and the limitations on your investigation?

Ms. PAULL. Well, we did not do our interviews on the record. We did them informally. So, anybody could choose not to be interviewed by us. We did have some folks who chose not to be interviewed by us.

The other problem, of course, is that Enron has had a substantial reduction of employees, and we were unable to locate some employees to be able to interview them.

And then you get varying degrees of cooperation. But I think, generally, we thought we had some pretty good cooperation. You have to rely on people's memories.

Senator BAUCUS. But essentially what has happened is that, in taking advantage of the book tax differential and complexity in arrangements, Enron simply boosted up their financial statements and, at the same time, were able to get very large tax losses. Is that basically what went on here?

Ms. PAULL. Well, Enron aggressively planned for some tax benefits that would boost its financial statement earnings.

Senator BAUCUS. And, as you said, sort of technically follow the law, perhaps, maybe artificially, but with the result that was certainly unintended.

Ms. PAULL. Right.

Senator BAUCUS. Just a couple of words about what we do about the book tax problem here. Some of you addressed it. That seems to be quite an issue. What do we do about it? Anybody?

Dr. PLESKO. I think the first step is better disclosure. And whether that disclosure has to be with revisions to FAS 109, which is done in the tax footnote, whether or not there are aspects of returns as filed that should be made public, I think that is the next area of debate.

I know this committee, and you and the Chairman, have looked at these issues. At some level, certainly where we are now, I think that there is some presumption shifted as to certain tax information needing to be confidential.

When we came in here this morning, we just tore into these reports very quickly, trying to see what we could get. We all focused on this wonderful Schedule M-1 reconciliation, and how close you could get to that.

That is tax return information that is not available now. The first question that I sort of asked myself, is why could this not be made public? Why could this part of a tax filing not also be part of the public filing of a 10-K, or part of a public filing of a corporation?

Senator BAUCUS. Do you all agree with that, the M-1?

Dr. OUTSLAY. In some form, sure.

Dr. SEIDA. I think tax disclosure could be improved. In my testimony I suggest that maybe we can disclose taxable income.

But in the point of Enron specifically, I mean, they did have information in their tax footnote that did suggest, from 1996 to 1999, that they had huge tax losses while reporting positive taxable income.

So, it kind of gets to the question of, how come analysts and other market participants did not question this gap between the two? In financial accounting income, we have incentives to overstate that.

In taxable income, we have incentive to report lower taxable income. We have these two alternative measures of income that can, sort of, be used to evaluate each other.

What happened with Enron? Was it a case of everyone turning away or was the information in the tax footnote not analyzed that closely? I do not have answers to those questions.

Ms. PAULL. Senator Baucus, we did include some of the Schedule M-1s in the appendix. This table that we prepared took a long time to put together. It seems like kind of the basic information for you to understand the story.

That is a table we put together from the materials we received, but it is hard to get that information and reconcile it. It took our staff a fair amount of time to do, which is an obvious thing that you needed to do to understand it.

On top of that, I think that any significant permanent book tax difference should be a big red flag in terms of, a sizeable transaction needs to have a lot of disclosure about it to the IRS. That is something our staff has recommended in the past.

Senator BAUCUS. I appreciate it, Ms. Paull. I, unfortunately, have to run. But I thank you very much for what you have done. You and your committee are to be commended.

I see Dr. Outslay has another point.

Dr. OUTSLAY. I just wanted to make one quick point.

Senator BAUCUS. Yes.

Dr. OUTSLAY. I think it is very alluring to make statements that book and taxable income should be unified in their computation, and I guess I would urge you to be cautious about doing that in the sense that so many of the book tax differences are things, for example, dealing with our international rules.

Senator BAUCUS. We understand that.

Dr. OUTSLAY. Yes. All right.

Senator BAUCUS. That is right. I understand the international complications.

Dr. OUTSLAY. All right. Consolidation rules.

Senator BAUCUS. Honestly, I very much understand that. That makes things even more complicated.

Dr. OUTSLAY. Right.

Senator BAUCUS. But it is something we are going to have to address.

But, anyway, I personally thank all of you panelists. This has been very helpful to me, and I know very helpful to the country. I just appreciate it very much.

This, Mr. Chairman, I hope is just the beginning of a series of hearings on this subject. Clearly, we have a responsibility to get to the bottom of this as much as we possibly can. Your help is getting us off to a great big start, and I thank you very much.

The CHAIRMAN. Senator Baucus, I think along the lines of what you just said, I am not sure I have in mind exactly what direction it should take. But, obviously, any views you have about the number or content of hearings, I would be willing to work with you and try to accommodate you. I am sure I will be moving in that direction anyway.

Senator BAUCUS. Good.

The CHAIRMAN. All right. Did you have a summation or anything?

Senator BAUCUS. I'm fine.

The CHAIRMAN. All right.

Now, here is what the situation is. At the drop of a hat, I may run out of the room because of the quorum down the hall. Then if I do, then whoever is answering a question, answer it and assume I have said thank you, and the meeting is adjourned. I do not know how long that might take, so I do not want to hold you up any more. We are just about done, anyway.

Ms. Paull, would you talk about Enron doing a couple of transactions in which it was "an accommodation party." Define that term as you understand it.

Ms. PAULL. Yes. Two of the 12 transactions that we have discussed here, Enron participated in those transactions in an accommodation to another party. Honestly, when we talked to the Enron staff, the tax department employees, about it, they did not know the whole extent of the transaction.

They did not have a lot of information about the transactions. But they served as an accommodation party, which is a person who is needed to make a transaction work. They are ostensibly an unrelated party. They did this for a fee, in one case, and for a reduced interest rate in another case.

It was kind of all part of the circle of advisors that Enron had. Those promoters had served as accommodation parties in some of Enron's transactions, and Enron returned the favor, so to speak, for a fee or for a benefit.

But the Enron employees could not explain to us the rest of the transaction, for the most part. So, it was just, while we were doing this, they did not have any particular business purpose in getting into this, other than they did earn a fee for it. At some point, the tax group promoted this activity as a way for the group to generate some revenue for the company in the internal memorandum.

The CHAIRMAN. Thank you, Ms. Paull.

Professor Kennedy, I think, again, this question falls into your area. First of all, have you seen the executive plans at Enron, and do you think that there were abuses inherent in those plans?

Before you answer that, a follow up. Also, the Joint Committee has said that there was poor recordkeeping for these executive compensation plans. Does any Federal agency have authority to regulate in that area?

Ms. KENNEDY. Yes. Under ERISA, the Department of Labor has reporting and disclosure obligations. These types of plans are subject to that. However, through the regulations, the Department of Labor has exempted these types of plans from any and all disclosure. I believe that should be corrected. Had we had this type of disclosure, maybe we would have known the volume or the size of benefits under these plans.

The CHAIRMAN. Now, in regard to the first question, you probably have not seen the executive plans. But from what you have heard today, do you think that there were abuses inherent in those plans?

Ms. KENNEDY. I have actually seen the 1994 and the 1998 plans. I do not know, since I have not checked the report, whether there are others. The abuse, with respect to the "haircut" provision allowing the \$54 million to come out in the first 2 months right before bankruptcy, is an abuse, really, though, of the insider knowledge that they had, not a per se abuse because of the haircut provision.

I would recommend that haircut provisions not be permitted for insiders for that very reason.

The CHAIRMAN. All right.

I think this one would be to Ms. Paull. The Finance Committee spent considerable time addressing issues relating to tax-favored retirement plans. What kinds of qualified retirement plans did Enron have, and what general observations can be made about those plans?

Ms. PAULL. Well, in terms of their qualified retirement plans, Enron had an ESOP, Enron had a retirement plan that was a defined benefit plan that was converted into the cash balance style of a plan, and Enron had a 401(k) savings plan. I think that basically Enron was pretty diligent about updating the plans whenever there was a change in the law, and things like that.

I think that we have called into some question a few issues here, one dealing with the diversification of investments, with a high concentration of investments in Enron stock, and perhaps an issue over the fiduciaries having a clear understanding what their duties were, especially when you have a situation with a high concentration of stock in one of the plans, and the stock is falling throughout the year. And, on the participants' side, education with respect to that.

When Enron converted to the cash balance type of approach, Enron did not do it in a manner that would lead to the kind of criticism that we have read about. Enron did not have a wear-away. Actually, the plan cost them more money in almost the first decade after that than it would have if Enron had stayed with the other plan.

So I think generally when it came to the qualified plans, our comments really centered around the investment in the company stock and what happens when there is a big decline in the stock values, and what the responsibilities of the fiduciaries are during that period.

The CHAIRMAN. Well, I do not have any more questions. I might have some in writing. I did not explain this to the other panelists. Ms. Paull understands. Not very many members, because of conflicts with other committees, were able to be here today.

But any member of this committee may have questions that they want to submit for answer in writing to any of you. I do not know who. There may not even be any. But, if they do, we would appreciate it if you would respond to those in writing.

I would like to close with just an observation or two. Now, maybe I should not have been shocked by what I have heard here today, but I want to tell you, I am. These business deals, probably legally, do not fall into racketeering, but it is just a little bit short of that. It is not too short of it.

I think I referred to a conspiracy novel in my opening comments. I think the testimony, particularly from Ms. Paull on the year's work, reinforces my feeling about that.

I hope that this hearing and information that comes from the study is helpful in criminal prosecutions. What hit me the most, was the moral fiber of the people involved in this Enron disaster, both inside the company and outside. It seems like they acted with

sort of unbridled greed, in blatant disregard for the laws of fairness.

Obviously, checks and balances that we thought were out there were not working. Hopefully those are back in place now, not just because of Congressional action but because of an awareness among everybody to be overly-cautious and be open and transparent, and the checks and balances working.

It seems to me that this disregard for law or fairness, they simply did not care about the effect of phony profits on investors, many of whom were just everyday people investing for retirement.

They could care less, it seems, about the dedicated and unsuspecting employees who worked at Enron. By the way, a couple hundred of a little subsidiary in my State of Iowa is an example of who got hurt by this. It seemed like, for these employees—all employees at Enron—that their futures were expendable.

The almighty dollar seems to have blinded people, that there was no sense of ethics left. But if they are blind, then it is time for us to let them see the light. That is beyond just this hearing. We know that Enron is not the only one, and this hearing, as Senator Baucus and I have suggested, will not be the last one.

But the day of reckoning has come, I think, for shelter promoters. We have to hunt them down. We have to shut them down and do whatever it takes to purge that cancer from our system. It may take years, as I indicated when we put this date of February 13 out there. Hopefully, it will only take a matter of months.

But I think it is fair for me to say, and hopefully I speak for many other Senators—and I do not pretend that I can—but I hope that the game is over.

I thank you all very much. The hearing is adjourned.

[Whereupon, at 12:42 p.m. the hearing was concluded.]

APPENDIX

PREPARED STATEMENT OF HON. MAX BAUCUS

It was almost one year ago today when we initiated the Finance Committee's investigation of Enron's tax returns. We called on the Joint Committee on Taxation—Congress's resident tax law experts—to review the activities and transactions related to Enron's tax returns. We also instructed the Joint Committee to review Enron's pension and executive compensation programs. Though allegations flourished about the demise of the country's 7th largest company, the Finance Committee did not rush to judgment. We proceeded carefully. We wanted a thoughtful and deliberative review. Our patience has proven wise.

Your report and findings will provide countless benefit to lawmakers and academics for years. It will be pivotal to our efforts to restore public confidence in corporate America and to our voluntary tax system. All across the country, the story of Enron undermined public confidence—in business ethics, in our accounting system, in our tax laws and in our pension laws.

The Joint Committee report shows that this erosion of confidence was warranted. Enron not only engaged in accounting gimmicks to boost stock prices—but Enron repeatedly abused the tax code. And they had help from investment bankers, lawyers, and accountants.

In transaction after transaction, these advisors helped Enron carry out its tax schemes with "opinion letters." Opinion letters are supposed to serve as an independent counsel's assurance of the proper tax treatment for specific facts in a given transaction. Enron paid millions of dollars for these opinion letters. Frankly, based on Joint Committee's investigation, many of them may not be worth the paper they were written on.

The report also describes collusion among these advisors. They made sure they kept the tax opinion writing business among friends. Enron and its advisors conspired to mine the tax code for tax schemes. They concealed the schemes in a complex maze of entities and transactions. They ensured that no one—particularly the IRS—would ever discover what they were up to.

It is abundantly clear. The IRS was kept in the dark and out-manuevered. The lack of adequate disclosure rules—and the lack of sufficient IRS enforcement resources—clearly helped Enron and its executives walk away with millions—maybe billions.

The Joint Committee's report raises serious concerns about corporate ethics and the ethics of tax advisors. Where was the independence? Did they meet their professions' code of ethics? How much were they willing to let greed affect their judgment?

The Joint Committee report should serve as a wake-up call. The conduct of some advisors who call themselves "professionals" is inexcusable. At the same time Enron was engaged in this shameful conduct, senior executives were lining their pockets. The company used schemes to "juice earnings" so their stock options skyrocketed.

Enron executives rushed to the bank to take out their own deferred savings—while leaving employees holding an empty bag. The rank-and-file employees watched as a lifetime of savings in Enron's pension plan turned to dust.

Executives also got a free ride from the Board of Directors. The Board was asleep at the wheel. According to the Joint Committee, it was anything but independent. The Board operated as a rubber stamp.

Ms. Paull, I look forward to hearing from you—and learning the answers to some specific questions.

Frist, what role did Enron's advisors—their outside lawyers, accountants, and investment bankers—play in these transactions? Was their conduct appropriate?

Second, was there collaboration among these so-called “independent” advisors? That is, instead of providing checks and balances—were they more concerned with padding their own pockets—and the pockets of their friends?

Third, what went wrong with Enron’s pension plans? Last Congress, this Committee reported out a bill to give rank-and-file employees more information—and help them diversify their pension plans. Is this enough to avoid future Enrons?

Fourth, what about the interplay between executive compensation and the rank-and-file pension plan? Rank-and-file employees had their entire life savings invested in the pension plan. While at the same time, Enron’s executives had an “executive privilege”—that is their own protected pot of money.

Mr. Chairman, the Joint Committee’s report provides the Committee with a unique opportunity. We now have an invaluable insight into corporate abuse of the tax code. I am more convinced than ever that the tax shelter legislation the Finance Committee approved last week *must* be enacted immediately. The idea that some would suggest tax shelters are not a problem, is simply without merit. The Joint Committee’s report puts that notion to rest.

This report may be viewed by some as a roadmap for abusing the tax code. Rest assured that it is not a roadmap. This is the end of the road.

The Joint Committee makes specific recommendations. Mr. Chairman, I look forward to working with you to develop additional legislation based on the report. And we should act without delay.

With that in mind, I support the Chairman’s statement that any legislation enacted to curb abuses—as those highlighted in this report—must have an effective date of February 13, 2003. I look forward to hearing from our other distinguished witnesses.

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

You are about to witness a shocking event in the history of American corporate tax policy and financial accounting. We are going to have the veil torn off the world of tax shelters and manipulation of accounting. The report reads like a conspiracy novel, with some of the nation’s finest banks, accounting firms and attorneys working together to prop up the biggest corporate farce of this century. Enron was a house of cards—and the cards were put together by these schemes that we will hear about today.

The Joint Tax Committee report provides us a wealth information. Much of this information has never been seen before—not only by the public but also the IRS and other government agencies. It includes tax return information, opinion letters from law firms, internal documents, accounting firm correspondence, shelter promotional material, and most importantly, internal Enron documents laying out how the scheme of deception plays out. Not only will we gain a fuller understanding of tax shelters and accounting gimmicks, but we are provided with the complete story of the people and the professionals working behind the scene to make it happen. The Joint Tax Committee report names and doesn’t pull punches in telling us about the law firms, accounting shops and investments bankers that were promoting and aiding Enron in its activities.

The conclusion is very troubling. “Shoe Me the Money!” is the catch phrase on an internal Enron document for one shelter. It is clear that that’s what it’s all about. Money, money, money. Money about honesty in financial accounting and tax return compliance. Money above professional and business ethics. Money above common sense. Money, money, money. I’m reminded that back in the 1980s there was a popular phrase that came from Wall Street. The phrase was “Greed is good. Greed cuts through and clarifies.” The irony is that, in this case, greed obscured and hid the real substance of the business of Enron. The substance is that there wasn’t much substance. All of the artifices were designed to make something appear real that was not real.

Enron viewed its tax shop’s goal in line with this general goal. That is, the tax shop was designed and managed with the objective of non-compliance with its responsibilities under the tax code. Instead Enron viewed the tax shop as a profit center where complexity was an ally and bending the rules a partner in a search for more paper gains. In addition to bending the rules there appears to be a culture of wining and dining amongst a small community of people that helps to drive these deals. One small but telling example is the Bankers Trust, one of the participants in this dance of shelters, takes Enron’s director of tax research for what was termed the Potomac Capital Investment Corporation Conference. The details can be found starting on B-203 of the report.

Let me tell you what this conference consists of: fly to Boca Raton, and Sunday night is Casino Night, then starting on Monday morning it's your choice of golf, tennis, fishing, then a golf clinic and finally a reception dinner cruise. The next day the real work starts with your choice of golf, tennis, fishing, a leisurely lunch and finally a reception dinner. To wind down on the last day is more golf or tennis. No amount of lipstick is going to make that pig pretty.

The Joint Committee report describes in detail the structures used by Enron to avoid tax and inflate earnings. Many of these schemes are not well-known, and their publication today could provide a road map for others to follow. So let me be clear: today, February the 13, 2003, will be the effective date for any legislation that we offer to shut down these tax schemes or anything like them. Today's date will not move—it will not slip. Senator Baucus and I are unified on that point. I don't care if it takes five years to get the legislation passed, the date will hold. So to all you lobbyists sitting out in the crowd today, write it down. If a company does an Enron deal after today, don't come in here whining that we aren't being fair. You are on notice, as are the lawyers, accountants, and investment bankers that profit so handsomely from these deals.

In addition to Enron's tax and accounting, the Joint Tax report gives equal time to the important issues of executive compensation and employee benefits. It goes from bad to worse. I find it stunning that a company that was a Fortune top 10 company was wholly incapable of answering simple answers of how much top executives got paid. Further, the Enron board seems unaware of its most basic responsibilities and duties of protecting the shareholders. In addition, the Joint Tax report provides new details of the jaw-dropping amount of executive compensation and benefits.

It doesn't pass the smell test that Enron had 200 executives—each of whom was being paid over a million dollars while they ran the company to bankruptcy—leaving thousands of dedicated employees to land high and dry. These employees helplessly watched their retirement savings go down the drain when the company's stock tanked from more than \$90 a share in 2000 to 34 cents a share in January 2002.

Again, we benefit from Joint Tax providing an enormous amount of documents detailing the executive compensation and employee benefit issues.

Finally, Joint Tax has much to say of findings and recommendations from its work. Joint Tax also raises serious concerns about the ability of the IRS to ever find out about these transactions. These findings and recommendations deserve serious consideration and will inform the Finance Committee as it compares its current corporate tax shelter legislation against the abuses listed in this report.

Let me make one last point. Lindy Paull sits before us today, the last time as chief of staff of the Joint Tax Committee. It is a tribute to her that she is going out with a report that will cause great shockwaves felt all down K Street. I want to thank you, Lindy, for all your dedication and hard work not only at the Joint Tax Committee but also previously here on the Finance Committee. Your dedication and knowledge will be greatly missed.

I also recognize that your staff has spent nearly a year on this report and have for the last few weeks been at it day and night preparing for this hearing. These men and women who served on this project have done so at great personal sacrifice. The travel and demands of this task have kept them away from their loved ones. They have continued to meet the needs of Congress while at the same time pursuing one of the ugliest and most complex financial disasters of recent time.

I would ask for members' indulgence while I take a moment to name the dedicated staff primarily responsible for the investigation: Mary Schmitt, Sam Olchyk, Carolyn Smith, Ray Beeman, Nikole Clark, Robert Gotwald, Brian Meighan, David Noren, Cecily Rock, Carol Sayegh, Ron Schultz and Allison Wielobob. In addition, thank you to the Government Printing Office for getting this major report to us in time for today's hearing. Thank you all very much for a job well done. You have given us a very sobering report about corporate tax practice and executive compensation in this country.

PREPARED STATEMENT OF KATHRYN J. KENNEDY

I. INTRODUCTION

Chairman Grassley, Ranking Member Baucus, and distinguished members of the Finance Committee, thank you for this opportunity to appear before you today to discuss executive compensation issues. I am Kathryn J. Kennedy, an associate professor of law at The John Marshall Law School in Chicago and director of the

school's graduate programs in taxation and employee benefits law. Our school's graduate program in employee benefits law is the *only* one of its kind in the nation. I teach and oversee its curriculum in 18 different employee benefits courses—ranging from executive compensation to health law to qualified retirement plans to employee stock ownership plans. As well as being an attorney, I am also an actuary. My research and scholarship also address employee benefits and related tax issues. I had the privilege of testifying before this Committee last April on executive compensation issues in the context of corporate governance.

The present text was submitted as requested on Tuesday, February 11, 2003, prior to the release of the Joint Committee of Taxation's investigative report on Enron. Thus, it does not address all the particular abuses uncovered under Enron's executive compensation plans. However, I am familiar with the terms of the Enron executive deferred compensation plans, and with the abuses that have been alleged in the area of executive deferred compensation plans and related security arrangements (such as rabbi trusts) by Enron and other employers.

II. PURPOSE OF MY TESTIMONY

The purpose of my testimony is twofold—to explain the uses of nonqualified deferred compensation plans for executives with related security arrangements and to offer proposed legislation to eliminate the abuses that have been alleged in this area. Attached to my testimony are proposed legislative changes to Sections 61 and 83 of the Internal Revenue Code and proposed regulatory changes to ERISA. A fuller discussion of this proposed legislation and an analysis of the similar legislative proposals considered by the 107th Congress will appear in the March 2003 *Tax Management Compensation Planning Journal*.

In my testimony in April 2002, I reviewed reviewed the tax rules applicable to executive deferred compensation plans and reiterated that such plans do not provide a tax subsidy for executives. These rules have been summarized in a law review article I wrote last year, entitled "A *Primer on the Taxation of Executive Deferred Compensation Plans*," available at 35 THE JOHN MARSHALL LAW REVIEW 487 (2002).

Qualified pension and profit sharing plans confer a substantial tax subsidy to both the covered employee and the employer plan sponsor, as the employee incurs no current income for vested benefits while the employer enjoys a tax deduction for contributions made under such plans. In contrast, *nonqualified* pension and profit sharing plans covering executives enjoy no such tax subsidy. Instead, the employer retains the compensation of the executive and pays taxes on such amount, including any subsequent earnings. During this period of deferral, the deferred compensation must remain exposed to risk, thereby subjecting the employee to some type of possible loss or forfeiture until the payment is actually made. To do otherwise would subject the employee to immediate taxation although actual receipt of the benefit has been delayed.

Why then have these arrangements? Employers rely on nonqualified executive deferred compensation plans (a phrase coined by practitioners but not defined by the Code) to provide additional benefits to executives for deferral or retirement purposes. Nonqualified deferred compensation plans serve the legitimate need of permitting an executive to supplement his/her retirement income through either elective or nonelective deferrals of income. The limitations imposed on *qualified* pension and profit sharing plans certainly put pressure on employers and executives to supplement these retirement benefits through either current deferrals or future benefits. These nonqualified arrangements provide flexibility by permitting the executive to alter the timing of receipt of such compensation, while permitting employers to retain the use of the employees' compensation during the period of deferral. Employers legitimately use such plans as a retention device by either requiring future performance or providing for forfeiture upon the occurrence of certain events (*e.g.*, subsequent employment with a competitor). There is nothing inherently wrong with permitting nonqualified deferred compensation plans. In fact, deferring receipt of compensation puts the executive at risk that the monies will not be there at the time promised, something that an employer may wish to encourage. However, the tax code should not be misused in a way to remove that risk and still avoid reporting current income.

What tax rules are applicable to these plans to avoid current taxation to the executive? Nonqualified deferred compensation plans are designed to postpone the payment of benefits, and the accompanying taxation (to the executive) of such benefits, until some date or future event (*e.g.*, termination of employment, retirement, death). To avoid current income tax to the executive, the Code's constructive receipt *and* economic benefit rules must be satisfied.

Simply stated, the purpose of Code Section 61's constructive receipt rule is to impose *current* taxation on a taxpayer if he/she has an unfettered control in determining when income is taxable. Both parties may elect to defer compensation to a future period of time provided the election to defer is made in a "timely fashion." According to the Service, such election must be made *before* the period of service that involves the rendering of services. The Service permits an exception to this rule, thereby permitting subsequent elections to be made after the services have been rendered, if the deferral is subject to a "substantial risk of forfeiture." Examples of such risk include a significant limitation or duty on the expected payment (e.g., payment only upon retirement, continued employment with the employer) or forfeiture of the payment upon a specific event (e.g., subsequent employment with a competitor).

In 1978, Congress imposed a moratorium on the issuance of new guidance under the constructive receipt rules by Secretary of the Treasury. Therefore, the constructive receipt rules that are currently applicable are those determined in accordance with principles set forth in regulations, rulings and case law that were in effect as of February 1, 1978. As a result, the Service has been unable to address many of the abuses that have developed and are currently alleged.

While the constructive receipt rules assume that the taxpayer is in receipt of income but focuses on the *timing* of such income, the economic benefit doctrine of Code Section 83 focuses on whether the taxpayer has any ownership or other "economic benefit" in property that should result in current taxation. Thus, its focus is directed to *property* that the taxpayer may have received in connection with the executive deferred compensation plan. The Service has long maintained that an employer's unsecured and unfunded promise to pay deferred compensation is not property for purposes of Section 83.

Executives have sought various ways of securing the employer's promise to pay, especially in the context of an employer's later "change of heart" (employer's refusal to pay benefits in bad faith or without cause) or a change of control of the employer. The Service has affirmed the use of trusts against the risks of "change of heart" and "change of control" without triggering adverse income tax consequences for the executives. As long as the trust assets are available to the employer's creditors in the event of bankruptcy or insolvency, the employer's promise is neither funded nor secured for Section 83 purposes. Such devices have been coined "rabbi trusts," as the first Service private letter ruling affirming their use was in the context of a trust established for a rabbi by his congregation. For tax purposes, the rabbi trust is treated as an employer grantor trust; thus the income, losses, and deductions flow back to the employer. And, although there is no similar moratorium on the Service's ability to issue new guidance under the economic benefit rules, the Service has announced through its revenue procedures that it will not issue any rulings on rabbi trusts that are *outside* its model version, except in rare and unusual circumstances. This regulatory gap has caused ambiguity and made conditions ripe for abuse. Executives have been seeking to extend the use of rabbi trusts to secure against other types of events (e.g., employer's declining financial health) and to shelter the trust assets in the event of employer bankruptcy or insolvency.

What abuses are we seeing in regards to nonqualified deferred compensation plans and their related security arrangements (such as rabbi trusts)?

List of Normal Distribution Dates: Many nonqualified deferred compensation plans are designed like qualified pension plans, allowing for the normal distribution of benefits upon certain events (e.g., retirement, termination of employment, death or disability). Although the employee could theoretically terminate employment or retire in order to trigger distribution of benefits, the Service has viewed these limitations as *substantial* and therefore does not impose the doctrine of constructive receipt since the employee does not have unlimited rights to receive such income.

In its cornerstone ruling on constructive receipt (Rev. Rul. 60-31, 1960-1 C.B. 174, as modified by Rev. Rul. 64-279, 1964-2 C.B. 121), the Service permitted the following list of events upon which distribution could be made under a nonqualified tied deferred compensation plan: attainment of a certain age; becoming incapacitated; completion of a certain period of service; termination of employment; and reduction in hours worked from full-time to part-time. In a series of private letter rulings, the Service has expanded the list to include change of employer control; decrease of employer's net worth below \$10 million; or employer's liquidation. *I recommend* Congress explicitly document the list of events that may be used under nonqualified deferred compensation plans to include separation from service; death or disability; retirement; attainment of a specified age; completion of a specified period of years; or a specified date. Permitting the list of events to include employer bankruptcy, insolvency or declining financial health may well be outside the control of the executive and thus not a concern from a constructive receipt standpoint. How-

ever, such a plan provision in conjunction with the use of a rabbi trust certainly provides the type of security to the employee that should result in taxation under Section 83.

Subsequent elections: These nonqualified deferred compensation plans generally contain provisions allowing participants to change their original election regarding *when* their plan distribution will begin and *what form* they will take (*e.g.*, installment payments or lump sum distribution). We are seeing plans that permit a change in timing and form of payment at any time. The Service's position is that the subsequent elections altering timing or form of payment may not be made. However, case law permits subsequent elections under the constructive receipt rules even after the performance of services as long as the participant does not have an unfettered right to receive the compensation at the time of the election.

To provide some compromise between the Service's rigid rulings and the flexibility needed by participants in the wake of changing events over a long period of deferral, *I recommend* allowing subsequent elections regarding the timing of payment, but requiring such elections be made at least 12 months in advance (or 24 months in advance in the case of a participant who is an officer, director or 10% owner). Instead of relying on the definition of the top 5 individuals who are "insiders" according to securities law, a more useful definition from the qualified plan context would subject all officers, directors and 10% owners to the more onerous standard. Subsequent changes to modify the form of payment (*e.g.*, from installment payments to lump sum) should also be permitted provided they are made at least 12 months in advance of payment.

Hardship and haircut provisions: Provisions under nonqualified deferred compensation plans typically permit participants to make *in-service* distributions from the plan either on account of "unforeseeable emergencies" or subject to a withdrawal penalty (*i.e.*, a haircut). As a hardship or unforeseeable emergency event is typically outside the control of the individual, adding this event to the list of permissible distribution dates should not cause any concern under the constructive receipt doctrine. In fact, the Service has affirmed the use of a withdrawal provision in the event of hardship or unforeseeable emergency. Some plans, however, have been extremely lenient in their definition of hardship and thus effectively permit unlimited withdrawal rights. If the definition of "unforeseeable emergency" is narrowly construed, such event is outside the control of the participant and thus should be a sufficient risk to avoid constructive receipt. Congress should explicitly define what constitutes a hardship or unforeseeable emergency.

Nonqualified deferred compensation plans are being drafted to permit unlimited *in-service* distributions, provided a financial penalty is incurred by the executive. The question is whether such a penalty is a substantial forfeiture, sufficient to avoid constructive receipt. Plans have set haircut penalties at 5% or even lower. While the Service has approved haircut provisions within the qualified plan context (when the constructive receipt rule was applicable), it has refused to rule on whether such provisions are appropriate under nonqualified plans. It certainly can be argued that the use of a financial penalty (*i.e.*, haircut) *if set at a sufficient level* (say 10%) does constitute a substantial risk of forfeiture, especially if the benefit was funded through elective participant deferrals. However, as Enron so clearly illustrates, a 10% penalty is meaningless if the participant is privy to the financial woes of its employer and is faced with a loss of 100% of his/her benefits. At that point, the interests of the executive and of the corporation are maximally mis-aligned. Thus, *I recommend* Congress affirm the use of haircut provisions with a minimum penalty of 10%, but limit the use of such provisions to participants who are *not* officers, directors or 10% owners.

So the officer, director or 10% owner wishing to remain in that capacity would be aligned with the corporate interest in no longer being able, with or without a haircut, to pull out funds potentially needed by the employer. Of course, the individual could retire under normal plan provisions and withdraw 100% of his/her nonqualified benefits with no haircut. Such withdrawal at retirement is, after all, the whole point of the plan. In the event of the employer's subsequent bankruptcy, the bankruptcy rules provide a look back provision to recoup payments to insiders within one year of bankruptcy.

Uses of security arrangements for nonqualified deferred compensation plans: The Service has affirmed under the economic benefit doctrine that a trust may be used (*e.g.*, rabbi trust) to protect executives from current or future management's change of control or change of heart. As a result, nonqualified deferred compensation plans often contain provisions, known as triggering mechanisms, that cause the automatic payout of benefits upon the occurrence of certain events or financial performance indicators.

I believe that legislation is necessary under Section 83 of the Code to restrict the use of all triggering mechanisms that would cause the plan to terminate or distribute all benefits except in the event of a change of control or a change of heart. These two triggers (change of control or change of heart) are appropriate because these deferrals are generally made with salaries and bonuses that the participants have earned and therefore should not be subject to the whims of a board of directors or new management. However, other triggering mechanisms that have been used by trusts (e.g., the employer's declining financial health or its impending bankruptcy or insolvency) clearly afford the executives preferential treatment to such assets to the detriment of the employer's creditors. Thus protection under the economic benefit doctrine should not be extended. *I recommend* that Congress should specifically limit the triggering events to change of control or change of heart.

In addition, any assets used to secure participant's rights under nonqualified deferred compensation plans (e.g., rabbi trust) should remain the sole property of the plan sponsor and be available at all times (until distribution) to the claims of the creditors. Plans have been moving these assets outside the jurisdiction of the U.S. courts (coined offshore rabbi trusts), to countries with strict asset protection laws, affording greater security for executives and lesser security for the employer's creditors. This defeats the intent of Section 83 to devote any underlying assets to meaningful protection of creditors. *I therefore further recommend* that Congress should impose the doctrine of economic benefit when rabbi trust assets are moved offshore.

Senate's initiatives during the 107th and 108th Congress

This Committee achieved substantial progress in reporting out S. 1971, the National Employee Savings and Trust Equity Guarantee (NESTEG) Act, last July during the 107th Congress. It sought to repeal the moratorium on the Secretary of the Treasury's authority to issue constructive receipt rulings for amounts under "private deferred compensation plans" that "improperly defer income." The criteria for what constitutes "improperly deferred income" were not set forth in the legislative proposal, but instead examples were provided for the Service through the Senate's report. These examples were not specific, but instead authorized the Service to engage in a "smell test." Such directive certainly does not provide practitioners with any meaningful guidance until the Service issues regulations. And even when the Service does issue regulations, the case law has not affirmed the Service's prior construction of constructive receipt. Given the terse statutory language and ambiguous legislative intent, it is unlikely that the regulations would be enforced by the courts. Thus, Congress must provide greater guidance and specificity to prevent the tax code being misused to confer benefits on the executives that should be taxable.

The committee report on S. 1971 also directed the Secretary of the Treasury to issue regulations addressing premature withdrawals on account of hardship and use of haircut provisions for premature withdrawals. As the Service presently permits premature withdrawals for hardship, it is not clear whether the reference in the report to "hardship" withdrawals is to eliminate their use or to require more guidance as to what constitutes hardship. Also the report does not specify whether haircut provisions should be totally eliminated from nonqualified deferred compensation plans regardless of the severity of the financial penalty imposed. The report for S. 1971 directed the Service to address through regulations the use of triggers and use of trusts where the rights of creditors to gain access to the funds is limited. But again there was no specificity as to what triggers would be valid and what triggers would be invalid.

On the first day of the 108th Congress, Senator Daschle and members of the Democratic Caucus introduced S. 9, the Pension Protection and Expansion Act of 2003. That proposal is also designed to curb abuses in the nonqualified deferred compensation and rabbi trust area. Those provisions are very similar to the legislative proposal of H.R. 3762, which was introduced in the 107th Congress by the Chair of the House Ways & Means Committee (referred to as the Thomas Bill), which attacked deferred compensation plans from a "funding" perspective. It would add a *new* Code provision (Section 409A), subjecting insiders to immediate tax for deferrals made pursuant to a "funded deferred compensation plan." It would also tax executives protected under offshore rabbi trusts.

While this new initiative provides more specificity, it has added to the complexity of the Code by adding a new Code Section, instead of simple amending Sections 61 and 83. It blurs the rules of constructive receipt and economic benefits by melding them together to defined a new term of art—the "funded deferred compensation plan." As it applies only to the top five insiders of the employer, its impact would be limited. But more importantly, it is silent on the rules applicable to nonqualified deferred compensation plans maintained for non-insiders. Certainly that next step should be taken.

I urge Congress to take the lead and specify the constructive receipt and economic benefit rules that are applicable to nonqualified deferred compensation plans. Encouragement without more specificity should not be left to the Secretary of the Treasury and the courts. *I have recommended* the attached proposed legislation under Sections 61 and 83 of the Internal Revenue Code that will curb current abuses and provide necessary guidance for the establishment and maintenance of these plans. The proposal defines the applicable constructive receipt rules under Section 61 for nonqualified deferred compensation plans and then permits the use of certain security arrangements (*e.g.*, rabbi trusts) provided the funding rules under Section 83(c) are satisfied. This bifurcation makes it clear what provisions are valid under nonqualified deferred compensation plans and what types of security arrangements may be used, and for what purposes, to protect deferrals under such plans. And while regulations by the Secretary of the Treasury may be needed, sufficient specificity must be given to make guidance meaningful.

As these plans are covered under ERISA, are there applicable reporting and disclosure requirements to keep the government and shareholders or other stakeholders aware of them? ERISA presently provides for reporting and disclosure requirements for most employee benefit plans, not just those qualified under the Internal Revenue Code. However, the Department of Labor, through its regulations, has exempted top hat deferred compensation plans from most of these requirements. As a result, plan documents for such plans are not required to be filed with the Department of Labor, nor made available to employee and shareholders. Annual reporting requirements to the participants are also not required. Enron's scandal has highlighted the inadequacy of these rules as the terms of this firm's top hat plans were unavailable to employees and shareholders, and the amount of benefit payments made to various executives in advance of bankruptcy did not have to be reported. S. 1971 was silent regarding changes to be made ERISA's reporting and disclosure rules for these executive deferred compensation plans.

I believe ERISA has sufficient well-known and well-established reporting and disclosure rules applicable to employee benefits plans that should be applied equally to top hat arrangements. *I recommend* that financial information (that generally is reported on the annual Form 5500) also be required for top hat plans including: basic plan information; number of participants/beneficiaries; current account balances; list of current distributions by name and amounts; list of assets set aside in a rabbi trust or other security arrangement. Such information should also be reviewed by the plan sponsor's independent auditors and received a signed attestation of its accuracy. The attached proposal would direct the Secretary of Labor pursuant to his/her power under Section 110 of ERISA, to provide new regulations for non-qualified deferred compensation plans similar to those required under the general reporting and disclosure requirements for qualified pension or profit sharing plans.

Conclusion

Congress should use its current momentum in the wake of corporate scandals to shed some meaningful light on the questionable practices used by some nonqualified deferred compensation plans and related security arrangements. But saddling the Internal Revenue Service with the task of defining the rules without any meaningful legislative guidance neither corrects the problem in the near future, nor assists the Service in future litigation. *I recommend* that the Senate Finance Committee specifically amend Sections 61 and 83 of the Internal Revenue Code, providing immediate and concrete guidance applicable to nonqualified deferred compensation plans and any related security arrangements. In addition, the Secretary of Labor should be directed to remove the regulatory exemption from ERISA's reporting and disclosure rules for these plans and to apply timetested similar rules that govern qualified plans. I look forward to working with you and your staff to implement these needed changes. Thank you for your consideration.

ATTACHMENT

Proposal to Change Section 61:

Within the context of Section 61, it is proposed that Congress add a new subsection (subsection (b)) to Section 61 which specifically exempts from current taxation deferrals under nonqualified executive compensation plans that satisfy the requirements of that subsection. The subsection is not intended to alter the current constructive receipt rules applicable to individual employment arrangements that are not regarded as nonqualified plans for purposes of section 61.

Section 61 of the Internal Revenue Code of 1986 (relating to gross income) is amended by adding the following new subsection:

“(b) Inclusion of Deferred Income under an Unfunded Nonqualified Deferred Compensation Plan”—In the case of a participant in an eligible nonqualified deferred

compensation plan, any amount of compensation deferred under the plan, and any income attributable to such amounts, shall be includible in gross income under this section in the taxable year in which such compensation or other income is distributed to the participant or beneficiary.

(1) **Eligible Nonqualified Deferred Compensation Plan Defined.**—For purposes of this section, the term “eligible nonqualified deferred compensation plan” means a plan established and maintained by a plan sponsor providing for the deferral of compensation for services, other than under a plan qualified under section 401(a), a section 403(a) annuity plan, a tax-deferred annuity under section 403(b), a simplified employee pension under section 408(k), and eligible deferred compensation plans under section 457, —

(A) in which only employees or independent contractors (individuals or entities) who perform service for the plan sponsor may be participants,

(B) for plans permitting participants to elect to have deferrals of any compensation for services be made under such plan, such election must be made before the beginning of the participant’s tax year in which the services are performed, except that an election may be made within 30 days of being eligible to participate in the plan or within 30 days of the plan’s effective date,

(C) which meets the distribution requirements of subparagraph (2), and

(D) for plans permitting participants or beneficiaries to elect among alternate forms of distribution payments, such election must be made at least 12 months in advance of the first distribution payment.

(2) **Distributable Requirements.**—

(A) **In General.**—For purposes of subparagraph (1)(C), a plan meets the distribution requirements of this subsection if—

(i) under the plan, amounts deferred, and any income attributable to, will not be made available to participants or beneficiaries earlier than—

(I) severance from employment, death, disability, retirement, or attainment of a specified age according to the terms of the plan,

(II) a specified date or completion of a fixed number of years as elected by the participant or beneficiary according to the terms of the plan, which may be subsequently altered by the participant or beneficiary according to the terms of the plan at least 12 months in advance of such date,

(III) upon an unforeseeable emergency (determined in a manner consistent with the Secretary’s regulations under section 457), or

(IV) at any time as requested by the participant according to the terms of the plan, provided such distribution is subject to a financial penalty of at least 10%, and

(ii) for purposes of applying subparagraph (i) to any participant or beneficiary who is a director, officer or 10% principal owner of the plan sponsor, “24 months” shall be substituted for “12 months” in subparagraph (i)(II), and the withdrawal provisions of subparagraphs (i)(III) and (i)(IV) shall not be made available. For purposes of this subparagraph, the term “10 percent owner” means any person who would be described as a “5 percent owner” in section 416(i)(1)(B)(i) if “10 percent” were substituted for “5 percent” each place it appears therein.

(B) Notwithstanding subparagraph (A), amounts contributed by the plan sponsor on behalf of the participant under the plan which are not subject to a participant’s distribution election nor the result of matching deferrals by the plan sponsor, including any income attributable to such amounts, maybe paid in accordance with the terms of the plan at an earlier date than those described in subparagraph (i) above provided such amounts remain subject to a substantial risk of forfeiture (as that term is defined by section 83(c)) during the period of deferral until the actual time of receipt.

The amendment made by this section shall apply to amounts deferred after the date of the enactment of this Act in taxable years ending after such date.

Proposal to Change Section 83:

Section 83(c) of the Internal Revenue Code of 1986 (relating to special rules for property transferred in connection with performance of services) is amended by adding the following new paragraph:

(4) **Use of Security Arrangements.**—

(A) **In General.** In determining whether there is a transfer of property for purposes of subsection (a), if assets—

(i) are designated or otherwise available to protect a participant or beneficiary in the event of a change of control or change of intent by the plan sponsor with respect to benefits under a nonqualified deferred compensation plan (as defined by section 61(b)), such assets shall not be treated as property provided—

(I) the rights of the participant or beneficiary to such amounts shall be those of a general unsecured creditor of the plan sponsor,

(II) such assets remain solely the property of the plan sponsor and are available to satisfy the claims of its creditors at all times until distribution under the terms of the plan, and

(III) except as authorized the Secretary by regulation, the indicia of ownership of such assets must be held inside the jurisdiction of the courts of the United States.

(B) For purposes of subparagraph (A)—

(i) the term “change of control” means the purchase or other acquisition of more than 30% of the total outstanding stock or total voting stock of a stockholder owned plan sponsor or more than 30% of the capital or profit interest in a non-stockholder-owned plan sponsor (as described by the Secretary by regulation), and

(ii) the term “change of intent” means either

(I) the plan sponsor’s refusal to pay benefits under the terms of the nonqualified deferred compensation plan other than for reasons of bankruptcy or insolvency, or

(II) the plan sponsor’s attempt to amend or terminate the existing terms of the nonqualified deferred compensation plan in a manner which adversely affects the payment of benefits already accrued under such plan.

The amendment made by this section shall apply to assets so designated or otherwise available after the date of the enactment of this Act in taxable years ending after such date.

Proposal to Change the Reporting and Disclosure Requirements of ERISA:

The Secretary of Labor is directed, pursuant to his/her authority under section 110 of the Act (88 Stat. 851), to provide new regulations applicable to unfunded or insured pension or profit sharing plans maintained by an employer for a select group of management or highly compensated employees requiring the disclosure of information similar to that required under the general reporting and disclosure requirements for pension or profit sharing plans.

Plan terms are to be disclosed to the Department of Labor upon plan adoption. The following financial information is also to be required for top hat plans on an annual basis, (similar to that generally reported on an annual Form 5500):

- basic plan information
- number of participants/beneficiaries
- current account balances/accrued benefit amounts
- current distributions: names and amount of yearly distributions
- assets set aside in a rabbi trust or other security arrangement.

Attestation of Plan Disclosure:

The Secretary of Labor is directed to require that the above information be reviewed by the plan sponsor’s independent auditors and receive a signed attestation as to its accuracy.

PREPARED STATEMENT OF DR. EDMUND OUTSLAY

Chairman Grassley, Ranking Member Baucus, esteemed members of the Committee, I appreciate very much the opportunity to testify before the U.S. Senate Committee on Finance on issues raised by Enron’s tax returns and practices. The following written testimony reiterates many of the points my colleague, Gary A. McGill, and I made in a recent paper entitled “Did Enron Pay Taxes? Using Accounting Information to Decipher Tax Status” (*Tax Notes*, August 19, 2002, pp. 1125–1136).

I. INTRODUCTION

As a result of the publicity surrounding the collapse of Enron Corporation and other major U.S. companies (e.g., WorldCom, Inc.), there has been a renewed interest in whether there should be more consistency between measures of book and taxable income and whether current accounting rules adequately disclose a publicly

traded corporation's tax status. The U.S. Treasury recently issued regulations requiring more tax return disclosure regarding "tax shelters" with a goal being to make such transactions more transparent. The Enron collapse also precipitated speculation and confusion about whether the company paid federal income taxes despite reporting billions of dollars of book income. This speculation led individuals, public interest groups, and members of Congress to question whether publicly traded companies should be required to make their federal income tax returns (or relevant summary information) public or whether financial accounting rules should be expanded to require such corporations to provide more details about their tax status in their accounting reports.

We believe current accounting disclosure rules do not provide sufficient tax information to determine a corporation's tax status. We support increased detail in the company's financial statements about the components of the company's tax expense, especially with regard to the taxes actually paid and the tax benefits from stock option exercises. We believe the public interest can be served without resorting to making corporate tax returns publicly available.

II. THE GROWING DISCREPANCY BETWEEN BOOK AND TAX INCOME

The current attention focused on discrepancies between publicly traded corporations' book and tax incomes harkens back to a similar period in the first half of the 1980s. As result of tax legislation enacted in the Economic Recovery Tax Act of 1981 (particularly accelerated depreciation and safe harbor leasing), corporate tax payments (and taxable income) shrank relative to reported accounting profits (see, for example, my paper with James E. Wheeler entitled "The Phantom Federal Income Taxes of General Dynamics Corporation," *The Accounting Review*, October 1986, pp. 760-774). Studies pointing out the growing discrepancies between book and tax income led Congress to enact major tax changes in the Tax Reform Act of 1986, including less generous tax depreciation, a repeal of the completed contraction method of tax accounting, and the enactment of the alternative minimum tax. One of the components of the alternative minimum tax was an add-back for fifty percent of the difference between a corporation's book and tax income, a provision that proved very difficult to calculate (and rationalize) and led corporations to "manage" their accounting earnings to avoid the tax. We should point out that much of the discrepancy between book and tax income during this period was due to "temporary differences;" that is, items that would eventually appear on both statements but in different periods (for example, a corporation often would adopt accelerated depreciation for tax purposes and straight line depreciation for book purposes). These temporary differences would appear as "deferred tax liabilities" in the balance sheet but would not impact the company's book tax provision reported in the company's income statement (the book-tax discrepancy would appear as a deferred tax rather than a "current" tax payable). Enron reports a change in its deferred tax liability for "depreciation, depletion, and amortization" for 2000 of \$6 million. Grossing up the amount by the 35 percent statutory tax rate, this represents an estimated book-tax difference for the year of \$17 million. The cumulative deferred tax liability for this item is \$1,813 million. On a cumulative basis, the book-tax difference from different depreciation accounting and tax methods is 55,180 million. The discrepancy between book and taxable income created by this item, while significant, should not be construed as evidence that the company is engaging in tax shelter activities. Rather, one could interpret this growing discrepancy as evidence the corporation was increasing its stock of capital, which is in line with what Congress intended when it enacted tax depreciation as an investment incentive.

The renewed interest of academic researchers into the book and tax income phenomenon stems from the U.S. government's concern over the rise of corporate tax shelters. Whereas tax planning strategies in the 1980s focused primarily on temporary differences, more recent tax planning strategies tend to focus on "permanent differences" (that is, items that appear on either the income statement or the tax return, but not both). The most prominent strategies that create permanent differences include income shifting to low-tax jurisdictions (including corporate inversions), using nonqualified stock options to create tax, but not book, deductions, and transactions that create tax credits (research and experimentation, foreign tax) or tax-exempt income (corporate life insurance policies on rank-and-file employees). The growth of these types of tax strategies reflects a shift in the manner in which companies view the role of their tax departments, moving them from cost centers (compliance-oriented) to profit centers ("bottom line" oriented). Tax strategies that lower tax, but not book, income, show up in a reduced book tax provision, thus increasing after-tax income and lowering the company's book "effective tax rate" (book tax expense divided by before-tax book income). Evidence that tax planning has become

an integral part of “earnings management” can be found in annual “tax efficiency scoreboards” published by journals such as *CFO Magazine* (see, for example, S. L. Mintz, “A Taxing Challenge,” *CFO Magazine*, Nov. 1, 1999). Using data from the IRS Statistics of Income, our colleague George Plesko of MIT determined that the difference between pre-tax book income and tax net income grew from \$92.5 billion in 1996 to 5159.0 billion in 1998, an increase of 71.9 percent (see G. Plesko, “Reconciling Corporation Book and Tax Net Income, Tax Years 1996–1998,” *Statistics of Income Bulletin*, Spring 2002).

To what extent these book and tax income discrepancies result from legal versus “aggressive” tax avoidance (evasion) strategies remains elusive to date. Recent studies have shown that a major component of the difference is due to stock option exercises by corporate employees, which could hardly be considered a “tax shelter” because the employees exercising the options pay tax on the difference between the stock’s option price and its fair market value at the date of exercise (at rates as high as 38.6%). Recent revelations that many top executives may have been using partnerships to avoid this tax perhaps calls our assertion into question, although this is an individual, not a corporate, tax shelter issue.

III. CORPORATE INCOME TAX DISCLOSURE RULES

Recent disclosure debates focus on two reporting issues: (1) What information regarding specific tax strategies should be reported to the Internal Revenue Service and (2) What information regarding the net economic consequences of such strategies should be reported to the public. The former issue has received intense scrutiny and discussion with regard to the recently issued tax shelter disclosure regulations. One issue that deserves attention is the debate over whether a transaction that creates a certain dollar amount of book and tax difference (currently proposed to be \$50 million) should automatically be classified as a “tax shelter” and be subject to separate identification and detailed disclosure. Efforts to carve out exceptions are on-going and likely will add significant complexity to these rules. We support increased reporting requirements with regard to tax shelter activities. An individual or firm willing to sell a tax strategy to a client should be willing to disclose its details to the tax authorities. However, we do not support efforts by Congress to define “economic substance.” This venerated, albeit illusive, judicial principle should remain within the purview of the courts. Bright line tests invite even more transactions that depend on form rather than substance.

Our focus on Enron has been with regard to the current accounting rules dealing with the company’s disclosure of its tax status. Analysts of the company’s publicly available accounting data have computed widely divergent estimates of the company’s most recent tax liability, ranging from zero to \$112 million. No less a corporate tax authority as Robert Willens of Lehman Brothers was quoted in a *Business Week* article on Enron as saying “Truth is, figuring out how much tax a company actually pays is impossible . . . Tax disclosure is just inscrutable” (see H. Gleckman, D. Foust, M. Arndt, and K. Kerwin. “Tax Dodging: Enron Isn’t Alone. Plenty of Companies Pay Little or Nothing,” *Business Week*, March 4, 2000, p. 40). Writing in *CFO Magazine*, S. L. Mintz observed that the financial accounting information regarding Enron’s tax status “resists comprehensive analysis” (S. L. Mintz, “A Taxing Challenge,” *CFO Magazine*, Nov. 1, 1999).

The exasperation expressed by analysts that accounting information lacks *precisiori* when it comes to discerning the tax status of Enron or any public corporations is not new. As far back as 1986, my colleagues and I noted that “GAAP concerning accounting for income taxes and the related reporting requirements are so difficult to comprehend that they are subject to varying interpretations which lead to extreme diversity in the treatment of similar transactions” (see G.M. Clowery, E. Outslay, and J. E. Wheeler, “The Debate on Computing Corporate Effective Tax Rates—An Accounting View,” *Tax Notes*, March 10, 1986, pp. 991–997). The question remains whether the “gaps” in “GAAP” (generally accepted accounting principles) regarding measurement and disclosure of a company’s income taxes can be narrowed to both protect the corporation from disclosing privileged information and provide investors with a more accurate assessment of the company’s tax status. We believe there is room for compromise.

Time and space do not allow us to discuss the accounting pronouncements that govern accounting for income taxes in any depth. We refer the interested reader to our August 19, 2002 Tax Notes article on the subject. We will focus our comments on the information disclosed in the Income Tax Note to the financial statements in the company’s annual report.

Statement of Financial Accounting Standards No. 109 (FAS 109) requires that a publicly traded corporation present a reconciliation of its “hypothetical tax expense”

(the tax expense that would have been reported if all of the company's pretax income from continuing operations was taxed at 35 percent) with its reported income tax expense. The company must disclose the estimated amount and nature of each "significant" reconciling item. The reconciling items include permanent book-tax differences, credits, and state and local income taxes and foreign taxes. SEC Regulation S-X, Rule 4-08(h)(2) states that reconciling items in the effective tax rate computation should be stated separately if they equal or exceed five percent of the "hypothetical tax expense" or the reconciliation would be "significant in appraising the trend of earnings." This reconciliation provides the starting point for comparing a company's book effective tax rate with some other measure of its tax effective tax rate. Under FAS 109 a corporation also must disclose the amount of any unrecognized deferred tax liability on its reinvested non-U.S. earnings "if determination of that liability is practicable." Most companies omit this disclosure on the grounds that such determination is "not practicable."

Under current accounting rules, corporations are not required to provide details regarding any specific transaction that creates a permanent difference. For example, the amalgam of tax strategies that shift income from the United States to lower tax jurisdictions appear as one line item in the effective tax rate reconciliation provided the tax savings exceed the five-percent threshold. Looking at Enron's effective tax rate reconciliation from 1997-2000, we see a decrease in the "foreign tax rate differential" from 13.3% in 1997 to (7.7%) in 1999 and (2.4%) in 2000. In dollar terms, the results of international operations added \$2 million to Enron's tax expense in 1997 whereas they reduced the company's tax expense by almost \$80 million in 1999. Enron does not disclose any details about its international tax strategies regarding this change. Corporations occasionally explain changes in the reconciling item by stating that the change reflects the company's ability to shift income into lower tax jurisdictions. Corporations rarely provide details as to whether these tax savings were achieved through transfer pricing, financing structures, or corporate restructurings.

A significant permanent difference that does not appear in the effective tax rate reconciliation statement relates to the tax benefits from employee exercise of non-qualified stock options. Under current accounting rules (*Accounting Principles Board Opinion No. 25*) tax benefits related to stock option deductions taken on the tax return that will not affect book income are recorded as an addition to the company's Additional Paid-in Capital. This accounting treatment overstates the reported "current" portion of the corporation's total tax provision reported in the income statement.

Analysts often are frustrated in estimating the tax benefits from stock option exercises because firms are not required to disclose the tax benefit separately in their Shareholder Equity statement. As a result, analysts must resort to estimating the benefit using the stock option information disclosed in a note separate from the Income Tax Note. The stock option note does not contain the pertinent information required for this calculation (number of options exercised during the year, the exercise price, and the fair value of the stock purchased), necessitating estimates that often are quite different from the actual benefits. Enron reports a tax benefit from employee stock option exercises of \$390 million in 2000. By grossing up the \$390 million tax benefit by 35 percent (the statutory tax rate), we estimate the tax deduction related to ESO exercises to be \$1,114 million. This \$1,114 million represents a permanent book-tax difference in 2000. Using the information provided in the stock option note, we would estimate the tax deduction to be \$1,470 million (see our *Tax Notes 2002* paper for the precise details). The corresponding tax benefit would be \$514 million, a difference of \$124 million. The calculation used would change an analyst's assessment of Enron's tax status.

The tax provision also likely includes an estimate ("cushion") for anticipated tax deficiencies that might arise due to aggressive positions taken on the current year tax return. Corporations may "hide" the cushion in either the current or deferred portion of the tax expense (shareholders may learn the amount of the cushion after the fact if litigation occurs).

IV. THOUGHTS ABOUT THE DISCLOSURE DEBATE

In his letter to then SEC chairman Pitt and then Treasury Secretary O'Neill, Senator Grassley asked whether "sufficient tax information is already publicly available" to determine a corporation's tax status. We would say no. Our analysis of Enron's tax status, which was prompted by Senator Grassley's query, demonstrates that current reporting leaves many gaps that require leaps of faith in estimating a corporation's tax status. There is far too much "noise" in the "current tax payable" portion of the Income Tax Note, which is further (often grossly) distorted by the fact

that the tax benefits of stock option exercises are omitted from the computation (in 2000, Microsoft Corporation's "current payable" and its "taxes paid" differed by more than \$4 billion).

The question is whether the solution requires surgery that is invasive or arthroscopic. Some commentators have suggested that the entire corporate tax return be made public. For a multinational corporation, such a return can exceed 10,000 pages. Very few investors would have the patience to sift through such voluminous materials. And even if they did, most would not be able to identify the specifics of the transactions that produced the reported information. Academic researchers and public interest groups likely would love such detailed information to be made publicly available. Such "sunlight" does not guarantee that a corporation's activities would become more transparent. For example, researchers who have examined the international reporting forms (Form 5471) attached to a U.S. corporation's Form 1120 have been unable to pin down with much precision how U.S. corporations are reducing their worldwide tax liabilities (for example, through transfer pricing or financing structures). Analysts would need access to the company or tax adviser's workpapers for the details. This issue has been ongoing between taxpayers, their advisers, and the Internal Revenue Service since the Supreme Court's decision in *United States v. Arthur Young*, 465 U.S. 805 (1984).

Also at issue is the extent to which full disclosure of a corporation's tax return would give proprietary business data away to competitors. Historically, tax return privacy has been a sacred right with virtually no exceptions (IRC section 6103). Disclosure does not have to be an all-or-nothing proposition, however. An expanded Income Tax Note would be a step in the right direction. As we mentioned previously, the "current" portion of the income tax expense is virtually meaningless. The prevailing misconception is that this number represents the actual tax paid or payable within 12 months. If this account is going to continue to serve as a "garbage can" for tax cushions and represents a residual computation that is distorted by putting the tax benefits of stock option exercises in paid-in-capital, then a separate statement of U.S., state and local, and international income taxes paid in the current year should be mandatory. An alternative would be to make the first four pages of the Form 1120 publicly available, although such information would not disclose the corporation's international tax liability. We would also like to see the deferred tax asset and liability balances in the Income Tax Note tie out to the amounts reported in the balance sheet. A more truthful presentation of the deferred tax assets and liabilities in the Income Tax Note would bring to light more of the items that create book-tax temporary differences. Currently, deferred tax assets and liabilities can be hidden in other balance sheet accounts (for example, compensation).

The issue of what to do with the book-tax difference in accounting (or not accounting) for the tax deduction related to stock option exercises presents a thornier issue. The arthroscopic solution would be to require all corporations to separately disclose the tax benefits from stock option deductions in their Shareholders' Equity statement and their Statement of Cash Flows.

Alternatively, the tax benefits could be taken directly to the book income tax provision and be reported as a permanent difference in the reconciliation of the company's effective tax rate. In Enron's case, the 5390 million stock option tax benefit would have reduced the company's tax expense from \$434 million to \$44 million in 2002. Enron would have reported an effective tax rate of 3.1%, and the permanent difference due to the stock option exercise would have shown up as a (27.6)%. Such reporting would have been more accurate in its depiction of the company's true tax status.

We do not support Congressional attempts to mandate comparability between financial accounting and tax accounting, especially with regard to stock option deductions. We are reminded of the Supreme Court's differentiation of the goals of financial and tax accounting in its decision in *Thor Power Tool Co. v. Commissioner*, 439 US 522 (1979):

[T]he presumption petitioner postulates is insupportable in light of the vastly different objectives that financial and tax accounting have. The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistent with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to

be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

Those who advocate conformity between book and taxable income may find their victory to be Pyrrhic. The Internal Revenue Service has won on many cases in which the taxpayer used generally accepted accounting principles for valuing inventory by arguing the accounting method did not produce a "clear reflection of income." We believe accounting principles should be left to the accounting establishment and tax rules left to Congress.

In summary, the issue as to whether Enron paid taxes opens debate on two fronts, both with the common theme of transparency. First, would tighter tax shelter disclosure rules have revealed more of the specifics of the company's tax strategies to the tax authorities. The likely answer is yes. Second, would more detailed accounting disclosure of the company's tax payments and its book-tax differences have painted a truer picture of the company's tax status. The likely answer also is yes. Accounting and tax reports should not be a cat-and-mouse game to the public or the government. The question becomes the size of the bell to put on the mouse. Regulations that label virtually every major transaction as a reportable tax shelter and disclosure rules that produce reams of detailed, yet impenetrable, information will have the perverse effect of producing less rather than more transparency.

Thank you for the opportunity to participate in this hearing. We welcome further dialogue on these important issues.



DID ENRON PAY TAXES?: USING ACCOUNTING INFORMATION TO DECIPHER TAX STATUS

By Gary A. McGill and Edmund Outslay

Confusion is the welcome mat at the door of creativity.
— Michael J. Gelb

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Using Enron's Annual Report information, the authors demonstrate how currently available financial statement data can be used to guesstimate a publicly traded corporation's tax status. They summarize the existing financial accounting literature on income tax disclosure and point out the "gaps" in such disclosure that make it difficult (impossible) to precisely discern the corporation's federal income tax status.

I. Introduction

The much publicized collapses of Enron Corporation and WorldCom, Inc. have heightened the discussion regarding the need for more consistency between measures of book and taxable income and the adequacy of the current annual report disclosure of a publicly traded corporation's tax status. As a result of the speculation and confusion about whether these corporations paid federal income taxes despite reporting billions of dollars of book income, commentators and members of Congress are calling for, or at least questioning the need for, publicly traded companies to be required to make their federal income tax returns (or relevant summary information) available to government agencies and perhaps even shareholders and employees.¹ In a recent letter to Treasury Secretary O'Neill, Sen. Charles Grassley, R-Iowa, asked the Secretary for his views on whether sufficient tax information is publicly available.² Senator Grassley observed that "Commentators have stated that the tax puzzle of a corporation can be put together from SEC filings, annual reports, etc. However, we saw with the Enron Corp. many analysts providing an estimate of taxes paid, or not paid, that were wildly contradictory."³

In this report we demonstrate how currently available financial statement data can be used to guesstimate a publicly traded corporation's tax status. In so doing, we summarize the existing financial accounting literature on income tax disclosure and point out the "gaps" in such disclosure that make it difficult (impossible) to precisely discern the corporation's

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¹See A. Murray, "Inflated Profits in Corporate Books Is Half the Story," *The Wall Street Journal*, July 2, 2002, p. A4, and letter from Sen. Charles E. Grassley, R-Iowa, to Treasury Secretary Paul O'Neill dated July 8, 2002, available at <http://www.senate.gov/~grassley>.

²Currently, section 6103(e)(1)(D)(iii) permits any bona fide shareholder of record owning 1 percent or more of the outstanding stock of such corporation to inspect the corporation's federal income tax return.

³Letter from Sen. Charles E. Grassley, *supra* note 1.

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federal income tax status. We hope the methodology and ensuing discussion help legislators, government agencies, academic researchers, and analysts better understand current disclosure rules and evaluate whether these rules provide sufficient information about a corporation's financial accounting and tax status.

II. The Growing Book and Tax Income Gap

Public scrutiny of the discrepancies between publicly traded corporations' book and tax incomes began in earnest during the mid-1980s, as corporate tax revenues as a percentage of total tax revenues shrank as a result of very favorable tax provisions enacted in the Economic Recovery Tax Act of 1981.⁴ The highly publicized Citizens for Tax Justice study interpreted the growing book-tax discrepancies as evidence of corporations' overindulgence in "corporate tax loopholes."

Subsequent to these initial studies, academic and government researchers began more in-depth analyses of corporate effective tax rates, which included discussions as to the appropriate measure of a corporation's tax burden.⁵ These studies tended to focus on whether corporations were paying their "fair share" of the corporate tax burden relative to their "economic" income (a modification of book income).

A new wave of academic research has arisen in response to the U.S. government's concern with the rise in corporate tax shelters.⁶ Whereas tax avoidance strategies in the 1980s tended to focus on book-tax temporary differences (for example, depreciation, leasing, completed contract method of accounting), recent tax shelters focus more on book-tax permanent differences (for example, income shifting to low-tax jurisdictions, tax-exempt income) that reduce the corporation's book "effective tax rate" and coincidentally

increase the corporation's after-tax book income.⁷ All of these recent studies confirm that the discrepancy between book income and tax income increased during the 1990s.⁸ Using data from the IRS Statistics of Income, Plesko determined that the difference between pre-tax book income and tax net income grew from \$92.5 billion in 1996 to \$159.0 billion in 1998, an increase of 71.9 percent.⁹

Determining the extent to which documented book and tax income discrepancies are due to tax avoidance strategies presents the biggest challenge to analysts. In the most extensive study to date, Desai shows that stock option exercises comprise a significant percentage of the discrepancy.¹⁰ He also finds that traditional book-tax differences and earnings management do not fully explain the discrepancies and surmises the unexplained differences to be due to tax sheltering activities.

III. Corporate Income Tax Disclosure

Analysts of a corporation's tax burden must depend on financial accounting income tax disclosures to calculate the corporation's tax liability in the absence of publicly available firm tax return data. No less a corporate tax authority than Robert Willens was quoted in a recent *Business Week* article on Enron as saying "Truth is, figuring out how much tax a company actually pays is impossible. . . . Tax disclosure is just inscrutable."¹¹ A *Washington Post* article dealing with whether Enron paid taxes stated that "Accountants cautioned that it is difficult to determine from a company's financial reports how much tax it paid. . . . Tax and accounting experts differed over the best way to interpret some of the data contained in the Enron reports."¹² Writing in *CFO Magazine*, S. L. Mintz observed that "While tax information is readily available — as provisions on income statements, as deferred as-

⁴See, e.g., Citizens for Tax Justice, *Corporate Taxpayers and Corporate Freeloaders* (1985); E. Outslay and J.E. Wheeler, "The Phantom Federal Income Taxes of General Dynamics Corporation," *The Accounting Review*, October 1986, p. 760; J. E. Wheeler and E. Outslay, "The 1986 Tax Reform Effort — The Defense Industry and Senator Danforth's Complaints," *Tax Notes*, Sept. 29, 1986, p. 1305; and C.P. Stickney, R.L. Well, and M. Wolfson, "Income Taxes and Tax-Transfer Leases: General Electric's Accounting for a Molotov Cocktail," *The Accounting Review*, April 1983, p. 439.

⁵See, e.g., G.M. Clowery, E. Outslay, and J.E. Wheeler, "The Debate on Computing Corporate Effective Tax Rates — An Accounting View," *Tax Notes*, Mar. 10, 1986, p. 991; S. Gupta and K. Newberry, "Corporate Average Effective Tax Rates After the Tax Reform Act of 1986," *Tax Notes*, May 4, 1992, p. 689; General Accounting Office, "Tax Policy: 1988 and 1989 Company Effective Tax Rates Higher Than in Prior Years," *GCD-92-111*, Sept. 19, 1992; and D. S. Callihan, "Corporate Effective Tax Rates: A Synthesis of the Literature," *Journal of Accounting Literature* 13 (1994), p. 1.

⁶This issue returned to the public spotlight with a 1998 *Forbes Magazine* cover story dealing with the rise in aggressive tax shelters sold by lawyers and accountants. See J. Novack and L. Saunders, "The Hustling of X-Rated Shelters," *Forbes*, Dec. 14, 1998, p. 198.

⁷See S. L. Mintz, "A Taxing Challenge," *CFO Magazine*, Nov. 1, 1999.

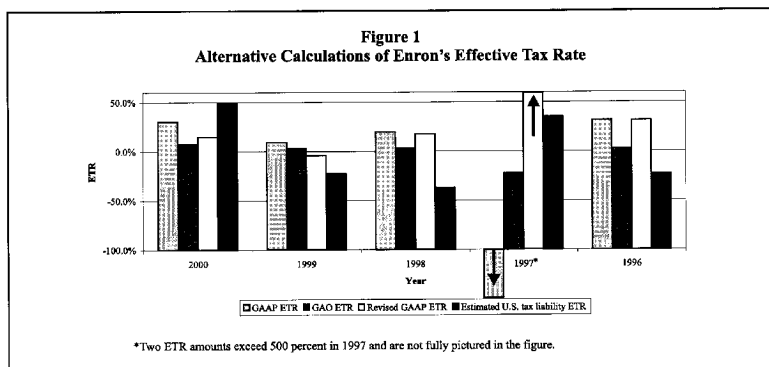
⁸Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*, July 1999, at pp. 31-33; R.S. McIntyre and T.D. Co Nguyen, *Corporate Income Taxes in the 1990s*, Institute on Taxation and Economic Policy (October 2000); G.B. Manzoni and G.A. Plesko, "The Relation Between Financial and Tax Reporting Measures of Income," *Tax Law Review* (forthcoming); L.K. Mills, K. Newberry, and W.B. Trautman, "Trends in Book-Tax Income and Balance Sheet Differences," *Tax Notes*, Aug. 19, 2002, p. 1109; and M. Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," *NBER working paper 8866*, 2002.

⁹G. Plesko, "Reconciling Corporation Book and Tax Net Income, Tax Years 1996-1998," *Statistics of Income Bulletin*, Spring 2002, p. 111 at p. 116.

¹⁰M. Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," *supra* note 8.

¹¹H. Gleckman, D. Foust, M. Arndt, and K. Kerwin, "Tax Dodging: Enron Isn't Alone. Plenty of Companies Pay Little or Nothing," *Business Week*, Mar. 4, 2000, p. 40.

¹²G. Kessler, "Enron Appears to Have Paid Taxes," *The Washington Post*, Feb. 3, 2002, p. A10.



sets and liabilities on balance sheets, as cash taxes on statements of cash flows, and often as footnoted items — the data resists comprehensive analysis. Further, little of it is reported in a consistent manner, even within industry groups.¹³

Much of the confusion can be traced back to the flexibility and "gaps" in Generally Accepted Accounting Principles (GAAP) regarding measurement and disclosure of a company's income taxes. As noted in *Tax Notes* as far back as 1986, "GAAP concerning accounting for income taxes and the related reporting requirements are so difficult to comprehend that they are subject to varying interpretations which lead to extreme diversity in the treatment of similar transactions."¹⁴ Indeed, estimates of how much federal income taxes Enron paid in 2000 ranged from zero¹⁵ to \$62 million¹⁶ to \$112 million.¹⁷ Table 1 presents data related to Enron's income taxes for the period 1996-2000 (Note 5 to the company's financial statements).

A. Accounting for Income Taxes

1. **FAS 109, *Statement of Financial Accounting Standards No. 109 (FAS 109)*** primarily governs the measurement and reporting of a publicly traded corporation's in-

come taxes (federal, state and local, and foreign). This statement, promulgated by the Financial Accounting Standards Board (FASB), applies to fiscal years beginning after December 15, 1992. FAS 109 states two objectives: (1) to recognize the amount of taxes payable or refundable for the current year; and (2) to recognize deferred tax liabilities and assets for the (expected) future tax consequences of events that have been recognized in a company's financial statements or tax returns.¹⁸

The statement attempts to implement its objectives through four basic principles: (1) A *current tax liability or asset* is recognized for the estimated taxes payable or refundable on tax returns for the current year; (2) A *deferred tax liability or asset* is recognized for the estimated future tax effects attributable to *temporary differences* and carryforwards; (3) The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; and (4) The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that based on available evidence, are not expected to be realized.¹⁹ A temporary difference generally is an amount that will appear on both the financial statement and the tax return; but in different accounting periods. An item that will produce a future tax liability creates a deferred tax liability, whereas an item that will produce a future tax reduction creates a deferred tax asset.

Unlike its predecessor, *Accounting Principles Board Opinion No. 11 (APB 11)*, FAS 109 recognizes that deferred income taxes are assets and liabilities and not residual charges (that is, the statement takes a balance sheet approach rather than an income statement ap-

¹³S.L. Mintz, "A Taxing Challenge," *supra* note 7.

¹⁴G.M. Clowery, E. Outslay, and J.E. Wheeler, "The Debate on Computing Corporate Effective Tax Rates — An Accounting View," *supra* note 5, at p. 992.

¹⁵Citizens for Tax Justice, "Less Than Zero: Enron's Corporate Income Tax Payments, 1996-2000" (Jan. 17, 2000).

¹⁶A. Witt and P. Behr, "Enron's Other Strategy: Internal Papers Reveal How Complex Deals Boosted Profits by \$1 Billion," *The Washington Post*, May 22, 2002, p. A01.

¹⁷L.D. Brumbaugh, "Enron and Taxes" *Congressional Research Service Report RS21149*, February 12, 2002, and G. Kessler, "Enron Appears to Have Paid Taxes," *The Washington Post*, Feb. 3, 2002, p. A10.

¹⁸Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 109*, para. 6 and 7.

¹⁹*Id.* at 3, para. 8.

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Components of income before income taxes (in millions)	2000	1999	1998	1997	1996
United States	\$ 640	\$ 357	\$ 197	\$ 96	\$ 551
Foreign	773	771	681	(81)	304
Income before income taxes	\$1,413	\$1,128	\$878	\$15	\$855
Total income tax expense (benefit) (in millions)	2000	1999	1998	1997	1996
Payable currently					
Federal	\$ 112	\$ 29	\$ 30	\$ 29	\$ 16
State	22	6	8	9	11
Foreign	93	48	50	46	37
	227	83	88	84	64
Payment deferred					
Federal	13	(159)	(14)	(39)	174
State	14	23	11	(42)	(1)
Foreign	180	157	90	(93)	34
	207	21	87	(174)	207
Total income tax expense	\$434	\$104	\$175	\$190	\$271
Effective tax rate reconciliation	2000	1999	1998	1997	1996
Statutory federal income tax provision	35.0%	35.0%	35.0%	35.0%	35.0%
Net state income taxes	2.5%	1.8%	1.7%	-140.0%	0.8%
Tight gas sands tax credit	0.0%	-0.5%	-1.4%	-80.0%	-1.8%
Foreign tax rate differential	-2.4%	-7.0%	0.8%	13.3%	0.0%
Equity earnings	5.3%	-10.1%	-4.3%	-253.3%	-3.3%
Minority interests	0.0%	0.8%	0.8%	186.7%	3.1%
Basis and stock sale differences	-11.9%	-10.8%	-14.2%	-526.7%	1.8%
Goodwill amortization	1.6%	1.6%	2.0%	60.0%	0.0%
Cash value in life insurance	0.0%	-0.9%	-1.1%	-46.7%	-3.2%
Audit settlement	0.0%	-1.8%	0.0%	0.0%	0.0%
Other	0.6%	1.1%	0.7%	153.4%	-0.7%
Book effective tax rate^a	30.7%	9.2%	20.0%	-598.3%	31.7%

^aTotal income tax expense/Income before income taxes.

proach). As a result, an enterprise's deferred tax expense or benefit is measured as the change during the year in the enterprise's deferred tax liabilities and assets.²⁰ The enterprise must reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.²¹ A company's total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.²²

Paragraphs 43-49 of FAS 109 govern the financial statement disclosure of the enterprise's income taxes. In general, paragraph 43 requires an enterprise to dis-

close the total of all deferred tax liabilities, the total of all deferred tax assets, the total valuation allowance, the net change in the valuation allowance for the year, and the types of temporary differences and tax carryovers that comprise a "significant" portion of the deferred tax liabilities or assets. An enterprise also must disclose components of the income tax provision allocated to continuing operations, including the current tax expense or benefit, the deferred tax expense or benefit, investment tax credits, the benefits of operating loss carryforwards, and adjustments to the beginning of the year valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years (paragraph 45).

Paragraph 47 requires a public enterprise to disclose a reconciliation using percentages or dollar amounts of (a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result

²⁰Id. at 7, para. 16.

²¹Id. at 8, para. 17 c.

²²Id. at 7, para. 16.

Table 2
Enron Stock Options Data (Note 11)

	2000 ^a	1999 ^b	1998	1997	1996
Exercised					
Shares (in thousands)	32,235	19,705	13,072	4,330	7,230
Weighted average exercise price of stock options granted	70.02	37.49	24.99	19.32	19.86
Weighted average exercise price of stock options exercised	24.43	18.08	15.70	11.65	12.21
Estimated compensation component of stock options exercised	45.59	19.41	9.29	7.67	7.65
Tax deduction related to stock options exercised (in millions) ^c	\$1,114	\$382	\$121	\$33	\$55

^aYear 2000 uses the tax benefit information provided by Enron (\$390 million) grossed up by the statutory tax rate (35 percent).

^bThe calculations take into account a 2-for-1 stock split in 1999.

^cShares exercised x estimated compensation component of stock options exercised.

from applying domestic federal statutory tax rates to pretax income from continuing operations (sometimes referred to as the "hypothetical" federal income tax expense). Paragraph 47 also requires the enterprise to disclose the estimated amount and the nature of each "significant" reconciling item (this would include permanent book-tax differences, the impact of state and local income taxes and foreign taxes, and the effects of enacted tax rate changes on temporary differences). FAS 109 does not provide any materiality guidelines for the disclosure of individual reconciling items. This reconciliation provides the starting point for comparing a company's book effective tax rate with some other measure of its tax effective tax rate.

2. **APB 23. Accounting Principles Board Opinion No. 23 (APB 23)**, issued in 1972, deals with "special areas" related to accounting for income taxes. APB 23 applies most frequently to the potential tax consequences related to reporting undistributed earnings of subsidiaries located outside the United States reported on the enterprise's income statement but not its tax return. APB 23 generally presumes that all undistributed income of a foreign subsidiary will be transferred to the parent company and deferred taxes should be recorded for this temporary difference, taking into account any deductions or credits available to the parent corporation.²³ This presumption can be overcome, in which case the parent company does not have to accrue income taxes, if "sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation."²⁴ This exception is referred to as the "indefinite reversal criteria." Where an enterprise chooses not to record deferred taxes on undistributed earnings of a foreign subsidiary, FAS 109 requires the enterprise to disclose the amount of the unrecognized deferred tax liability "if determination of that liability is practicable or a statement that determination is not practicable."²⁵ The great majority of

publicly traded companies choose not to record deferred income taxes for undistributed earnings of their foreign subsidiaries, and many find it "not practicable" to estimate the deferred taxes that would be payable if such earnings were remitted.²⁶

3. **APB 25. Accounting Principles Board Opinion No. 25 (APB 25)**, issued in 1972, deals with accounting for the tax benefits related to employee stock option exercises. Tax benefits related to stock option deductions taken on the tax return that will not affect book income (for example, employee exercises of nonqualified stock options) are recorded as an addition to the company's additional paid-in capital.²⁷ This accounting treatment overstates the "current" portion of the total tax provision reported in the enterprise's income statement by the amount of the stock option tax benefit.²⁸ The tax benefits also are reported in the company's Statement of Cash Flows as an operating cash flow.²⁹

4. **FAS 5. Statement of Financial Accounting Standards No. 5 (FAS 5)** deals with accounting for contingencies. Most enterprises include in their tax provision a "cushion" for anticipated tax deficiencies that might arise due to positions taken on the current year tax return. FAS 5 allows an enterprise to book an estimated loss from a loss contingency if it is "probable" the liability has been incurred at the date of the financial statement and the amount of the loss can be reasonably estimated.³⁰ Whether a potential deficiency due to a potential future IRS audit meets these criteria is subject to debate,³¹ but the practice of recording a tax cushion

²⁶An exception is Microsoft Corporation, which reported a deferred tax liability related to its undistributed international earnings of \$1,667 million at June 30, 2001.

²⁷Accounting Principles Board Opinion No. 25, para. 17.
²⁸M. Hanlon and T. Shevlin, "Accounting for Tax Benefits of Employee Stock Options and Implications for Research," *Accounting Horizons*, March 2002, p. 1.

²⁹See Emerging Issues Task Force Issue No. 00-15.
³⁰Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, para. 8.

³¹See, e.g., J.E. Wheeler, *Advanced Accounting: A Professional Approach* (Richard D. Irwin, Inc., 1981), p. 18.

²³Accounting Principles Board Opinion No. 23, para. 10, as amended by FAS 109, para. 287.f.

²⁴*Id.*, para. 12.

²⁵Financial Accounting Standards Board Statement of Financial Accounting Standards No. 109, para. 44.c.

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	2000	1999	1998	1997	1996
	<i>Net income before cumulative effect of accounting changes^a</i>				
[Add/Sub]	979	1,024	703	105	584
[Add/Sub]	434	104	175	(90)	271
[Add]	154	135	77	80	75
[Sub/Add]	(87)	(309)	(97)	(216)	(215)
[=]	1,480	954	858	(121)	715
[Sub/Add]	(22)	(6)	(8)	(9)	(11)
[=]	1,458	948	850	(130)	704
[Add/Sub]	(773)	(771)	(681)	81	(304)
	<i>U.S. profit before tax</i>				
[Sub/Add]	685	177	169	(49)	400
[Subtract]	(37)	454	40	111	(497)
[=]	(137)	(102)	(104)	(52)	(30)
[=]	511	530	105	10	(127)
[x]	0.35	0.35	0.35	0.35	0.35
[=]	179	185	37	4	(44)
[Subtract]	---	(6)	(12)	(21)	(15)
[=]	179	180	25	(17)	(60)
[Compare]	112	29	30	29	16
	<i>Over (under) estimated difference</i>				
	67	151	(5)	(46)	(76)

^aAs reported in the Consolidated Income Statement.
^bAs reported in the Income Taxes Note to the financial statements (See Table 1).
^cFrom the Income Taxes Note: 2000: 13/0.35; 1999: (159)/0.35; 1998: (14)/0.35; 1997: (39)/0.35; 1996: 174/0.35.
^dFrom the Income Taxes Note: Includes only basis and stock sale differences, cash value in life insurance, goodwill amortization, other.
^eFrom the Income Taxes Note: Alternative fuel credit under IRC section 29(a).

is common.³² Although it would seem logical that a tax cushion would be included in the deferred portion of the tax provision, discussions with practitioners indicate that companies often record the cushion in the current portion of the tax provision. Weber and Wheeler note that "There is no accounting convention that specifically covers the reporting of tax audit cushions, and for obvious reasons, corporations do not generally disclose information about their cushion."³³

5. SEC Regulation S-X, Rule 4-08(h). Rule 4-08(h) deals with income tax disclosures required by companies subject to SEC regulation. The primary disclosure requirement imposed by this rule is the bifurcation of income (loss) before income tax expense (benefit) as either domestic or foreign. Companies also are required to separately state the portion of the income tax expense related to federal income taxes, foreign income taxes, and other income taxes (state and

local). Foreign income (loss) is defined as income (loss) that is generated from a registrant's operations located outside its home country. Rule 4-08(h)(2) also states that reconciling items in the effective tax rate computation should be stated separately if they equal or exceed 5 percent of the "hypothetical tax expense" (income before taxes times the applicable statutory federal income tax rate — currently 35 percent for U.S. domiciled companies). No reconciliation is required if the total reconciling differences are less than 5 percent of the hypothetical tax unless the reconciliation would be "significant in appraising the trend of earnings."

B. Gaps in GAAP Income Tax Disclosure

1. Interpreting the 'current' portion of the income tax provision. Many individuals, including analysts, view the "current" portion of a company's income tax provision as the amount that relates to the entity's current year taxable income. For example, in a recent *Business Week* article on how to interpret a company's income tax disclosure, the author stated that "if you look up the 'current' portion of its tax bill . . . , you can see that the company sent the IRS a check for \$46.3 million, deferring the remaining \$46.2 million."³⁴ Given that the current portion of the income tax pro-

³²Dworin pointed this out in a 1985 *Tax Notes* article. See L. Dworin, "On Estimating Corporate Tax Liabilities From Financial Statements," *Tax Notes*, Dec. 2, 1985, p. 965. FAS 5 does sanction the recording of a cushion when an enterprise is litigating a tax matter (para. 39).

³³R.P. Weber and J.E. Wheeler, "Using Income Tax Disclosures to Explore Significant Economic Transactions," *Accounting Horizons*, September 1992, p. 14 at p. 17.

³⁴A. Turgesen, "How to Spot Tax Tinkering," *Business Week*, May 20, 2002, p. 142.

		2000	1999	1998	1997	1996
	Foreign income (loss) ^a	773	771	681	(81)	304
[Sub/Add]	Increase (drawdown) of non-U.S. deferred tax provision/0.35	(514)	(449)	(257)	266	(97)
	Estimated foreign taxable income	259	322	424	185	207
[x]	35% (U.S. statutory tax rate)	0.35	0.35	0.35	0.35	0.35
[=]	Tax on foreign income at the U.S. statutory rate	91	113	148	65	72
[Subtract]	Foreign taxes payable currently ^a	93	48	50	46	37
[=]	Foreign taxes less (greater) than U.S. taxes on foreign income	(2)	65	98	19	35
[Compare]	Foreign tax rate differential ^b	(34)	(79)	70	2	—
	Over (under) estimated difference	32	144	28	17	35

^aAs reported in the Income Taxes Note to the financial statements (See Table 1).
^bEquals the "foreign tax rate differential" (from Table 1) x Income Before Income Taxes (from Table 1).

vision often becomes a clearinghouse for bestiaris such as the tax cushion and does not reflect the tax benefits of employee stock option deductions, a correspondence between the reported federal income tax "payable currently" and the check sent to the Internal Revenue Service would be surprising, if not only coincidental. Relying on the current portion of the tax expense as indicative of a corporation's tax status could lead to erroneous implications. For example, Microsoft Corporation reported current income taxes of \$5,279 million for 2000, of which \$4,744 related to U.S. and state income taxes. The company noted that it "paid" income taxes of \$1.1 billion in 2000. With a tax deduction of more than \$15 billion related to employee stock option deductions not reported in the income statement,³⁵ it is likely that the company paid little, if any, federal income taxes in 2000.³⁶

2. Estimating the tax benefits from employee stock option exercises. APB 25, para. 17, requires a company to record the excess of the tax benefit related to employee stock option exercises over the amount reported for net income purposes (which usually is zero) as an addition to paid-in-capital in the shareholders' equity section of the balance sheet. The tax benefits from employee stock option exercise also are included in the company's Statement of Cash Flows. The Emerging Issues Task Force recently reached a consensus that the income tax benefit realized from stock option exercise

should be classified as an operating cash flow and should be separately disclosed if material.³⁷

Not all firms disclose the tax benefit of stock options separately in their Changes in Shareholder Equity statement, necessitating an estimate using stock option information required under *Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation*.³⁸ Relevant information required to be disclosed under this statement includes the number of options exercised during the year, the average exercise price, and the average exercise price of new options granted during the year. The average value of the stock when the options were exercised is not provided. As a result, studies analyzing the stock option benefits to individual companies have estimated the tax benefits (and resulting tax deduction) from such exercises using the following formula: Number of options exercised x (average price of new options granted — average exercise price).³⁹ Alternatively, the average price of new options granted could be replaced by the weighted average price of the company's stock for the year (this takes into account the volume of stock sold and the price at which sold for each trading day during the year).⁴⁰

³⁵See Emerging Issues Task Force *Issue No. 00-15*. See also Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 95 — Statement of Cash Flows* for a more thorough discussion of the components of a company's Statement of Cash Flows.

³⁶M. Hanlon and T. Shevlin, "Accounting for Tax Benefits of Employee Stock Options and Implications for Research," *supra* note 28.

³⁷Citizens for Tax Justice, "Less Than Zero: Enron's Corporate Income Tax Payments, 1996-2000," *supra* note 15; M. Hanlon and T. Shevlin, "Accounting for Tax Benefits of Employee Stock Options and Implications for Research," *supra* note 28 and M.A. Sullivan, "Stock Options Take \$50 Billion Bite Out of Corporate Taxes," *supra* note 36.

³⁸M. Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," *supra* note 8.

³⁵Dividing the reported tax benefit of \$5,279 million by 35 percent translates to a deduction of slightly more than \$15 billion.

³⁶See also M. Hanlon and T. Shevlin, "Accounting for Tax Benefits of Employee Stock Options and Implications for Research," *supra* note 28, and M.A. Sullivan, "Stock Options Take \$50 Billion Bite Out of Corporate Taxes," *Tax Notes*, Mar. 18, 2002, p. 1396, for a slightly different computation of the company's estimated stock option deduction.

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		2000	1999	1998	1997	1996
	<i>Net income before cumulative effect of accounting changes^a</i>	979	1,024	703	105	584
[Add/Sub]	Income tax expense (benefit) ^a	434	104	175	(90)	271
[Add]	Minority interests ^a	154	135	77	80	75
[Sub/Add]	Equity in earnings of unconsolidated affiliates ^a	(87)	(309)	(97)	(216)	(215)
[=]	<i>Before tax income (BTI)</i>	1,480	954	858	(121)	715
[Sub/Add]	State and local taxes (current) ^a	(22)	(6)	(8)	(9)	(11)
[Subtract]	Deduction from employee exercise of ESOs ^a	(1,114)	(382)	(121)	(33)	(55)
[=]	<i>Worldwide profit before tax</i>	344	566	729	(163)	649
[Add/Sub]	Foreign income (loss)	(773)	(771)	(681)	81	(304)
	<i>U.S. profit before tax</i>	(429)	(205)	48	(82)	345
[Sub/Add]	U.S. deferred tax provision (drawdown)/0.35 ^d	(37)	454	40	111	(497)
[Subtract]	Reduction in tax provision due to "permanent differences" ^e	(137)	(102)	(104)	(52)	(30)
[=]	<i>Estimated U.S. taxable income</i>	(603)	148	(16)	(23)	(182)
[x]	35%	0.35	0.35	0.35	0.35	0.35
[=]	<i>Estimated pre-credit U.S. tax liability (benefit)</i>	(211)	52	(5)	(8)	(64)
[Subtract]	U.S. tax credits ^f	—	(6)	(12)	(21)	(15)
[=]	<i>Estimated U.S. tax liability</i>	(211)	46	(18)	(29)	(79)
[Compare]	Federal income tax payable currently ^g	112	29	30	29	16
[Subtract]	Tax benefit from ESO exercise (deduction * 35%)	(390)	(134)	(42)	(12)	(19)
	Federal income tax payable currently adjusted for ESO exercises	(278)	(105)	(12)	17	(3)

^aAs reported in the Consolidated Income Statement.
^bAs reported in the Income Taxes Note to the financial statements (See Table 1).
^cFrom Table 2.
^dFrom the Income Taxes Note: 2000: 13/0.35; 1999: (159)/0.35; 1998: (14)/0.35; 1997: (39)/0.35; 1996: 174/0.35.
^eFrom the Income Taxes Note: Includes only basis and stock sale differences, cash value in life insurance, goodwill amortization, other.
^fFrom the Income Taxes Note: Alternative fuel credit under IRC section 29(a).

Enron provides an example of the complexities in estimating the tax deduction related to employee stock option (ESO) exercises. Table 2 presents data related to Enron's stock options over the period 1996-2000 (Note 11 to the company's financial statements). The company reports a tax benefit from employee stock option exercises of \$390 million in 2000. No such disclosure is made for 1996-1999. By grossing up the \$390 million tax benefit by 35 percent (the statutory tax rate), we estimate the tax deduction related to ESO exercises to be \$1,114 million. Using the "formula approach" we would estimate the tax deduction to be \$1,470 million (32,235 thousand shares x (\$70.02 - \$24.43). The corresponding tax benefit would be \$514 million. Using a weighted average stock price for 2000 of \$83.13, our estimate of the ESO tax deduction increases to \$1,892 million and the tax benefit increases to \$662 million.⁴¹ Depending on which calculation is used, one could make widely divergent estimates of Enron's tax status based solely on stock option exercises.

⁴¹The weighted average stock price was computed using data from the Center for Research in Security Prices (CRSP) database.

3. **Disclosure of specific reconciling items.** Companies are required to disclose individual items making up deferred tax assets and liabilities (temporary differences) only if they are "significant."⁴² In the case of items that reconcile the company's book effective tax rate with the hypothetical (statutory) tax rate (including permanent differences), SEC regulation S-X, Rule 4.08(h)(2) requires specific identification only if the amount equals or exceeds 5 percent of the hypothetical amount or rate. Where reconciling items are combined, it is impossible to determine if the item represents a deduction or exclusion (in which the item needs to be grossed up to compute the tax return effect) or a credit (which reduces the company's tax liability but not its taxable income). Although the deferred tax portion of the tax provision is calculated as the difference between the beginning and ending balances in the deferred tax balance sheet accounts, the change in deferred tax assets and liabilities reported in the income tax note and the corresponding deferred tax expense for the current year often diverge widely. For

⁴²Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 109*, para. 43.

example, the change in Enron's net deferred tax liability from 1999 to 2000 was \$230 million compared to the deferred tax provision of \$13 million.

C. Investments in Other Companies

1. Financial accounting rules. The entities that are combined on a consolidated income statement often differ from the entities combined on a consolidated tax return, especially for multinational companies. For book purposes, a corporation must control (that is, own more than 50 percent of the voting interest of) another corporation before its income and expenses are consolidated.⁴³ Consolidated net income includes income from both U.S. and foreign subsidiaries and is reduced by any after-tax minority interest in the subsidiary's net income. Consolidating the income of more-than-50-percent-owned subsidiaries is mandatory for financial accounting purposes.

Corporations owning 20-50 percent of another corporation usually account for their investment under the equity method.⁴⁴ Under the equity method, the investor corporation reports its share of the investee corporation's net income or loss in its income statement in the year earned. The equity method assumes the investor corporation can "significantly influence" the investee corporation's financial and operating policies. Corporations owning less than 20 percent of the investee corporation can use the equity method if their ownership influence meets the equity method criterion.⁴⁵ Corporations owning more than 50 percent of a voting interest in another corporation also can use the equity method if the control is temporary.

Corporations owning less than 20 percent of another corporation usually use the cost method to account for such investments.⁴⁶ Under the cost method, book income from the corporate investee is reported when it is received as a dividend.

2. Tax accounting rules. Corporations can elect to consolidate the income and expenses of 80 percent-or-more-owned U.S. subsidiaries in computing taxable income.⁴⁷ All of the income of consolidated subsidiaries is reported in consolidated taxable income (that is, no subtraction is made for minority interests). The operations of foreign subsidiaries are not included on the consolidated U.S. tax return, except to the extent the subsidiary remits its earnings to the U.S. corporation

in the form of interest, dividends (actual or deemed), fees, rents, and royalties. Income from less-than-80-percent-owned corporations (domestic or foreign) is reported for tax purposes only when it is received as a dividend. Consolidating the income of 80-percent-owned U.S. subsidiaries is elective for tax accounting purposes (although once elected, corporations must continue to file consolidated tax returns unless the Internal Revenue Service allows them to discontinue doing so, which is very rare).

3. Reconciliation issues. These differences in tax and accounting rules must be considered when estimating a corporation's tax status using financial statement information. Adjustments must be made to add back any minority interests and add back or deduct any equity loss or income reported on the income statement. Reconciliation is not possible to the extent the financial statements include income or loss from an entity that is more than 50 percent owned but less than 80 percent owned. Mills, Newberry, and Trautman note that anecdotal evidence from large case IRS audits indicate that very large U.S. corporations do not have many 50-to-less-than-80-percent-owned entities.⁴⁸

IV. Estimating Enron's Tax Status

A. Reconciling Enron's FIT 'Payable Currently'

Table 3 provides a methodology for reconciling the federal income tax "payable currently" as reported by Enron in the Income Taxes Note to the financial statements.⁴⁹ The reconciliation begins with "net income before cumulative effect of accounting changes" as reported in the Consolidated Income Statement. We add back (subtract) the book "Income Tax Expense (benefit)" to put net income on a before-tax basis. We then add back the amounts representing minority interests and subtract out (add back) undistributed equity income (loss) to reflect the difference in book and tax accounting methods applied to less than 100-percent-owned consolidated subsidiaries and 20-to-50-percent-owned unconsolidated investees. The resulting amount, "before tax income" often is the denominator in the computation of a company's GAAP "effective tax rate" as reported in the Income Taxes Note to the financial statement. This is not the case for Enron, which does not make any adjustments for minority interests and equity income, but instead reports the tax effects of these items in its effective tax rate reconciliation.

We reduce before tax income by state and local taxes payable currently as reported in the Income Taxes Note to reflect the fact that these income taxes are deducted in computing a corporation's federal taxable income under section 164. This adjustment is consistent with the methodology used by Citizens for Tax Justice and the General Accounting Office in their computations of

⁴³Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 94 — Consolidation of All Majority-Owned Subsidiaries*.

⁴⁴Accounting Principles Board *Opinion No. 18 — The Equity Method of Accounting for Investments in Common Stock*.

⁴⁵Financial Interpretation No. 35 — *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock — An Interpretation of APB Opinion No. 18*.

⁴⁶Under Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 115 — Accounting for Certain Investments in Debt and Equity Securities*, corporations must include in income any unrealized gain or loss from marking-to-market trading securities, with a corresponding charge to deferred taxes.

⁴⁷Sections 1501-1504.

⁴⁸L.K. Mills, K. Newberry, and W.B. Trautman, "Trends in Book-Tax Income and Balance Sheet Differences," *supra* note 8.

⁴⁹We are using Enron's terminology in all of the tables. Many U.S. companies refer to their "foreign" income as "international" or "non-U.S."

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	2000	1999	1998	1997	1996
<i>Per Enron's Financial Statement (GAAP)</i>					
Provision for income taxes/Income before income taxes ^a	30.7%	9.2%	20.0%	-598.3%	31.7%
<i>GAO/JCT formula</i>					
U.S. taxes payable currently/Worldwide profit before tax	7.7%	3.1%	3.5%	-22.3%	2.3%
<i>Revised GAAP ETR adjusted for ESOs</i>					
Revised provision for income taxes/Revised income before taxes ^b	14.7%	-4.0%	17.5%	564.2%	31.5%
<i>Estimated U.S. tax liability/U.S. profit before tax adjusted for ESOs^c</i>	49.2%	-22.5%	-37.0%	35.2%	-22.9%

^aFrom Enron's Income Taxes Note — see Table 1.
^bRevised provision for income taxes = Provision for income taxes (Table 1) — ESO tax benefit (Table 5) (2000 = \$434 - \$390); revised income before income taxes = Income before income taxes (Table 1) — ESO tax deduction (Table 5) (2000 = \$1,413 - \$1,114).
^cFrom Table 5.

corporate effective tax rates. One could argue that deferred state and local income taxes could be included in the adjustment in that Enron is an accrual-based company. However, under section 461(h), state and local income taxes are considered "payment liabilities" and are deductible in the year accrued only if paid within 8½ months after the close of the corporation's tax year. These liabilities likely are classified as payable currently. Also, anecdotal discussions with practitioners indicate that deferred state and local taxes could represent a tax cushion for such liabilities. The amounts in Enron's case are not material.

We next reduce "worldwide profit before tax" by income earned by entities located outside the United States as reported in the Income Taxes Note. We adjust the resulting "U.S. profit before tax," to reflect "temporary" and "permanent" differences as defined in FAS 109. Temporary differences are reflected in the deferred portion of the company's federal income taxes, as reported in the Income Taxes Note (see Table 1). We gross up the deferred tax charge (or drawdown) by the statutory tax rate (35 percent) to compute the tax return amount that created the deferred tax charge. We decrease book income by the adjustment where the deferred tax amount is positive (an increase in a deferred tax amount indicates that book income exceeds taxable income in the current period) and increase book income by the adjustment where the deferred tax amount is negative. Enron reports the tax effects of permanent differences in the reconciliation of its effective tax rate with the hypothetical rate in the Income Taxes Note (Table 1). Care must be taken to only include items that are reflected on the corporation's U.S. income tax return. We exclude items relating to "net state income taxes," "foreign tax rate differential," "equity earnings," "minority interests," "audit settlement," and the "tight gas sands tax credit" (reported separately in the Income Taxes Notes before 2000) from the adjustment because we already have adjusted net income for the item or the item does not pertain to permanent differences between U.S. book income and U.S. taxable income. We compute the tax effect of the permanent differences used in the adjust-

ment by multiplying the percentage effect of the difference as reported in the ETR reconciliation times the company's "income before income taxes," which also is reported in the Income Taxes Note (see Table 1). We gross up the tax effect in dollars by 35 percent to compute the taxable income adjustment.

The adjustments for temporary and permanent differences produce Enron's estimated U.S. taxable income without considering employee stock option (ESO) exercises. This amount times 35 percent provides an estimate of the company's pre-credit U.S. tax liability without taking into account ESO exercises. We then deduct the estimated alternative fuel credit under section 29(a) as reported in the company's ETR reconciliations for years before 2000 (Enron did not report the section 29(a) credit separately in 2000). The result is the company's estimated federal income tax before ESO exercises. This amount should reflect the company's reported federal income tax payable currently as reported in the Income Taxes Note. Differences, which tend to vary widely for 1996-2000, could reflect the tax cushion, rounding differences, and amounts that cannot be accounted for due to lack of disclosure. For years 1998-2000, our estimated federal income tax payable and the company's reported federal income tax payable currently are in the same direction (all positive), whereas we estimate a federal income tax benefit in 1996-1997 while the company reports a positive federal income tax payable currently in those two years.

B. Enron's Foreign Income Tax Rate Differential

Table 4 presents a methodology for reconciling the company's reported "foreign tax rate differential" in the effective tax rate reconciliation. We adjust foreign income as reported in the Income Taxes Note (Table 1) for the deferred charge (drawdown) related to foreign income taxes. We multiply the resulting "estimated foreign taxable income" by 35 percent to compute the tax Enron would have paid on such income using the U.S. statutory tax rate. This amount compared to foreign income taxes "payable currently" should reflect the excess (shortage) of foreign income taxes relative

to the hypothetical amount. Except for 1999, the differences are fairly small, which could be due to rounding and the inclusion in "other" of permanent differences related to foreign income in the ETR reconciliation.

C. Enron's Tax Income Including ESO Exercises

In Table 5 we adjust Enron's net income to take into account the effect of tax return deductions generated by employee exercises of non-qualified stock options. Except in 2000, we use the same methodology as Citizens for Tax Justice and Hanlon and Shevlin. That is, we multiply the number of options exercised during the year times the difference between the average exercise price of new options issued during the year and the average exercise price of options exercised during the year. This information, reproduced in Table 2, can be found in the Common Stock Note (Note 11) to the company's financial statements. This calculation likely overstates the income tax deduction resulting from ESO exercises, as we showed previously.

Using the ESO tax benefit number reported by Enron in 2000 (\$390 million), we estimate the corresponding ESO tax deduction to be \$1,114 million (\$390 million/0.35). Using the CTJ methodology and the information from Note 11 (Table 2), we would have estimated the tax deduction to be \$1,470 million (32,235,000 shares times \$45.59). Using the formula approach in 2000 would have increased the company's estimated tax benefit from \$278 million to \$403 million, an increase of \$125 million. For 1996-1999, we are forced to use the formula approach because the company does not disclose the tax benefits from ESO exercises. We should note that not all of the stock options exercised were nonqualified options (the company does not get a tax deduction when employees exercise incentive stock options), which could account for some of the discrepancy. Required separate disclosure of the tax benefits in the Changes in Shareholders' Equity statement and the Statement of Cash Flows statement would allow analysts to more accurately determine the impact of ESO exercises on the company's tax status.

Factoring in the tax deduction for ESO exercises changes Enron's tax status significantly, as the company goes from being a "tax payer" to a "tax payee" in every year except 1999 (although a net operating loss carryback created by the ESO exercises in 2000 could have eliminated the company's federal income tax in that year as well).

D. Calculations of Enron's Effective Tax Rate

We use the calculations in Tables 3 and 5 to compute alternate measures of Enron's tax status as measured by its "effective tax rate." These alternative measures are summarized in Table 6. We compare the rates to the GAAP-reported number from the company's Income Taxes Note. The GAAP-reported ETR fluctuates wildly, from a low of negative 600 percent in 1997 to a high of 31.7 percent in 1996. Clearly, this company did not attempt to manage its book effective tax rate. The ETRs calculated using the General Accounting Office/Joint Committee on Taxation methodology, which focus on the federal income tax liability, are more stable (ranging from negative 22.3 percent in 1997 to 7.7 percent in 2000), perhaps leading one to conclude that the fluctua-

tions in the company's worldwide ETR were due to its international operations.

We present two additional ETR computations. The first is a revised GAAP computation taking into account the tax deduction related to ESO exercises. The numerator (provision for income taxes) reflects the tax benefit from ESO exercises, and the denominator (income before income taxes) takes into account the tax deduction from ESO exercises. The revised ETRs are reduced in every case except 1997 from the current GAAP-reported rates. These revised numbers reflect the change in reported ETRs that would occur if Congress enacted the McCain-Levin proposal to require companies to reduce net income by the ESO tax deduction.

The next ETR calculations reflect the company's tax status using the company's estimated federal income tax liability (after ESO deductions) as the numerator and U.S. net income after ESO deductions as the denominator (see Table 5). This rate perhaps reflects most accurately the company's tax status in relation to its book income. Care should be taken in interpreting the results, however. The positive ETRs in 2000 and 1997 reflect a division of two negative numbers (a tax benefit divided by a book loss). One could interpret these numbers as reflecting the fact that the company received a tax benefit from the federal government at a rate higher than the statutory rate. The negative ETRs result from either a positive federal income tax liability divided by a book loss or a negative federal income tax liability divided by book income. Cases where the estimated federal income tax is negative and U.S. profit before tax is positive likely would be red-flagged as situations where the company was "overindulging" in corporate "tax loopholes" (temporary and permanent differences and credits, but not ESO deductions). Figure 1 illustrates the differing estimates of Enron's effective tax rate. The variability in the ETR calculations we could make regarding Enron calls to mind Mark Twain's observation that there are "lies, damn lies, and statistics."

V. Observations About the Disclosure Debate

Trying to understand the words and phrases found in a company's Income Taxes Note calls to mind the conversation between Alice and Humpty Dumpty in Lewis Carroll's *Through the Looking Glass*.

"When I use a word," Humpty Dumpty said in a rather scornful tone, "it means just what I choose it to mean — neither more nor less." "The question is," said Alice, "whether you can make words mean so many things." "The question is," said Humpty Dumpty, "which is to be master — that's all."⁵⁰

We hope the above analysis is useful to policymakers (tax and accounting), analysts, and "ordinary citizens" in helping to understand the limits of

⁵⁰Lewis Carroll, *Through the Looking Glass and What Alice Found There* (Macmillan and Co., Ltd., 1899), chapter 6.

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using financial statement information to decipher a publicly traded company's tax status. If anything comes from this exercise, we hope the reader will appreciate that reliance on the company's taxes "currently payable" as a measure of the corporation's current year tax status can be very misleading, despite the theoretical underpinnings of the term as defined in FAS 109. Estimating the corporation's "true" tax status requires a rather sophisticated understanding of the arcane world of "accounting for income taxes," a realm many tax and accounting practitioners would rather not visit if at all possible. However, most tax shelter products today have vitality because of their positive impact on the corporation's tax liability (reduced) and its earnings per share (increased).

Requiring corporations to make their tax returns public seems rather extreme because of the potential for giving away investment and finance strategies to competitors. Historically, tax return privacy has been a sacred right with virtually no exceptions.⁵¹ However, the recent public disclosure of KPMG's client names in a tax shelter dispute with the IRS opens a crack in the privacy door previously thought to be sealed shut.⁵² Commentators are rightly concerned with this prece-

dent.⁵³ But disclosure is not an all-or-nothing proposition and probably should not require release of tax returns. More disclosure, perhaps in line with the recommendations by Citizens for Tax Justice,⁵⁴ would likely make a corporation's tax status more transparent and perhaps help analysts (including academic researchers) and policymakers understand how the current tax rules are applied domestically and internationally.

The difficulty in interpreting the effect of ESO exercises on effective tax rates is not likely to be solved with current proposals (and actions) to report the compensation expense related to ESO exercises in the income statement. The recent announcement by Coca-Cola Company, The Washington Post Company, Bank One, and General Motors that they would begin to include the expense related to stock option exercises will not make the tax effect of ESO exercises any more transparent than it already is (or isn't) because the book expense is estimated when the options are granted and the tax deduction is computed when the options are exercised, potentially resulting in vastly different amounts.

⁵¹See, e.g., "The IRS Out of Control," *The Wall Street Journal*, July 17, 2002, page A16.

⁵²See R.S. McIntyre and T.D.C. Nguyen, *Corporate Income Taxes in the 1990s* (Institute on Taxation and Economic Policy, 2000, at p. 13. This report is available on the Citizens for Tax Justice website (<http://www.ctj.org>).

⁵³Section 6103.

⁵⁴See, e.g., "Taxpayer Confidentiality: Civilian Casualty in War on Shelters?" *Tax Notes*, July 22, 2002, p. 470.

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**WRITTEN TESTIMONY OF THE STAFF OF THE
JOINT COMMITTEE ON TAXATION
ON THE REPORT OF INVESTIGATION OF
ENRON CORPORATION AND RELATED ENTITIES
REGARDING FEDERAL TAX AND COMPENSATION ISSUES,
AND POLICY RECOMMENDATIONS**

**Presented by
Lindy L. Paull
Chief of Staff of the
JOINT COMMITTEE ON TAXATION**

**At a Hearing of the
SENATE COMMITTEE ON FINANCE
On February 13, 2003**



February 13, 2003
JCX-10-03

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INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), is the written testimony of Lindy L. Paull, Chief of Staff, Joint Committee on Taxation, at the hearing of the Senate Committee on Finance on February 13, 2003 relating to the Joint Committee on Taxation staff investigation relating to Enron Corporation and related entities. The testimony describes and summarizes the Joint Committee on Taxation staff's official report of the investigation (the "Report").² This investigation began in February 2002 at the request (by letter dated February 15, 2002) of Senator Max Baucus and Senator Charles E. Grassley of the Senate Committee on Finance.

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¹ This document may be cited as follows: Joint Committee on Taxation, *Written Testimony of the Staff of the Joint Committee on Taxation on the Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCX-10-03), February, 13, 2003.

² Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

**WRITTEN TESTIMONY OF THE STAFF OF THE
JOINT COMMITTEE ON TAXATION
AT A HEARING OF
THE SENATE COMMITTEE ON FINANCE
ON FEBRUARY 13, 2003**

My name is Lindy L. Paull. As Chief of Staff of the Joint Committee on Taxation ("Joint Committee"), I am pleased to have the opportunity to appear before you today to transmit and summarize the Joint Committee staff's official Report of its investigation of Enron Corporation and related entities ("Enron").³

This Report, which was requested by Senator Max Baucus and Senator Charles E. Grassley, is the culmination of one year of extremely hard work of the Joint Committee staff. I would like to express my sincere appreciation for the herculean effort of our staff in conducting this investigation and writing the Report in a timely manner, while at the same time performing their normal legislative duties throughout the year. This was a massive project and I am grateful for the dedication of each member of the Joint Committee staff who worked on the investigation and the Report.

The Report consists of three volumes and is about 2,700 pages in length. Volume I (723 pages) contains the actual report of the investigation, which includes general observations, findings, and recommendations; a description of the methodology and scope of the investigation; a history of Enron; a detailed discussion of certain of Enron's tax-motivated business transactions; and a detailed discussion of Enron's pension plans and compensation arrangements.

Volumes II and III contain four Appendices to the Report, totaling 1,968 pages. The Appendices provide a variety of documents relating to the investigation, including detailed documentation relating to Enron's tax-motivated transactions, copies of the tax opinion letters provided with respect to Enron's tax-motivated transactions, and information relating to Enron's pension plans and other compensation arrangements.

³ Except as otherwise indicated, all references to "Enron" refer to Enron Corporation and its affiliates, and all references to "Enron Corp." refer specifically to the parent company.

I. GENERAL OVERVIEW OF THE INVESTIGATION

A. Scope and Methodology of the Investigation

This investigation was a rare opportunity to look inside of one of the ten largest corporations in the United States. Enron's size and broad range of businesses necessarily dictated that the topics to be reviewed would have to be selected carefully. As a result, the Joint Committee staff review focused on two principal areas: (1) Enron's use of tax shelter arrangements, off-shore entities, and special purpose entities, and (2) the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, in order to analyze the factors that may have contributed to the loss of benefits and the extent to which losses were experienced by different groups of employees.

Enron agreed to cooperate with the Joint Committee staff investigation.⁴ Enron complied with requests for information from the Joint Committee staff through the voluntary production of documents.

In conducting its investigation, the Joint Committee staff:

- Requested Enron's income tax returns since 1985;
- Reviewed more than 100 boxes of documents received from Enron in response to seven extensive document requests;
- Reviewed more than 40 boxes of documents from the Internal Revenue Service ("IRS") relating to Enron;
- Conducted 46 interviews of current and former Enron employees and other individuals with information relevant to the investigation;
- Made four trips to Houston, Texas, to review documents and conduct interviews;
- Reviewed publicly available information relating to Enron, including information made available by various Congressional committees, governmental agencies, the U.S. Bankruptcy Court for the Southern District of New York, and information contained in media reports; and
- Reviewed information provided by the Pension Benefit Guaranty Corporation, the Department of Labor, and the Senate Permanent Subcommittee on Investigations.

⁴ On March 6, 2002, a disclosure agreement was executed by representatives of Enron Corp., the Senate Finance Committee, and the Joint Committee staff. Under the terms of the disclosure agreement, Enron agreed to the disclosure of its tax returns and tax return information that would otherwise be confidential under the Federal tax laws. The Senate Finance Committee and Joint Committee staff agreed that any disclosure of information collected during the investigation would only be disclosed through official reports, meetings, or hearings of either Committee.

**B. Summary of Income Tax Information and
Tax-Motivated Structured Transactions**

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

As of December 31, 2001, Enron's worldwide operations included roughly 250 foreign entities that were associated with ongoing businesses. Enron had a total of approximately 1,300 different foreign entities, including foreign corporations and partnerships that were controlled by Enron, as well as other entities in which Enron owned a significant stake. Approximately 80 percent of Enron's foreign entities were inactive shells that did not hold and were not engaged in or associated with any ongoing business.⁵

1. Summary of selected tax information

Federal income tax

Enron and certain of its subsidiaries and affiliates filed a consolidated Federal income tax return for each year from 1985 through 2001. Based on Enron's income tax returns without regard to audit adjustments, Enron paid approximately \$325 million in Federal income taxes for 1990 through 1995, paid no Federal income taxes for 1996 through 1999, and paid approximately \$63 million in Federal income tax for 2000 and 2001.

Table 1, below, lists Enron's Federal tax liability for its taxable years 1996 through 2001, as shown on Enron's Federal income tax returns.

⁵ Enron created many entities in jurisdictions that do not impose a tax on such entities. In particular, as of December 31, 2001, the Enron ownership structure included 441 entities formed in the Cayman Islands, a country that has never imposed a corporate income tax. Most of these entities were inactive shells not associated with any ongoing business and were largely irrelevant for tax purposes.

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

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

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

The IRS uses a coordinated industry case program to coordinate the examination of large and highly diversified taxpayers. Enron has been in the coordinated industry case program since January 1989. The IRS has completed its examination of Enron's tax returns through 1995 and is currently examining Enron's 1996 through 2001 tax returns. The IRS adjustments to Enron's taxable years 1988 through 1994 increased Enron's taxable income by \$361 million, which, after taking into account net operating loss carryovers from earlier years, resulted in additional tax payments of \$4.3 million for 1988 through 1994.⁶ It is impossible to fully assess Enron's ultimate tax liability until the IRS examination of Enron's tax returns for 1996 through 2001 is completed and the bankruptcy court has reviewed the IRS proof of claim, which is expected to be filed by March 31, 2003.

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

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

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

⁶ Although the IRS examination of Enron's Federal income tax return for 1995 is complete, the impact of any IRS adjustments for 1995 will not be known until the examination of 1996 through 2001 is complete.

Table 2.—Enron Corp. and Subsidiaries: Reconciliation of Financial Statement Income to Taxable Income 1996-2000
 (Millions of dollars)

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

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

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

In the mid-1990's, Enron's management began to view the role of its tax department as more than managing its Federal income tax liabilities. Rather, Enron's tax department became a source for financial statement earnings, thereby making it a profit center for the company. With an emphasis on short-term profitability and cash flow, Enron used various techniques to generate current financial statement net income, including tax planning by engaging in 12 large structured transactions during the period from 1995 until it filed for bankruptcy. At their core, Enron's structured transactions were designed to permit Enron to take the position that its long-term tax benefits could be converted to current or short-term financial statement net income. In most of the structured transactions discussed in the Report, the origin of the financial accounting benefits was the reduction in Federal income tax that the transaction was anticipated to provide either currently or in the future.

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

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

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

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

Project Name	Financial Accounting Income through 2001 ¹	Total Projected Financial Accounting Income ²	Federal Tax Savings through 2001 ³	Total Projected Federal Tax Savings ⁴	Promoter	Primary Tax Opinion Provider	Total Project Fees ⁵
Tanya (1995)	66	66	66	66	Arthur Andersen	Arthur Andersen	0.5
Valor (1996)	---	82	82	82	Arthur Andersen	Arthur Andersen	0.1
Steele (1997)	65	83	39	78	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	11
Teresa (1997)	226	257	(76)	263	Bankers Trust	King & Spalding	12
Cochise (1998)	101	143	---	141	Bankers Trust	McKee Nelson, Ernst & Young	16
Apache (1998)	51	167	51	167	Chase Manhattan	Shearman & Sterling	15
Tomas (1998)	37	113	95	109	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	14
Renegade (1998) ³	1	1	---	---	Bankers Trust	---	---
Condor (1999)	88	328	---	332	Deloitte & Touche	Vinson & Elkins	10
Valhalla (2000) ⁵	16	64	---	---	Deutsche Bank	Vinson & Elkins	---
Tammy I (2000)	---	406	---	414	Deloitte & Touche	Vinson & Elkins	9
Tammy II (2001)	---	369	---	370	---	---	---
Totals	651	2,079	257	2,022	N/A	N/A	87.6

Notes:

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

II. GENERAL OBSERVATIONS

Enron entered the 1990s as a rapidly growing company with an ambition to grow faster and larger and to change the nature of its business from an “old” economy energy company to a “new” economy firm with diverse interests and global reach. Enron’s desire to grow pushed Enron’s leaders to find ways to increase reported earnings and thereby drive up Enron’s stock price, which would fuel further growth. Ultimately, the reported picture of the company failed to comport with the underlying economic reality and Enron notoriously collapsed.

The Report’s detailed analysis of Enron’s structured transactions reveals a pattern of behavior showing that Enron deliberately and aggressively engaged in transactions that had little or no business purpose in order to obtain favorable tax and accounting treatment. For Enron’s leaders, financial statement income became paramount, and Enron announced to the world its target of \$1 billion in net income for year 2000.⁷ As Enron’s management realized that tax-motivated transactions could generate financial accounting benefits, Enron looked to its tax department to devise transactions that increased financial accounting income. In effect, the tax department was converted into an Enron business unit, complete with annual revenue targets. The tax department, in consultation with outside experts, then designed transactions to meet or approximate the technical requirements of tax provisions with the primary purpose of manufacturing financial statement income. The slogan “Show Me the Money!” exemplified this effort.⁸ However, a bona fide business purpose, that is, a purpose other than to secure favorable tax and accounting treatment, was either lacking or tenuous in many of the transactions and clearly was not the impetus for the transactions.⁹

Viewed in their entirety, Enron’s structured transactions not only pushed the concept of business purpose to the limit (and perhaps beyond) but also highlight several general issues about the nature of the tax system and a corporation’s attitude towards it. Enron’s behavior illustrates

⁷ According to Kenneth L. Lay: “Enron achieved its earnings and operational goals in 1996, the first year of our ENRON 2000 initiative to reach net income in excess of \$1 billion and achieve a minimum double digit growth in annual earnings per share.” Press Release, Enron Corp., Enron Reports 12 Percent Increase in 1996 Earnings Per Share, to \$2.31 Per Share (January 21, 1997), at <http://www.enron.com/corp/presroom/releases/1997/12per.html> (last visited February 11, 2003). Enron’s reported net income in 2000 (before restatements) was \$979 million.

⁸ This is documented by Enron presentation materials titled “Show Me the Money! Project Steele Earning Benefits.” The expected pre-tax operating earnings from this transaction was approximately \$133 million. The Project Steele materials in Appendix B contain the document.

⁹ Nearly all of the reviewed transactions are vulnerable to attack under judicial or administrative anti-abuse and anti-avoidance doctrines. Many of the reviewed transactions shared common characteristics, such as claiming the same tax loss twice in order to generate a financial statement benefit, and the shifting of tax basis from a nondepreciable asset to a depreciable asset.

that a motivated corporation can manipulate highly technical provisions of the law to achieve significant unintended benefits. Remarkable in many respects was Enron's ability to parse the law to produce a result that was contrary to its spirit and not intended by Congress or the Treasury Department.

In transaction after transaction, Enron obtained sophisticated advice and in most instances received assurances that the proposed transaction "should" comply with technical tax law requirements. Often, these assurances were based on highly technical interpretations of the law even though the transaction produced surprising and questionable results. Many of the opinions hinged on a determination that the transaction had sufficient business purpose. Enron represented the business purpose of the transaction, and Enron's counsel did not bother to look beyond the representation. Troubling is the lack of responsibility or independent assessment that some advisors showed in evaluating Enron's stated business purpose.¹⁰ In one case, the advisors were involved in the promotion of the transaction and the creation of its ostensible "business purpose." It would not be surprising if this collusion also existed in other transactions.

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

A critical component of many of Enron's structured transactions was the involvement of an accommodation party such as an Enron employee or the party promoting the transaction. Such parties were not related to Enron from an ownership standpoint, but their interests were aligned with Enron and they shared the same objectives as Enron for purposes of the transactions. The tax law generally assumes that unrelated parties to a transaction are independent and therefore will negotiate the terms of a deal consistent with their best (and selfish) interests. Typically, the tax law views parties as related by reference to entity ownership or family relationship. However, if nominally unrelated parties have the same interests and

¹⁰ The following statement by the managing partner of Enron's primary legal counsel, Vinson & Elkins, suggests that this minimal level of review perhaps was not unintentional.

With regard to the related party transactions, it is important to consider the role of legal counsel. If a transaction is not illegal and it has been approved by the appropriate levels of a corporation's management, lawyers, whether corporate counsel or with an outside firm, may appropriately provide the requisite legal advice and opinions about legal issues relevant to the transactions. In doing so, lawyers are not approving the business judgment of their clients. Likewise, lawyers are not responsible for the accounting treatment of the transactions.

Statement of Joseph C. Dilg, managing partner at Vinson & Elkins, in testimony before the House Committee on Energy and Commerce (March 14, 2002), available at <http://energycommerce.house.gov/107/hearings/03142002Hearing511/hearing.htm>.

objectives, the paradigm breaks down. Enron's activities show that, in general, when transactions can be structured by parties that have the shared goal of obtaining favorable tax treatment, the tax rules do not function as intended and may produce undesirable results.

In addition, rules that ordinarily produce sensible results generated a tax benefit for Enron because of the way Enron utilized its own stock in many transactions. Just as the tax law generally assumes that the interests of unrelated parties to a transaction will be adverse, the tax law also generally assumes that a corporation uses its stock as a source of capital. Enron, however, repeatedly used its stock in a way that yielded a financial statement benefit from a permanent tax savings.

Paradoxically, the legislative and regulatory systems permitted Enron to enter into transactions that policymakers either had prohibited by law or questioned by regulation. Congress abolished the tax advantages of certain types of transactions, but nevertheless permitted corporations such as Enron to take advantage of transitional rules to engage in the transactions despite the imminent change to the law. Enron also was free to ignore proposed Treasury Regulations (some of which were longstanding) that, if finalized by the Treasury, would have stripped Enron of some of its tax positions.

Enron also excelled at making complexity an ally. Many transactions used exceedingly complicated structures and were designed to provide tax benefits significantly into the future. For any person attempting to review the transaction, there would be no easy way to understand its terms or purpose. Rather, a reviewer would be required to parse details from a series of deal documents, make assumptions about the parties' intent in future years, and only then apply technical rules to the transaction to test for legitimacy. In short, Enron had the incentive and the ability to engage in unusually complicated transactions in order to preclude meaningful review.

Corporations like Enron have an inherent advantage over the IRS. Enron structured its deals with the advice of sophisticated and experienced lawyers, investment bankers, and accountants. Assertions of attorney-client privilege hinders the ability of the IRS to obtain many of the most instructive documents, which impedes the IRS's ability to audit the transaction. Some of the transactions resulted in the payment of some income tax in the early years, with significantly larger deductions to follow in later years. This pattern makes it less likely that the IRS will identify and challenge the transaction. Further, Enron's recent position as a company with significant net operating losses worked to its advantage in IRS examination. A company with significant losses generally is of less immediate concern to the IRS because the losses will offset any increased taxable income arising from the audit. Thus, the IRS has less incentive to investigate and devote resources to such examinations. Enron's activities show that the IRS cannot minimize the importance of loss companies on examination because to do so would ignore a breeding ground for tax-motivated transactions that also could be used by taxpaying companies.

Enron's aggressive interpretation of business purpose, the cooperation of accommodation parties, the protections provided by tax opinions, the complex design of transactions -- all were factors that encouraged Enron to engage in tax-motivated transactions. Thus, Enron places the spotlight once again on the general ineffectiveness of present law in regulating tax shelters. Tax shelters are in many ways a product of the ambiguity of complex provisions of law, lack of

administrative guidance, or inconsistent interpretations of the law by courts. Tax shelters often involve the juxtaposition of unrelated, incongruous Code provisions in a single transaction or a series of connected transactions. Taxpayers use the complexities of the system to their advantage and perform a clinical assessment of the risks and benefits of an action, often concluding that the low risk of effective enforcement (including the low risk of penalties) easily is outweighed by the promised benefits.¹¹ Until the costs of participating in tax-motivated transactions are substantially increased, corporations such as Enron will continue to engage in transactions that violate the letter or the spirit of the law.

¹¹ For detailed information of the present law rules and judicial doctrines applicable to tax-motivated transactions and related recommendations and developments, *see e.g.*, Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint 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).

III. GENERAL FINDINGS AND RECOMMENDATIONS RELATING TO BUSINESS TAX MATTERS

A. General Findings Relating to Business Tax Matters

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

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

The Joint Committee staff believes that stronger measures are necessary to discourage transactions that lack a non-tax business purpose or economic substance. Such measures, however designed, must significantly increase the economic risk to taxpayers of entering into tax-motivated transactions. Under the present system, the expected tax benefits from these transactions typically far outweigh the associated costs. Taxpayers will continue to engage in tax-motivated transactions unless and until there is a meaningful change in this cost-benefit analysis. At a minimum, taxpayers that engage in tax-motivated transactions should be subject to substantial penalties.

2. Business purpose

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

3. Accommodation parties

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

4. Tax advisors

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

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

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

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

6. Disclosure of tax-motivated transactions

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

7. Continued use of certain structured transactions

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

B. Recommendations Relating to Corporate Tax Issues

1. Curtail duplication of losses

General rule preventing duplication of losses¹²

A single economic loss should not be deducted more than once. The Joint Committee staff recommends limiting a corporation's basis in property acquired in a tax-free transfer (or reorganization) to its fair market value. Alternatively, the Joint Committee staff recommends expanding the sec. 358(h) basis reduction rule.

Specific rule preventing duplication of losses relating to real estate mortgage investment conduit residual interests¹³

Under the statutory rules regarding the taxation of a real estate mortgage investment conduit ("REMIC"), generally phantom income is allocated to REMIC residual interest holders. The phantom income allocation inevitably creates built-in losses to the holders of the REMIC residual interests, thus making such interests a natural component for transactions designed to duplicate a single economic loss. As such, the Joint Committee staff recommends that either a corporation's basis in REMIC residual interests acquired in a tax-free transfer (or reorganization) be limited to its fair market value or that a transferor's basis in the stock received in exchange for REMIC residual interests be limited to the fair market value of the REMIC residual interests.

2. Strengthen rules preventing acquisitions made to evade or avoid Federal income tax¹⁴

Section 269 disallows certain tax benefits if a taxpayer acquires direct or indirect control of a corporation for the principal purpose of Federal income tax evasion or avoidance. The Joint Committee staff recommends expanding section 269 to apply to acquisitions of equity interests in a corporation, without regard to whether such interests provide to the acquirer control of the corporation, if the principal purpose of the acquisition is the evasion or avoidance of Federal income tax.

The Joint Committee staff also recommends expanding section 269 to disallow tax benefits that can be obtained through either controlling or non-controlling interests in a corporation, if the principal purpose of the transaction in which the benefits are acquired is the evasion or avoidance of Federal income tax.

¹² Further discussion of this recommendation is provided in the descriptions of the transactions known as Project Tanya and Project Valor in Part Three of the Report.

¹³ Further discussion of this recommendation is provided in the descriptions of the transactions known as Project Steele and Project Cochise in Part Three of the Report.

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

3. Strengthen the extraordinary dividend rules¹⁵

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

4. Provide guidance on the replication of earnings and profits in a consolidated group¹⁶

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

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

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

C. Recommendations Relating to Partnership Tax Issues

1. Strengthen disclosure of disguised sales¹⁷

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

2. Strengthen partnership allocation rules¹⁸

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

3. Provide guidance regarding transfers of partial partnership interests¹⁹

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

4. Provide rules for the appropriate interaction between partnership rules and corporate stock nonrecognition rules²⁰

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

¹⁷ Further discussion of this recommendation is provided in the description of the transaction known as Project Tomas in Part Three of the Report.

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

¹⁹ Further discussion of this recommendation is provided in the description of the transaction known as Projects Tammy I and Tammy II in Part Three of the Report.

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

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

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

D. Recommendations Relating to International Tax Issues

1. Modify the rules for allocating subpart F income²¹

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

2. Modify the interaction between the subpart F rules and the passive foreign investment company rules²²

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

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

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

²² Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of the Report.

3. Strengthen the earnings stripping rules²³

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

4. Require annual information reporting with respect to disregarded entities²⁴

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

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

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

²⁴ Further discussion of this recommendation is provided in the description of Enron's use of foreign entities in Part Three of the Report.

E. Recommendation Relating to Financial Asset Securitization Investment Trusts²⁵**1. Repeal financial asset securitization investment trust rules**

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

²⁵ Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of the Report.

**F. Recommendation Relating to Corporate-Owned
and Trust-Owned Life Insurance²⁶**

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

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

²⁶ Further discussion of this recommendation is provided in the description of Enron's corporate-owned and trust-owned life insurance contracts in Part Three of the Report.

G. Recommendations Relating to Structured Financing Transactions²⁷

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

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

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

2. Modify the rules relating to disqualified indebtedness

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

²⁷ Further discussion of these recommendations is provided in the description of Enron's structured financing transactions in Part Three of the Report.

IV. PENSION AND COMPENSATION ARRANGEMENTS

A. Overview of Pension and Compensation Arrangements

1. Overview

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

2. Enron's qualified retirement plans

Overview of Enron qualified plans

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

The Enron ESOP was invested primarily in Enron stock.

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

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

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

The Enron Savings Plan is a 401(k) plan. Participants could make elective deferrals and after-tax contributions to the Enron Savings Plan, and had a range of investment choices available for their contributions, including Enron stock. In addition, Enron made matching

contributions based on employee elective deferrals. The matching contributions were invested in Enron stock pursuant to the plan terms; participants could elect to invest the matching contributions in another investment after attaining age 50.

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

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

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

Issues reviewed with respect to Enron qualified plans

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

3. Other compensation arrangements

In general

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

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

Executives of Enron were extremely highly compensated. Table 4, below, shows information compiled by the IRS, which is based on information provided by Enron, on compensation of the top-200 highly compensated employees for 1998 through 2000. Compensation for the top-200 increased over recent years, particularly in the area of stock options.

Table 4.—Compensation Paid to the Top-Paid 200 Employees for 1998-2000²⁸

Year	Bonus	Stock Options	Restricted Stock	Wages	Total
1998	\$41,193,000	\$61,978,000	\$23,966,000	\$66,143,000	\$193,281,000
1999	\$51,195,000	\$244,579,000	\$21,943,000	\$84,145,000	\$401,863,000
2000	\$56,606,000	\$1,063,537,000	\$131,701,000	\$172,597,000	\$1,424,442,000

Overview of Enron's executive compensation arrangements

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

Nonqualified deferred compensation plans

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

Nonqualified deferred compensation was a major component of executive compensation for Enron. 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. Amounts deferred in these years are shown in the following table.

²⁸ The information provided by the IRS includes some inconsistencies. In reproducing the summary data, the Joint Committee staff attempted to reconcile inconsistencies and included the data that appears to be accurate. Amounts are approximates.

Table 5.—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 ²⁹
2001	54.4

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

Stock-based compensation

Enron used stock-based compensation as a principal form of compensation for executives. Enron's stock-based compensation programs included nonqualified stock options, restricted stock, and phantom stock. The amount of income attributable to stock options and restricted stock is shown in Table 4, above. Enron's deduction for compensation attributable to the exercise of nonqualified stock options increased by more than 1,000 percent from 1998 to 2000. Enron's directors were also compensated partially in Enron stock.

Pre-bankruptcy bonuses

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

Special compensation arrangements

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

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

²⁹ According to the documents provided by Enron, in 2000, Mr. Lay deferred \$32 million under the 1994 Deferral Plan in 2000.

allowed to exchange interests in plans for large cash payments or stock options and restricted stock grants.

Employee loans

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

Purchase and reconveyance of Mr. Lay's annuity contracts

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

Split-dollar life insurance arrangements

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

B. General Observations With Respect to Pensions and Compensation

Enron's stated philosophy was a pay for performance approach to compensation; those who performed well were paid well. Enron implemented this approach with a broad array of compensation arrangements for its executives that included base pay, bonuses, and long-term incentive payments. In 2000, total compensation for the 200 highest paid employees of Enron was \$1.4 billion dollars (\$1.2 billion of which was attributable to stock options and restricted stock). In the same year, Enron reported \$975 million of financial statement net earnings.

Enron's approval of compensation packages for its executives rested almost entirely with internal management. Although the Compensation Committee of the Board of Directors formally approved both the total amount of compensation paid to executives and the form of such compensation, the Compensation Committee's approval generally was a rubber stamp of recommendations made by Enron's management. Missing was an objective assessment of the value added by top executives; compensation was typically deemed to be justified if it appeared to be consistent with what other companies paid executives. Targets for compensation were sometimes set, but in practice the total amount paid frequently exceeded the targets. The Compensation Committee went through the motions of satisfying its role as objective evaluator of reasonable pay by commissioning "independent" studies with respect to Enron's compensation arrangements; in some cases, the studies appeared to be designed to justify whatever compensation arrangement management wanted to adopt.

The lack of scrutiny of compensation was particularly prevalent with respect to Enron's top executives, who essentially wrote their own compensation packages. In some cases, although going through the formalities of reviewing arrangements, the Compensation Committee merely rubber stamped what was presented. In other cases, the Compensation Committee either never reviewed certain arrangements for executives, or performed such a cursory review that they were not fully aware of what they were approving. For example, a former chairman of the Compensation Committee could not remember an arrangement under which an Enron executive was awarded a fractional interest in an airplane as a form of compensation.

There was no indication that Enron's Compensation Committee ever rejected a special executive compensation arrangement brought to them. Indeed, the Compensation Committee used studies, sometimes commissioned after the fact, to justify the compensation arrangements for top executives. As a result, Enron's top executives earned enormous amounts of money and even used the company as an unsecured lender. For example, from 1997 through 2001, Mr. Lay borrowed over \$106 million from Enron through a special unsecured line of credit with the company.

Enron did not appear to maintain consistent or centralized recordkeeping with respect to compensation arrangements in general and executive compensation in particular. Enron could not provide documentation relating to many of Enron's special compensation arrangements for its top executives. When asked about compensation arrangements in interviews, current and former Enron employees with responsibility for such matters had no knowledge of certain aspects of executives' compensation, particularly in the case of special arrangements. Although Enron represented that it properly reported income with respect to employee compensation arrangements, the lack of recordkeeping made it impossible to verify whether this was true.

Enron's heavy reliance on stock-based compensation, both with respect to executives and with respect to rank and file employees, caused significant financial loss when Enron's stock price collapsed. As part of a philosophy that a large portion of executive compensation should depend on shareholder return, Enron rewarded executives with huge amounts of stock options, restricted stock, and bonuses tied to financial earnings. In addition, a strong company culture encouraging stock ownership by all employees led to high investments in Enron stock by employees through the Enron Corp. Savings Plan (the "401(k)" plan). In the end, when Enron's stock price plummeted, Enron's employees and executives lost millions of dollars in retirement benefits under Enron's qualified plans and nonqualified deferred compensation arrangements and through the loss of value of stock that had been received as compensation for services. Although some executives suffered losses that appear stunning in amount, many executives also reaped substantial gains from their compensation arrangements. Enron's rank and file employees in many cases lost virtually all of their retirement savings because they believed statements made by Enron's top executives up to the very end that Enron was viable and that Enron's stock price would turn around.

C. Findings and Recommendations Relating to Pension and Compensation Arrangements

1. Cash balance plans

In converting the Enron Retirement Plan into a cash balance plan, Enron did not adopt many of the plan features that gained media attention in the 1990s when several large plans were converted to cash balance plans. Enron did not adopt a “wearaway” and took steps to protect the expectation interests of plan participants close to retirement under the old plan formula. The review of the plan has been pending in the IRS National Office for almost three years pursuant to a 1999 IRS moratorium on the issuance of determination letters for cash balance conversions pending clarification of applicable legal requirements. The Treasury Department has recently issued proposed regulations which, when finalized, would address many, but not all issues relating to cash balance plans.

The Joint Committee staff believes that the lack of clear guidance with respect to cash balance plan conversions and cash balance plans in general creates uncertainty for employers and employees. Thus, the Joint Committee staff recommends that clear rules with respect to such plans should be adopted in the near future.

2. Blackout periods under qualified plans

Enron implemented a change of recordkeepers under the Enron Savings Plan in October and November of 2001. As part of this change, plan participants experienced a “blackout” period of approximately two and one-half weeks during which investment changes could not be made. During this time, the price of Enron stock fell from \$15.40 to \$9.98.

Changes in plan recordkeepers or other third-party service providers is a normal part of qualified retirement plan operations. The Joint Committee staff review of the change in recordkeepers with respect to the Enron Savings Plan indicates that Enron had legitimate reasons for changing recordkeepers, and undertook an extensive search in order to find a new recordkeeper that would meet its needs.

The main issue raised with respect to the change in recordkeepers under the Enron Savings Plan is whether plan fiduciaries, including the Enron Savings Plan Administrative Committee, acted in accordance with their fiduciary obligations in implementing the blackout period or whether they should have stopped the blackout from occurring given the falling price of Enron stock and its financial circumstances. Members of the Administrative Committee interviewed by the Joint Committee staff indicated that they viewed their responsibilities as relatively narrow, and did not focus on the possible effects of the proposed blackout on plan participants until after the blackout had begun. Whether there was a breach of fiduciary responsibilities in this case will be resolved through litigation.

The blackout also raises questions regarding whether plan participants received notice of the blackout sufficient to allow them to make appropriate decisions in anticipation of the blackout. The information reviewed by the Joint Committee staff indicates that Enron provided a variety of advance notices to plan participants explaining the proposed blackout. The Joint Committee staff did not undertake to review whether all participants in fact received notice of

the blackout; however, the Joint Committee staff determined that not all participants received the same notices. In particular, certain active employees received additional reminders of the blackout that were not sent to other participants.

The Sarbanes-Oxley Act of 2002, enacted after the Enron bankruptcy, includes a notice requirement with respect to blackout periods under qualified plans. Thus, the Joint Committee staff does not recommend further legislative changes in this area at this time.

3. Investments under 401(k) plans

Many Enron Savings Plan participants lost considerable amounts of retirement savings due to a high level of investment in Enron stock. Plan design features which required Enron's matching contributions to be invested in Enron stock contributed to the significant investment in Enron stock. Other factors may also have played a role, including a lack of understanding of the importance of diversification and the actions (or inactions) of plan fiduciaries. The Joint Committee staff believes that an overwhelming factor was a corporate culture that actively promoted investment in Enron stock.

The Joint Committee staff believes that the importance of diversification of retirement savings cannot be overemphasized. The Joint Committee staff recommends that a variety of changes should be made to reduce the likelihood that participants in plans that allow participant directed investments will have high concentrations of assets in a single investment.

The Joint Committee staff recommends that plans should provide participants with investment education in a manner consistent with fiduciary standards. This should include periodic notices describing sound investment practices and individualized notices to plan participants whose plan investments are over concentrated in a single asset.

The Joint Committee staff recommends that plans should not be permitted to require that employee elective deferrals or after-tax contributions be invested in employer securities. In addition, plan participants should be given greater opportunity to diversify the investment of employer matching and certain other employer contributions made in the form of employer securities.

The Joint Committee staff recommends certain changes with respect to ERISA fiduciary rules. The experience at Enron points out the difficulties that may arise when individuals play more than one role, particularly roles as a fiduciary and as an executive of the employer. These two roles may conflict and cause confusion among plan participants. The experience at Enron demonstrates that plan fiduciaries may have difficulty determining what actions are consistent with their dual roles. The Joint Committee staff believes that fiduciary rules should apply to the statements of senior executives, whether or not they are otherwise plan fiduciaries, regarding qualified plans or plan investments. The Department of Labor should also take steps to educate plan fiduciaries regarding their fiduciary duties.

Because of the strong corporate culture that encouraged Enron stock ownership by Enron employees, it is not clear that the outcome would have been any different if these measures had been in place prior to the bankruptcy. Further, Enron is not alone in its high concentration of investment in employer stock. A recent study of 219 large 401(k) plans found 25 plans that had

over 60 percent of their assets invested in employer securities.³⁰ Given these factors, the Joint Committee staff is concerned that, absent legal restrictions on the amount of employer securities that can be held in defined contribution plans, situations such as Enron's may occur again. Such restrictions would involve a major policy change from present law.

4. Nonqualified deferred compensation

Through Enron's nonqualified deferred compensation programs, executives were able to defer more than \$150 million in compensation from 1998 through 2001. The key motivating factor in deferring compensation was the desire of Enron's employees to avoid current income inclusion with respect to their compensation. In the weeks preceding the bankruptcy, apparently in accordance with the terms of the deferred compensation arrangement, Enron paid executives \$53 million in accelerated distributions of nonqualified deferred compensation. In addition to the accelerated distributions, participants were able to direct investment of their accounts and to make subsequent elections to change the timing of distributions.

The nonqualified deferred compensation arrangements of Enron illustrate the common practice of allowing executives to defer tax on income, but also to maintain security and control over the amounts. Given the significant amounts of compensation deferred by Enron executives, it appears that the risks and restrictions associated with deferring compensation were not viewed as impediments to deferral.

Enron's deferred compensation plans allowed executives to receive benefits similar to those of qualified plans. To the extent that it is possible for executives to defer taxes and have security and flexibility through nonqualified arrangements, this undermines the qualified retirement plan system. If executives can obtain the result they desire through the use of nonqualified plans and arrangements, there will be less incentive for companies to maintain qualified plans, which will result in rank and file employees losing pension coverage.

Enron allowed its executives to defer significant amounts of compensation even though Enron had to forego a current deduction with respect to such amounts. The fact that Enron was apparently indifferent to the deferral of its deduction provides further support for the need for changes to the tax treatment of nonqualified deferred compensation. Changes to the present-law rules regarding the taxation of deferred compensation would reduce the amount of income deferred.

Rules should be developed to require current income inclusion in the case of plan features that give taxpayers effective control over amounts deferred. The Joint Committee staff believes that the existence of plan provisions that allow accelerated distributions, participant-directed investment, or subsequent elections should result in current income inclusion. In addition, the Joint Committee staff believes that consideration should be given to whether rabbi trusts are appropriate for deferred compensation and whether the rules relating to such arrangements

³⁰ See *Enron Debacle Will Force Clean Up of Company Stock Use in DC Plans*, DC Plan Investing (Institute of Management & Administration), at 1-2 (Dec. 11, 2001).

should be tightened. The use of programs such as Enron's deferral of stock options gains and restricted stock programs should not be allowed.

In addition, the Joint Committee staff believes that section 132 of the Revenue Act of 1978 should be repealed. This would allow the Treasury Department to issue much needed guidance in the nonqualified deferred compensation area. The lack of guidance over the last 25 years has given taxpayers latitude to use creative nonqualified deferred compensation arrangements that push the limit of what is allowed under the law.

The Joint Committee staff also believes that reporting of deferred amounts should be required to provide the IRS greater information regarding such arrangements.

5. Stock-based compensation

Enron utilized considerable amounts of stock-based compensation, including stock options, restricted stock, and phantom stock arrangements. The use of stock-based compensation was not limited to executives. Enron had all-employee stock option arrangements and, as described above, also facilitated the ownership of Enron stock through Enron's qualified plans. The use of stock-based compensation was part of Enron's overall compensation philosophy, and also reflected the views of the Compensation Committee that a significant amount of executive compensation should be dependent on shareholder return.

The amount of compensation generated from stock-based compensation arrangements was significant, and increased dramatically over the period 1998 through 2000. Over this period, Enron's deduction attributable to stock options increased by more than 1,000 percent; from \$125 million in 1998 to over \$1.5 billion in 2000. Income attributable to restricted stock for the top-200 most highly compensated employees rose from \$24 million in 1998 to \$132 million in 2000.

Although the intent of many of Enron's stock-based compensation programs was to align the interests of shareholders and executives, the Enron experience raises a potential conflict between short-term earnings from which executives can reap immediate rewards and longer-term interests of shareholders.

In addition, the use of stock options highlights the differences between the treatment of stock options for Federal income tax purposes and accounting purposes. The accounting rules and the income tax rules have different purposes, and therefore the two sets of rules may be necessary in order to accomplish their intended purposes.

In implementing its stock-based compensation programs, Enron appeared generally to follow IRS published guidance. Thus, no recommendations are made with respect to such programs.

6. Employee loans

While Enron did not have a formal policy regarding employee loans, it nevertheless made a variety of loans to certain executives, including top management. The loans raise Federal tax issues as well as corporate governance issues.

In some cases, loan agreements provided that the loan would be forgiven if the executive stayed with Enron for a certain period of time. For example, such an arrangement was provided for Mr. Skilling.³¹ While these arrangements were treated by Enron and the executives involved as loans, it is difficult to distinguish such arrangements factually from the pre-bankruptcy bonuses paid by Enron, which had to be repaid if the employee did not remain with Enron for a certain period of time and which were treated by Enron as taxable compensation. Loans of this type raise the question of whether the arrangement at the outset should have been treated as taxable compensation.

Other loans did not have a provision regarding forgiveness, but were forgiven by Enron. In such cases, the amount forgiven was treated as compensation to the executives.

The loan transactions raise corporate governance issues of whether corporate funds are in essence being used for personal purposes. A line of credit for Mr. Lay provides an example of the issues raised. Pursuant to his \$7.5 million line of credit, in a series of 25 transactions in 2001 alone, Mr. Lay withdrew a total of over \$77 million (all but \$7.5 million of which was repaid). The total amount withdrawn under the line of credit was over \$106 million; over \$94 million of this amount was repaid with Enron stock. Mr. Lay's attorneys have stated that the loan transactions related to Mr. Lay's personal investment.

The Sarbanes-Oxley Act of 2002 contains a prohibition on executive loans. Thus, the Joint Committee staff is not making any recommendation regarding loans at this time.

7. Split-dollar life insurance contracts

Enron had split-dollar life insurance contracts for three top executives, ranging from \$5 million to \$30 million of coverage. The Treasury Department has issued notices and proposed regulations offering more detailed guidance than was previously available with respect to split dollar life insurance. This guidance generally requires the inclusion in income of the value of the economic benefit received by the employee under the arrangement. This guidance provides clear rules and should be finalized expeditiously.

8. Limitation on deduction of compensation in excess of \$1 million

The \$1 million deduction limitation on the compensation of top executives did not appear to have a major effect on the overall structure of Enron's compensation arrangements or the total amount of compensation paid to Enron employees. For 1998 through 2000, total compensation for Enron's top executives was \$433.6 million. Although most of this compensation was treated by Enron as qualifying for the exception for performance-based compensation (86 percent), Enron paid a significant amount of nondeductible compensation during this period (\$48.5 million which was 11 percent of total compensation).³² Given Enron's net operating loss carryovers, the

³¹ Mr. Skilling did not remain with Enron for the period specified in his loan agreement, and he repaid the loan. According to Enron, some interest on the loan is still outstanding.

³² As explained in the Report, the compensation numbers presented here are approximate, due to inconsistencies in information obtained from Enron. These numbers are from information provided by Enron to the IRS.

nondeductibility of this compensation may not have had a significant impact on Enron's overall tax liability.

The \$1 million deduction limitation was designed to address corporate governance concerns that top executives were receiving excessive compensation. The experience with Enron indicates that the limitation is not effective in achieving its purposes. Taxpayers may choose to pay nondeductible compensation, and accept the potential adverse tax consequences. In the case of Enron, there may in fact be little adverse tax impact.

The Joint Committee staff recommends that the limitation be repealed, and that any concerns regarding the amount and types of compensation be addressed through laws other than the Federal income tax laws.

PREPARED STATEMENT OF GEORGE A. PLESKO

Chairman Grassley, Ranking Member Baucus, members of the Committee, thank you for inviting me to testify at today's hearing marking the release of the Joint Committee on Taxation's Investigative Report on Enron.

There has been substantial anticipation of this report in the academic tax community, as I am sure there has been in other areas. Those of us who study the effects of the tax code are usually only able to examine behavioral patterns across broad groups of firms facing different tax incentives. The ability to better understand the mechanics of specific transactions firms have used provides important insight into the operation of the tax system, and the incentives and motivations of individual firms and their managers.

My charge this morning is to provide a context for the JCT report. To do this I will address three issues that are not specific to Enron, but which are generally related to the financial and tax reporting environment firms face. First, I will discuss the differences in the accounting systems for financial and tax purposes, and the growth in these differences over time. For publicly traded firms there are two sets of accounting numbers: those reported to investors, through quarterly and annual financial reports, and those reported annually to the Internal Revenue Service for tax purposes. While there is strong historical and economic justification for them being different, the relation between the two appears to have changed dramatically during the late 1990s. The causes of this divergence are not fully understood, but one possible factor is the increased ability to structure financial and tax transactions in ways that affect only one set of reporting numbers.

Second, I will address the issue of whether improvements can be made in disclosure of tax information by publicly-traded firms. While both the financial and tax reporting systems have rules to provide a reconciliation to the other, neither set of disclosures appear to be currently adequate. The tax footnote and other tax disclosures in a firm's 10-K do not provide sufficient detail to identify many of the tax characteristics of interest to users. Similarly, the Schedule M-1 of the Form 1120 is not sufficiently detailed to provide the IRS and other government users with all of the information they could benefit from having.

Finally, I will briefly touch on the administration's proposals for dividend relief, and the effects such a change could have on firms' incentives to engage in tax minimizing transactions.

Book-Tax Reporting Differences

Treasury, in its 1999 report on tax shelters and related testimony, suggested the disparity in both the levels and growth rates of book and taxable income is partial evidence of the growth in shelters. To examine this issue, one must start with an understanding of the principles of each reporting system.

Financial Accounting Standard Board's (FASB) Statement of Financial Accounting Concepts No. 1 (CON1), "Objectives of Financial Reporting by Business Enterprises," issued in 1978, outlines the objectives of financial reporting. The essential element is that financial accounting provide information useful to investors and creditors in making investment and other decisions about firms. Concept No. 2 (CON2), "Qualitative Characteristics of Accounting Information," issued in 1980, describes the characteristics of accounting information that make it useful. Of the five qualities outlined, two, relevance and reliability, are considered the primary qualities. By relevant, the information provided should be helpful to external users in

making their decisions. Reliability, in the context of CON2, merely implies the data presented “represents what it purports to represent.” CON2 also recognizes that collection and dissemination of information is not costless, and the perceived benefits of a disclosure must exceed the perceived costs associated with it.

Other characteristics of quality financial accounting information are comparability and consistency. Comparability and consistency require financial accounting information to be similar across firms, and that each firm use accounting methods consistently over time. These criteria do not require the financial accounting rules to be implemented uniformly in each company. This is in contrast to the approach taken in much of the tax law, where uniformity in the accounting for economic events is required.

The discretion left by accounting standards for firms to differ in their application of the accounting rules is viewed as a virtue of the system. It is generally assumed that allowing managers financial reporting discretion can increase the quality of the information they provide. Owing to this discretion, managers of firms within the same industry can reach different conclusions about how to recognize revenues and/or expenses, in order to provide information on each firms’ unique circumstances to their respective shareholders.

CON1 recognizes that tax authorities may have informational needs beyond the general user, but also the authority to obtain information on their own:

. . . both the information needed to enforce tax laws and regulations and the information needed to set rates for public utilities are specialized needs. However, although both taxing authorities and rate-making bodies often use the information in financial statements for their purposes, both have the statutory authority to require the specific information they need to fulfill their functions and do not need to rely on information provided to other groups. (Paragraph 26)

CON1 also makes explicit that the goals of financial accounting are not based on assisting regulatory authorities:

The objectives in this Statement are those of general purpose external financial reporting by business enterprises. The objectives stem primarily from the informational needs of external users who lack the authority to prescribe the financial information they want from an enterprise and therefore must use the information that management communicates to them. (Paragraph 26)

By contrast, the objective of the Internal Revenue Code (IRC) is the efficient and equitable determination of tax liabilities and the collection of revenue. To facilitate the work of the Internal Revenue Service, the IRC permits fewer choices in the application of accounting methods than are available to determine financial reporting income. A secondary objective of the IRC is to provide incentives or disincentives for particular economic or social activities.

Tax accounting specifies certain approaches to income and expense recognition that differ from financial accounting. Even when both systems allow for the same revenue or expense, the measurement rules may be very different. For example, for financial reporting firms can calculate depreciation based on idiosyncratic determinations of specific asset lives and residual values that reflect their economic value. Tax depreciation is based on explicit asset classifications that, on average, appear to allow faster recovery than implied by economic depreciation.

When comparing a financial statement to a tax return, the income can differ because of the entities included in each report as well as how the income is defined for each purpose. There are two sources of income measurement differences between financial reporting and taxable income. First, tax and financial reporting rules may allow for differences in the timing of revenue and expense recognition. These timing differences result in differences in the amount of income recognized for financial reporting and tax purposes for a given period, but net to zero over time. Consider again the depreciation of tangible assets. For financial reporting purposes depreciation is generally calculated on a straight-line basis over an estimate of an asset’s expected useful life. For tax purposes, depreciation is generally calculated using an accelerated method. In the early years of an asset’s life, accelerated depreciation for tax purposes will result in taxable income being lower than income for financial reporting purposes. Because total depreciation over an asset’s life can sum to no more than the asset’s cost, depreciation taken in the later years of an asset’s life will be lower for tax purposes than for financial reporting purposes.

The second source of difference between financial reporting and taxable income arises when revenue or expense is recognized under one system but not the other. For example, interest on municipal bonds and a portion of intercorporate dividends received are generally excluded from a corporation’s taxable income, but considered income for financial reporting purposes. Unlike timing differences, these differences do not reverse (and are thus referred to as permanent differences) and do not give rise to deferred tax assets or liabilities and related expenses. Firms are required to

quantify material permanent differences in a reconciliation of the firm's effective tax rate in their tax footnote. Notably, non-qualified stock options generate substantial permanent differences that are not reconciled in the tax footnote.

In addition to these measurement differences, it is also important to note that entities combined in the financial reports will generally be more inclusive than the consolidated entity for tax purposes. For financial reporting purposes, firms are required to file consolidated financial statements for worldwide operations in which the parent has at least a 50 percent interest. For tax purposes, consolidation is voluntary and is only permitted for 80 percent owned domestic corporations. As a result, an observed set of consolidated financial statements can include any number of separate taxable entities.

Beyond the differing objectives of financial reporting and tax rule makers, firms face different incentives for financial reporting and tax reporting. Specifically, managers of firms may have incentives to increase income reported to shareholders while at the same time making choices that minimize reported taxable income. It is apparent from the academic literature and from known transactions that neither tax nor financial reporting considerations consistently dominates the other. Firms may be willing to pay more in taxes if it is necessary to achieve financial reporting objectives, or decrease reported earnings if the tax savings are large enough.

The conflicting objectives guiding the development of rules for financial reporting and tax reporting and the differing incentives of preparers with respect to the two different measurements ultimately result in differences between financial reporting income and taxable income. Data on the differences in income reported under each system has been published only sporadically and not necessarily in comparable ways, but some comparisons over time can be made. Data from the 1970s suggest book net income was approximately 20 percent larger than after-tax tax net income (ranging from 7 percent in 1975 to nearly 40 percent in 1972). During the late 1990s book net income exceeded after-tax tax net income by more than 36 percent in each year, including a difference in excess of 70 percent in 1998. These percentages, however, mask the economic significance of the magnitude of these differences. From 1996 to 1998, the dollar amount of the difference in pretax income grew from \$92.5 billion to more than \$159.0 billion, an increase of nearly 72 percent. In 1998, the difference in pretax income equaled 24.2 percent of total tax net income. This growth from 1996 to 1998 does not appear to be driven primarily by stock options, which reduce taxable income without affecting book income. Overall, from 1996 to 1998, tax net income fell slightly while pretax book income grew 8.5 percent.

In a paper coauthored with Gil Manzon of Boston College and published a year ago in the *Tax Law Review*, we conclude a small number of factors are responsible for a significant amount of book-tax differences, and that accounting and economic factors explain a relatively stable share of the difference in each year. However, given the increasing magnitude of the difference, the dollar value of the unexplained portion is continuing to increase.

The evidence shows that large book tax differences are neither economically insignificant nor a transitory feature of the tax system. A full understanding of the tax system, and firms' response, requires access to comprehensive information about the specific sources of accounting differences, a point I will address below. However, an important consideration particularly relevant to today's discussion is whether these large differences are due to firms actively seeking to decrease their taxable income, to efforts to overstate their financial reporting income, or a combination of both.

Given the potentially competing tax and financial reporting incentives, a well-designed tax strategy may well reduce taxable income, leaving income reported for financial purposes unaffected. David Weisbach (2002) asserts that "[v]irtually no shelters in the current market reduce book income." While any reporting difference should be reflected in the Schedule M-1 or the tax footnote of financial statements, the degree of detail within these schedules is insufficient to easily make inferences about sheltering activities.

The Senate Committee on Governmental Affairs held a series of hearings during 2002 on the role of financial institutions played in Enron's collapse. These hearings highlighted transactions which primarily resulted in Enron improperly recording revenues or improperly classifying sources of cash flows. On January 2, 2003, the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs, released a report on *Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions*. Each of these transactions were related to Enron's initiatives on electronic trading in the paper and pulp industry. Regarding these transactions, three (*Fishtail, Bacchus, Sundance*) were classified by the Subcommittee staff as sham asset sales, and do not appear to have been motivated by tax reasons nor directly affected Enron's tax liability. Rather, as the report suggests these transactions "enabled Enron to

produce misleading financial statements that made Enron's financial condition appear better than it was." (page 3) The fourth transaction, *Slapshot*, was categorized as a sham loan designed to reduce Canadian taxes, but which would not reduce U.S. tax liabilities or produce a tax benefit for financial reporting purposes. The report concluded

The cumulative evidence from the three Subcommittee hearings demonstrates that some U.S. financial institutions have been designing, participating in, and profiting from complex financial transactions explicitly intended to help U.S. public companies engage in deceptive accounting or tax strategies. This evidence also shows that some U.S. financial institutions and public companies have been misusing structured finance vehicles, originally designed to lower financing costs and spread investment risk, to carry out sham transactions that have no legitimate business purpose and mislead investors, analysts, and regulators about companies' activities, tax obligations, and true financial condition. (Page 2)

The results of the Permanent Subcommittee's report suggest that many of the book tax differences of Enron were not solely due to tax-minimizing behavior, but rather inappropriate revenue recognition. If companies engage in both types of transactions, book tax differences will be even larger. However, it is not clear firms provide sufficient information for outside monitors to disentangle these effects. The next section specifically addresses this issue.

Disclosure

An important element of outsiders ability to understanding the role of taxes is being able to know the amount of taxes paid. On July 8, 2002, Chairman Grassley wrote the Treasury Secretary and the Chairman of the Securities and Exchange Commission asking "whether the information contained in the corporate tax returns of publicly traded companies could be of benefit to government regulators as well as shareholders and workers."

To provide my answer to the additional question of whether "sufficient tax information is already publicly available," the short answer is no, it is not. As the Chairman observed in his letter, analysts had differing estimates of Enron's taxes even though common financial information was available to all. The difficulties in the ability to reconcile the tax return and the financial statements are not limited to Enron, nor are the affected users only the financial community. It does not appear to me that either tax authorities, or investors, have all of the information that could be made available about a firm's tax position, and major improvements would not be difficult to achieve. Shortcomings in the current state of financial and tax information suggest a failure of both sets of regulatory guidelines.

At this point, I am not convinced full public disclosure of corporate returns is warranted, and recognize the confidentiality concerns expressed by firms as to revealing potentially sensitive competitive information. However, I am convinced that more and better disclosure of tax information could be achieved with little, or no, additional administrative or economic cost to the firm.

Lillian Mills of the University of Arizona and I have outlined a proposal for substantial revisions to the Schedule M-1. The existing schedule, largely unchanged since its introduction in 1963, currently provides insufficient detail related to many reconciliation issues. Our proposed modifications provide for a more detailed reconciliation anchored to income numbers reported in a firm's 10-K.

In addition to improvements in tax administration, we conclude that any debate on public disclosure of corporate tax return information should begin with the idea of disclosing the information on the Schedule M-1. We argue that, potentially, the entire M-1 of each return filed could be made publicly available, as it contains information that others, such as FASB, have already deemed as important to the general public. Revisions to the Schedule M-1 should not pose a significant problem to firms from either a regulatory burden or competitiveness standpoint. From a burden view, the details that would be provided in a modified M-1 should already be available as part of a firm's normal filing. From a competitive perspective, any concern that these disclosures would harm a company should be considered only to the extent to which new information goes beyond the detail a firm should be providing under GAAP.

Dividend Relief and Tax-Minimizing Transactions

Let me address a final issue this committee will soon be considering, and one related to the broader accounting issues we are discussing today. This issue is the effect of recently proposed changes to the taxation of dividends, and in particular the incentives that any change may have on the aggressive pursuit of tax minimizing behavior. While the general topic of dividend relief is outside the scope of today's

hearing, the argument has been made that the proposal will discourage companies from engaging in aggressive tax planning because “[t]he less tax paid by a corporation, the less tax-free cash that can be paid to its shareholders” (Treasury Office of Public Affairs, KD-3762, January 14, 2003). While this statement is qualitatively true, I think any quantitative effect is likely to be small.

There are strong economic arguments to be made for integrating the corporate and individual taxes as part of a broad and fundamental tax reform. Tax distinctions between debt and equity invite complicated transactions as firms seek to exploit one or the other characterization. Many of these types of transactions were typical of those engaged in by Enron. However, taxes are not always the primary motivation, but rather other incentives that firms face in the financial markets, or incentives faced by managers within the firm.

The assumption has always been that firms seek to maximize shareholder wealth by increasing the value of their shares. Consistent with this is the maximization of after-tax profits or cash flows. Theory suggests firms should consider the tax situation of their investors, but there is no strong evidence that firms operate in such a manner. The market solves this issue on its own, with market participants making investments in opportunities that match their desires for taxable or tax-preferred returns. Many market participants will either not benefit or remain indifferent to dividend relief. In such an environment, it will still make sense for corporations to maximize their own after-tax profits. Further, given the continued preference for long-term capital gains, taxable investors may still be better off through a combination of tax minimization, retention, and deferral. The incentive to minimize taxes will continue to be reinforced unless alternatives to current managerial compensation schemes are developed, as they tend to focus on after-tax returns or stock prices.

Thank you, again, for the opportunity to be here today. I look forward to the further discussion of these issues.

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PREPARED STATEMENT OF JIM A. SEIDA

TAX SHELTER'S AND ANALYSIS OF ENRON'S DISCLOSED TAX INFORMATION

Good morning Chairman Grassley and members of the Committee. I appreciate the opportunity to be a part of today's hearing regarding the Joint Committee on

Taxation's (JCT) report about Enron. I would like to make some comments regarding tax shelters, disclosure of taxable income, and Enron.

II. Tax Shelters

Given what appears to be the ever increasing use of overly aggressive tax shelters it is fairly clear that shelter promoters and business managers have not demonstrated the ability to determine when a tax shelter crosses the line from a legitimate and ethical tax planning device to an abusive tax shelter. Without some established guidance of where this line is, or where it should be, the line of demarcation will probably continue to drop. On this 'slippery slope,' one shelter will be compared to another in terms of its legality. The prevalence of abusive corporate tax shelters potentially puts corporate managers in compromising positions. They are faced with this question: should management elect to utilize a tax shelter of questionable legal merits in order to better compete with foreign competitors that may have lower tax costs and/or with domestic firms that engage in more aggressive tax sheltering transactions? There needs to be a line to evaluate what is acceptable and what is not acceptable with respect to tax shelters. Given the myriad of facts associated with various court decisions and the inability of tax shelter promoters to selfregulate, legislation may be the only way to establish this line. However, we also must ensure that U.S.-based firms are not placed at a competitive disadvantage in the international economy due to the U.S. income tax system.

II. Disclosure of taxable income

Under current accounting rules (GAAP) and SEC standards there is no requirement that a corporation disclose its reported U.S. taxable income. Statement of Accounting Standards No. 109 (SFAS 109) specifies the method—deferred tax accounting—to compute and to report tax expense for financial accounting purposes. Further, SFAS 109 and SEC pronouncements specify items that should be disclosed in the financial statements. Unfortunately, it is often difficult to accurately estimate a corporation's taxable income from the information provided in the financial statements.¹ Modifying the current disclosure rules to require the disclosure of U.S. taxable income might allow investors, creditors, and other interested parties to assess the extent to which a corporation uses abusive tax shelters to reduce taxable income and/or aggressive accounting methods to increase reported earnings.

Since corporate managers generally have incentives to report higher financial accounting income and lower taxable income, one measure can be used to evaluate the other. While differences may not necessarily indicate abusive tax sheltering or aggressive financial reporting, large differences are consistent with such activity and should result in additional scrutiny of the reported income numbers by outside parties. Given that the magnitude of the divergence between taxable and financial accounting income could raise a red flag, management would have an incentive to voluntarily explain items that created the difference. Failure to adequately explain the difference could result in skepticism about management and the reported income amounts which could increase the firm's cost of capital and negatively affect the corporation's stock price.

Thus, the disclosure of the best estimate of taxable income in the financial statements could mitigate both aggressive financial reporting and abusive tax sheltering. The next section compares Enron's reported pre-tax book income and an estimate of Enron's taxable income. Over the 1996–1999 period the difference between Enron's reported pre-tax book income and taxable income estimate was substantial.

III. Enron

Since there are no requirements that corporate tax returns be publicly disclosed, publicly available information, such as 10-K filings, need to be utilized to draw inferences about a corporation's tax position. This analysis is completed using data from Enron's financial statements.

From Enron's financial statements, it appears likely that Enron paid only a small amount of federal income taxes over the 1996–2000 period. An analysis of Enron's income tax disclosures reveals that Enron generated tax net operating losses (i.e., negative taxable income) in each year from 1996–1999. This observation is based on the fact that Enron discloses a U.S. tax net operating loss (NOL) carryforward

¹ Robert Willins, an accounting analyst for Lehman Brothers, states that “. . . figuring out how much tax a company actually pays is almost impossible” and that “tax disclosure is just inscrutable.” [quoted in Tax Dodging: Enron Isn't Alone, Business Week, p. 40]. Willins also states that the tax information provided in financial statements under SFAS 109 is a “total black box” and that he has never met a stock analyst who has any idea what deferred tax accounting is. [I. Carnahan and J. Novack, Forbes Magazine, March 4, 2002 p. 40].

in 1996 (\$222 million) and that the NOL increases each year through 1999.² Absent a corporate acquisition, a tax NOL carryforward will increase only if taxable income is negative for the year. Since it appears Enron's regular taxable income was negative for each year during the 1996–1999 period, it is likely Enron paid little or no regular corporate income tax during these years. The fact that the reported NOL falls from \$2.9 billion at the end of 1999 to \$65 million at the end of 2000 implies that Enron's taxable income for 2000 was \$2.835 billion (1999 NOL carryforward of \$2.900 billion less 2000 NOL carry-forward of \$65 million).³ However, Enron was able to use the 52,900 million NOL to offset its 2000 taxable income and therefore likely paid no regular tax in 2000. It appears that Enron paid some federal tax due to the alternative minimum tax provisions.⁴ An analysis of Enron's tax footnote suggests that Enron actually paid at least \$34 million to federal alternative minimum tax for the 2000 taxable year.⁵ Evidence of Enron's \$34 million AMT payment comes from the fact that Enron's disclosed AMT credit carryforward increased from \$220 million in 1999 to \$254 million in 2000.⁶ In addition to the AMT payment in 2000, analysis of changes to the AMT credit carryforward suggests that AMT was paid in 1996 and 1997 (see income tax carryforwards section of the attached table).⁷ Thus, it appears Enron paid some federal income tax, albeit a relatively small amount, in three of the five years during the 1996–2000 period. The net taxes paid due to the AMT during the 1996–2000 period is, based on the disclosed information, probably around \$23 million (compare the 1995 AMT credit carryforward of 5231 [not reported on the table] and the 2000 AMT credit carryforward of \$254).

The above federal tax payment analysis suggests that Enron, despite recording substantial pre-tax financial accounting income, paid very little federal income taxes during the 1996–2000 period. It is common to have a difference between taxable income and financial accounting income because each system has a different set of objectives and set of rules. What sets Enron apart, however, from a more typical situation are the magnitudes of the annual differences between taxable and financial accounting income. While corporations are not required to disclose taxable income, corporations with significant NOL carryforwards are supposed to disclose the amount of such carryforwards and also whether or not they are subject to tax law restrictions. So for firms with an NOL carryforward, an approximation of reported U.S. taxable income is available by examining the changes in the disclosed NOL carryforward amount.

I use the changes in the reported U.S. NOL to measure Enron's annual U.S. taxable income. The attached table shows the regular U.S. tax NOL for each year during the 1996–2000 period and an implied U.S. taxable income based on these changes. The estimate of Enron's taxable income for each year during the 1996–99 period (beginning with 1996) is -\$222, -\$523, -\$655, and -\$1,500 million. These estimated taxable income figures sharply diverge from the reported pre-tax book income amounts during these same years: \$855, \$15, \$878, and \$1,128 (see table). The difference between estimated U.S. taxable income and reported pre-tax book income for the 1999 year alone is a staggering \$2.628 billion (see table). The cumulative difference over the 1996–1999 period is nearly \$5.8 billion. Almost as stunning as the 1996–99 difference is the reversal of this trend in 2000. Enron's implied U.S. taxable income for the 2000 year is \$2,835 million (see table), while reported pre-tax total book income is \$1,413 million. Thus, fiscal 2000's estimated taxable income exceeds reported pre-tax book income by approximately 1,400 million.

As mentioned above, taxable income may differ from financial accounting income for reasons other than abusive tax shelters and aggressive financial reporting. One important difference between financial accounting and U.S. tax accounting deals with the overall reporting entity. For financial accounting purposes, controlled enti-

²The tax net operating loss rules provide for a carry-back and carry-forward period to eliminate inequities caused by the annual tax-paying period when income fluctuates year-to-year. A tax rebate generated by a NOL carryback simply returns a taxpayer's previously paid taxes (without any interest earned on the tax payment).

³The taxable income could exceed this estimate if the remaining \$65m NOL relates to an acquired entity. If this is the case, the remaining NOL could be subject to restrictions under IRC §382 which limit the extent to which acquired NOLs can offset taxable income of the acquiring company (i.e., Enron).

⁴The AMT is a parallel income tax system to the regular income tax system. AMT is paid in years where the tax liability under the AMT system exceeds that under the regular tax system.

⁵In a recent article in the Washington Post, Karen Denne, an Enron spokeswoman, states that Enron paid \$112 million in federal income taxes in 2000 [G. Kessler, *Enron Appears to Have Paid Taxes*, Washington Post, Feb. 3, 2002, P. A10].

⁶In years where the AMT exceeds the regular corporate income tax a credit is generated that can be used in years in which the regular corporate income tax exceeds the AMT.

⁷The AMT credit carryforward disclosed in the 1995 annual report was \$231m.

ties are generally consolidated for financial statement purposes (unless they are unconsolidated special purpose entities). For tax purposes, however, only entities where the parent controls at least 80% are consolidated and foreign subsidiaries are generally not included to the consolidated U.S. tax return. This does not mean that foreign operations of U.S.-based companies permanently escape U.S. taxation. The timing of the tax consequences associated with foreign operations depends on the *type* of entity that is used to conduct the foreign operations. If the entity is not classified as a corporation for U.S. tax purposes, any income (or loss) from the entity flows to the U.S. parent's tax return on an annual basis. If the entity is classified as a corporation for tax purposes, the U.S. tax is deferred until the foreign earnings are actually remitted to the US parent or deemed remitted through the operation of Subpart F (applies to passive sources of income). Unfortunately, it is not a simple exercise to compute how much foreign income is included on the U.S. parent's tax return using financial statement data. However, even if all of Enron's foreign source income during the 1996–99 period is not included in financial accounting income (to make it comparable to taxable income if no foreign earnings are subject to tax), which total \$1,675 million, the difference between the foreign-income-adjusted pre-tax income and taxable income is still \$4,125 million.⁸ Another interesting aspect of Enron's international operations is that while recording positive financial accounting income from foreign sources, Enron's tax footnote shows that non U.S. tax net operating losses (i.e., foreign NOLs) increased to \$874 million at the end of 1999 (\$1,200 million at the end of 2000). Thus, there also appears to be a large difference between reported foreign income and foreign taxable income.

A second significant difference between taxable income and financial accounting income relates to the treatment of certain stock options. For tax purposes, a deduction is allowed for the difference between the exercise price of a nonqualified stock option and the stock's price the day the option is exercised. Under the permissible stock option accounting method used by Enron (and most corporations), no expense is recognized in connection with most stock option awards. The tax benefit associated with the exercise of incentive stock options is reflected in stockholder's equity. The stock option difference, however, does not explain the huge difference between tax and financial accounting income during the 1996–1999 period (see implied federal tax deduction from stock options on the table). Based on a computed stock option tax benefit figure, the total tax deduction associated with stock options over the 1996–99 period was \$594 million. Thus, stock option expense represents only a small portion of the \$5.8 billion cumulative 1996–99 book-tax difference.

It is not clear what is responsible for the large divergence between financial accounting and taxable income. What is relatively clear is that Enron, given its large regular tax net operating loss during the 1996–99 period, had little incentive to further reduce taxable income. Thus, it seems likely that Enron's large divergence between taxable income and reported income is primarily due to aggressive financial reporting and not abusive tax shelters. The difference could be partly due to the different revenue recognition rules for tax and financial accounting purposes. For financial accounting purposes, Enron used estimates to value long-term energy contracts and changes to these estimated values affected reported book income. In contrast, for tax purposes, gains and losses on these contracts would not have been recognized until the contract was settled.

IV. Summary

Is it possible that information disclosed to tax footnotes could be used to determine firms that are using abusive tax shelters and/or making aggressive financial accounting reporting decisions? Could the disclosure of reported taxable income improve investor ability to detect abusive tax shelter and aggressive financial reporting? If Enron's taxable income was disclosed more prominently, would its aggressive financial reporting practices been detected sooner?

Given what we know now about Enron (they lost money) it is not surprising that it paid very little in taxes over the 1996–2000 period. What is surprising is the magnitude of the divergence between taxable income and reported book income for Enron. More surprising is the fact that information necessary to compute this divergence was effectively disclosed each year but it raised no red flags. Taxable income is likely to be a more conservative measure of income than financial accounting income because an extra dollar of taxable income costs \$0.35 in taxes. In Enron's case, taxable income paints a considerably different picture than reported book income does.

⁸ Enron's reported balance for foreign earnings deemed permanently reinvested (\$1,200 million in 1999) suggests that much of Enron's foreign earnings were not repatriated to the U.S.

If stock analysts utilized information contained in the tax footnote, or alternatively if Enron's tax information was made more transparent, maybe Enron's financial accounting gimmicks could have surfaced earlier. Who knows how much wealth could have been preserved by earlier detection? Perhaps analysts and investors should become better equipped to use information in the tax footnote. Perhaps the FASB or SEC should mandate improved tax disclosures and/or require the disclosure of U.S. taxable income. How many more Enrons are out there? Perhaps the tax footnote is a useful place to begin this examination.

Enron Inc. Federal Income Tax Analysis - J Seida
amounts in millions of dollars

	2000	1999	1998	1997	1996
<i>Reported pretax book income:</i>					
U.S.	640	357	197	96	551
Foreign	773	771	681	(81)	304
Total	<u>1,413</u>	<u>1,128</u>	<u>878</u>	<u>15</u>	<u>855</u>
<i>Reported book income tax expense:</i>					
Current					
Federal	112	29	30	29	16
State	22	6	8	9	11
Foreign	93	48	50	46	37
Total current	<u>227</u>	<u>83</u>	<u>88</u>	<u>84</u>	<u>64</u>
Deferred					
Federal	13	(159)	(14)	(39)	174
State	14	23	11	(42)	(1)
Foreign	180	157	90	(93)	34
Total deferred	<u>207</u>	<u>21</u>	<u>87</u>	<u>(174)</u>	<u>207</u>
Total book income tax expense	<u>434</u>	<u>104</u>	<u>175</u>	<u>(90)</u>	<u>271</u>
Cash paid for income taxes (net of refunds)	62	51	73	68	89
<i>Income tax carryforwards:</i>					
Regular U.S. tax net operating loss (NOL)	65	2,900	1,400	745	222
Alternative minimum tax credit	254	220	238	247	235
Non-U.S. net operating loss	1,200	874	353	300	nr
Implied U.S. taxable income before NOL carry-back or carry-forward ^a	2,835	(1,500)	(655)	(523)	(222)
Estimated federal tax payment ^b	34	0	0	12	4
Difference between pre-tax book income and implied U.S. taxable income	(1,422)	2,628	1,533	538	1,077
Federal income tax benefits from stock options:	(390)	(134)	(43)	(12)	(19)
Implied federal tax deduction (tax benefit/.35) ^c	(1,114)	(383)	(123)	(34)	(54)
<i>Deferred tax asset (liabilities):</i>					
Assets:					
AMT credit carryforward	254	220	238	247	235
NOL carryforward	369	1,302	605	361	(a)
Other	189	188	111	218	143
Total deferred tax assets	<u>812</u>	<u>1,710</u>	<u>954</u>	<u>826</u>	<u>378</u>
Liabilities:					
Depreciation, depletion, and amortization	(1,813)	(1,807)	(1,940)	(2,036)	(1,622)
Price risk management activities	182	(1,133)	(645)	(457)	(536)
Other	(933)	(782)	(700)	(588)	(638)
Total deferred tax liabilities	<u>(2,564)</u>	<u>(3,722)</u>	<u>(3,285)</u>	<u>(3,081)</u>	<u>(2,796)</u>
Net deferred tax assets (liabilities)	<u>(1,782)</u>	<u>(2,012)</u>	<u>(2,331)</u>	<u>(2,255)</u>	<u>(2,418)</u>

nr - indicates amount not reported.

^a - the implied U.S. taxable income is computed by examining changes in the NOL c/f amount (the amount for 1996 reflects the minimum reported current year NOL since it is possible some of the 1996 NOL was carried-back to prior years).

^b - the estimated U.S. corporate income tax for 1994, 1996, 1997, and 2000 is due to the alternative minimum tax.

^c - the implied tax deduction for stock option is computed as the stock option tax benefit divided by 35% (i.e., the corporate tax rate). Unless otherwise stated the source for information is Enron's 10-Ks as reported on Enron's website (www.enron.com).

Enron Corp. and Subsidiaries Consolidated Income Statement

(In millions, except per share amounts)	Year ended December 31,		
	2000	1999	1998
Revenues			
Natural gas and other products	\$ 90,500	\$19,536	\$13,276
Electricity	33,823	15,238	13,939
Metals	9,234	-	-
Other	7,232	5,338	4,045
Total revenues	100,789	40,112	31,260
Costs and Expenses			
Cost of gas, electricity, metals and other products	94,517	34,761	26,381
Operating expenses	3,184	3,045	2,473
Depreciation, depletion and amortization	855	870	827
Taxes, other than income taxes	280	193	201
Impairment of long-lived assets	-	441	-
Total costs and expenses	98,836	39,310	29,882
Operating Income	1,953	802	1,378
Other Income and Deductions			
Equity in earnings of unconsolidated equity affiliates	87	309	97
Gains on sales of non-merchant assets	146	541	56
Gains on the issuance of stock by TNPC, Inc.	121	-	-
Interest income	212	162	88
Other income, net	(37)	181	(37)
Income Before Interest, Minority Interests and Income Taxes	2,482	1,995	1,582
Interest and related charges, net	838	656	550
Dividends on company-obligated preferred securities of subsidiaries	77	76	77
Minority interests	154	135	77
Income tax expense	434	104	175
Net income before cumulative effect of accounting changes	979	1,024	703
Cumulative effect of accounting changes, net of tax	-	(131)	-
Net Income	979	893	703
Preferred stock dividends	83	66	17
Earnings on Common Stock	\$ 896	\$ 827	\$ 686
Earnings Per Share of Common Stock			
Basic			
Before cumulative effect of accounting changes	\$ 1.22	\$ 1.36	\$ 1.07
Cumulative effect of accounting changes	-	(0.19)	-
Basic earnings per share	\$ 1.22	\$ 1.17	\$ 1.07
Diluted			
Before cumulative effect of accounting changes	\$ 1.12	\$ 1.27	\$ 1.01
Cumulative effect of accounting changes	-	(0.17)	-
Diluted earnings per share	\$ 1.12	\$ 1.10	\$ 1.01
Average Number of Common Shares Used in Computation			
Basic	736	705	642
Diluted	814	769	695

Enron Corp. and Subsidiaries Consolidated Statement of Comprehensive Income

(In millions)	Year ended December 31,		
	2000	1999	1998
Net Income	\$ 979	\$ 893	\$ 703
Other comprehensive income:			
Foreign currency translation adjustment and other	(307)	(579)	(141)
Total Comprehensive Income	\$ 672	\$ 314	\$ 562

The accompanying notes are an integral part of these consolidated financial statements.

SUPPLEMENTAL CONSOLIDATED FINANCIAL STATEMENTS

Cash paid for income taxes and interest expense, including fees incurred on sales of accounts receivable, is as follows:

(In millions)	2000	1999	1998
Income taxes (net of refunds)	\$ 62	\$ 51	\$ 73
Interest (net of amounts capitalized)	834	678	585

Non-Cash Activity

In 2000, Enron acquired all minority shareholders' interests in Enron Energy Services, LLC and other businesses with Enron common stock. See Note 2.

In 2000 and 1999, Enron entered into various transactions with related parties, which resulted in an exchange of assets and an increase in common stock of \$171 million in 2000. See Note 16.

In 2000, a partnership in which Enron was a limited partner made a liquidating distribution to Enron resulting in a non-cash increase in current assets of \$220 million, a decrease of \$20 million in non-current assets and an increase in current liabilities of \$160 million.

During 2000 and 1999, Enron received the rights to specific third-party fiber-optic cable in exchange for the rights on specific fiber-optic cable held for sale by Enron. These exchanges resulted in non-cash increases in assets of \$69 million and \$111 million, respectively.

During 1999, Enron issued approximately 7.6 million shares of common stock in connection with the acquisition, by an unconsolidated equity affiliate, of interests in three power plants in New Jersey.

In December 1998, Enron extinguished its 6.25% Exchangeable Notes with 10.5 million shares of EOG common stock.

7 CREDIT FACILITIES AND DEBT

Enron has credit facilities with domestic and foreign banks which provide for an aggregate of \$1.4 billion in long-term committed credit, of which \$150 million relates to Portland General, and \$2.4 billion in short-term committed credit. Expiration dates of the committed facilities range from February 2001 to May 2005. Interest rates on borrowings are based upon the London Interbank Offered Rate, certificate of deposit rates or other short-term interest rates. Certain credit facilities contain covenants which must be met to borrow funds. Such debt covenants are not anticipated to materially restrict Enron's ability to borrow funds under such facilities. Compensating balances are not required, but Enron is required to pay a commitment or facility fee. At December 31, 2000, \$290 million was outstanding under these facilities.

Enron has also entered into agreements which provide for uncommitted lines of credit totaling \$420 million at December 31, 2000. The uncommitted lines have no stated expiration dates. Neither compensating balances nor commitment fees are required as borrowings under the uncommitted credit lines are available subject to agreement by the participating banks. At December 31, 2000, no amounts were outstanding under the uncommitted lines.

In addition to borrowing from banks on a short-term basis, Enron and certain of its subsidiaries sell commercial paper to provide financing for various corporate purposes. As of December 31, 2000 and 1999, short-term borrowings of \$15 million and \$330 million, respectively, and long-term debt due within one year of \$1,713 million and \$670 million, respectively, have been reclassified as long-term debt based upon the availability of committed credit facilities with expiration dates exceeding one year and management's intent to maintain such amounts in excess of one year. Weighted average interest rates on short-term debt outstanding at December 31, 2000 and 1999 were 6.9% and 6.4%, respectively.

Detailed information on long-term debt is as follows:

(In millions)	December 31,	
	2000	1999
Enron Corp.		
Senior debentures		
6.75% to 8.25% due 2005 to 2012	\$ 262	\$ 318
Notes payable ^(a)		
7.00% exchangeable notes due 2002	532	239
6.40% to 9.88% due 2001 to 2028	4,416	4,114
Floating rate notes due 2000 to 2005	92	79
Other	242	34
Northern Natural Gas Company		
Notes payable		
6.75% to 7.00% due 2005 to 2011	500	500
Transwestern Pipeline Company		
Notes payable		
9.20% due 2004	11	15
Portland General		
First mortgage bonds		
6.47% to 9.46% due 2000 to 2023	328	373
Pollution control bonds		
Variable rates due 2010 to 2033	200	200
Other	282	129
Other	414	204
Amount reclassified from short-term debt	1,318	1,000
Unamortized debt discount and premium	(47)	(54)
Total long-term debt	\$8,550	\$7,151

^(a) Includes debt denominated in foreign currencies of approximately \$355 million and \$525 million, respectively, at December 31, 2000 and 1999. Enron has entered into derivative transactions to hedge interest rate and foreign currency exchange fluctuations associated with such debt. See Note 3.

The indenture securing Portland General's First Mortgage Bonds constitutes a direct first mortgage lien on substantially all electric utility property and franchises, other than expressly excepted property.

The aggregate annual maturities of long-term debt outstanding at December 31, 2000 were \$2,112 million, \$750 million, \$852 million, \$646 million and \$1,592 million for 2001 through 2005, respectively.

In February 2001, Enron issued \$1.25 billion zero coupon convertible senior notes that mature in 2021. The notes carry a 2.125 percent yield to maturity with an aggregate face value of \$1.9 billion and may be converted, upon certain contingencies being met, into Enron common stock at an initial conversion premium of 45 percent.

MINORITY INTERESTS

Enron's minority interests at December 31, 2000 and 1999 include the following:

(In millions)	2000	1999
Majority owned limited liability company and limited partnerships	\$1,759	\$1,773
Elektro ^(a)	462	475
Other	192	182
	\$2,414	\$2,430

^(a) Relates to the respective parents of Elektro, which had minority shareholders in 2000 and 1999.

Enron has formed separate limited partnerships and a limited liability company with third-party investors for various purposes. These entities are included in Enron's consolidated financial statements, with the third-party investors' interests reflected in "Minority Interests" in the Consolidated Balance Sheet.

In October 2000, Enron contributed approximately \$1.0 billion of net assets to a wholly-owned limited liability company. A third party contributed \$500 million for a preferred membership

1. "MERCHANT" ASSETS

An analysis of the composition of Enron's merchant investments and energy assets at December 31, 2000 and 1999 is as follows:

(In millions)	December 31,	
	2000	1999
Merchant investments (a)		
Energy	\$137	\$ 516
Energy-intensive industries	63	218
Technology-related	99	11
Other	302	341
	<u>601</u>	<u>1,086</u>
Merchant assets (b)		
Independent power plants	53	152
Natural gas transportation	36	35
	<u>89</u>	<u>187</u>
Total	\$690	\$1,273

(a) Investments are recorded at fair value in "Other Assets" with changes in fair value reflected in "Other Revenues."

(b) Amounts represent Enron's investment in unconsolidated equity affiliates with operating earnings reflected in "Equity in Earnings of Unconsolidated Equity Affiliates."

Enron provides capital primarily to energy and technology-related businesses seeking debt or equity financing. The merchant investments made by Enron and certain of its unconsolidated affiliates (see Note 9) are carried at fair value and include public and private equity, government securities with maturities of more than 90 days, debt and interests in limited partnerships. The valuation methodologies utilize market values of publicly-traded securities, independent appraisals and cash flow analyses.

Also included in Enron's wholesale business are investments in merchant assets such as power plants and natural gas pipelines, primarily held through equity method investments. Some of these assets were developed, constructed and operated by Enron. The merchant assets are not expected to be long-term, integrated components of Enron's energy networks.

For the years ended December 31, 2000, 1999 and 1998, respectively, pre-tax gains from sales of merchant assets and investments totaling \$104 million, \$756 million and \$628 million are included in "Other Revenues," and proceeds were \$1,838 million, \$2,217 million and \$1,434 million.

INCOME TAXES

The components of income before income taxes are as follows:

(In millions)	2000	1999	1998
United States	\$ 640	\$ 357	\$197
Foreign	773	771	681
	<u>\$1,413</u>	<u>\$1,128</u>	<u>\$878</u>

Total income tax expense is summarized as follows:

(In millions)	2000	1999	1998
Payable currently			
Federal	\$112	\$ 29	\$ 30
State	22	6	8
Foreign	93	48	50
	<u>227</u>	<u>83</u>	<u>88</u>
Payment deferred			
Federal	13	(159)	(14)
State	14	23	11
Foreign	180	157	90
	<u>207</u>	<u>21</u>	<u>87</u>
Total income tax expense (a)	\$434	\$104	\$175

(a) See Note 11 for tax benefits related to stock options exercised by employees reflected in shareholders' equity.

The differences between taxes computed at the U.S. federal statutory tax rate and Enron's effective income tax rate are as follows:

	2000	1999	1998
Statutory federal income tax provision	35.0%	35.0%	35.0%
Net state income taxes	2.5	1.8	1.7
Foreign tax rate differential	(2.4)	(7.0)	0.8
Equity earnings	5.3	(10.1)	(4.3)
Basis and stock sale differences	(11.9)	(10.8)	(14.2)
Goodwill amortization	1.6	1.6	2.0
Audit settlement related to Monthly Income Preferred Shares	-	(1.8)	-
Other	0.6	0.5	(1.0)
	<u>30.7%</u>	<u>9.2%</u>	<u>20.0%</u>

The principal components of Enron's net deferred income tax liability are as follows:

(In millions)	December 31,	
	2000	1999
Deferred income tax assets		
Alternative minimum tax credit carryforward	\$ 254	\$ 220
Net operating loss carryforward	369	1,302
Other	189	188
	<u>812</u>	<u>1,710</u>
Deferred income tax liabilities		
Depreciation, depletion and amortization	1,813	1,807
Price risk management activities	(182)	1,133
Other	963	782
	<u>2,594</u>	<u>3,722</u>
Net deferred income tax liabilities (a)	\$1,782	\$2,012

(a) Includes \$138 million and \$118 million in other current liabilities for 2000 and 1999, respectively.

Enron has an alternative minimum tax (AMT) credit carryforward of approximately \$254 million which can be used to offset regular income taxes payable in future years. The AMT credit has an indefinite carryforward period.

Enron has a net operating loss carryforward applicable to U.S. subsidiaries of approximately \$65 million, which will begin to expire in 2011. Enron has a net operating loss carryforward applicable to non-U.S. subsidiaries of approximately \$1.2 billion, of which \$1.0 billion can be carried forward indefinitely. The remaining \$200 million expires between the years 2001 and 2010. Deferred tax assets have been recognized on the \$65 million domestic loss and \$1.0 billion of the foreign losses.

U.S. and foreign income taxes have been provided for earnings of foreign subsidiary companies that are expected to be remitted to the U.S. Foreign subsidiaries' cumulative undistributed earnings of approximately \$1.8 billion are considered to be permanently reinvested outside the U.S. and, accordingly, no U.S. income taxes have been provided thereon. In the event of a distribution of those earnings in the form of dividends, Enron may be subject to both foreign withholding taxes and U.S. income taxes net of allowable foreign tax credits.

COMMUNICATIONS

March 5, 2003

The Honorable Charles Grassley
United States Senate
135 Hart Senate Building
Washington, DC 20510

The Honorable Max Baucus
United States Senate
511 Senate Hart Building
Washington, DC 20510

Dear Chair Grassley and Ranking Member Baucus:

On behalf of 2400 members of The ESOP Association, and the employee ownership community at-large, I register a strong, and deep-rooted protest against a statement of opinion and positions taken by the Joint Committee on Taxation in its written testimony on its *Report of Investigation of Enron Corp. and Related Entities Regarding Tax, Compensation Issues and Policy Recommendations* (JCX-10-03), presented by Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, at a February 13, 2003 hearing of the Senate Committee on Finance.

I would like to request that the Senate Finance Committee consider this letter as a statement for the record, with regard to its February 13 hearing entitled, "Enron: The Joint Committee on Taxation's Investigative Report."

Specifically, this protest is directed at Section IV, "Pension and Compensation Arrangements, Subsection C., Findings and Recommendations Relating to Pension and Compensation Arrangements, Item 3, Investments under 401(k) Plans."

This section can only lead to the conclusion that the staff of the Joint Committee on Taxation, basing its views on the episode of one specific corporation, perceives an "ownership culture" to be negative, and detrimental to employees; believes diversification out of company stock to be more important than policies directed toward ownership distribution patterns in a capitalistic society; and desires that that Congress implement strict limits on the amount of company stock employees may own.

If Congress accepted the recommendations of the Joint Committee staff as taking precedent over prior Congressional decisions to encourage more employee stock ownership, Congress would seemingly be adopting policies to ensure and encourage that only a few wealthy and privileged Americans could be owners of the companies where they work.

While one might surmise that the recommendations by the Joint Committee are limited exclusively to 401(k) arrangements, the view set forth in the written testimony is, in fact, general, and it is not limited in scope with regard to one, specific type of retirement savings plan.

Particularly objectionable is the condemnation of a company's promoting an "ownership culture." Over the past 25 years, an already strong trend in America toward making employees stock owners in the companies where they work has been accelerated by laws enacted by Congress, specifically the ESOP laws. (Interestingly, many U.S. companies established "ownership cultures" in their companies in the 19th Century, long before the existence of federal income tax laws. Many of these companies, as well as their former and current employees still thrive today.)

Two recent studies, covering hundreds of U.S. companies are prime examples:

1. In May 2001, Dr. Joseph R. Blasi and Dr. Douglas L. Kruse, professors at the School of Management and Labor Relations at Rutgers University concluded that ESOPs appear to increase sales, employment and sales/employee by about 2.3% to 2.4% over what would have been anticipated in a private company, absent an ESOP. According to Dr.'s Blasi and Kruse, ESOP companies are also more likely to continue operating as independent companies over the course of several years by a factor of 15%. In addition, it is substantially more probable that ESOP companies have other retirement-oriented benefit plans than comparable non-ESOP companies.
2. Research conducted by Professor Hamid Mehran, while he served on the faculty of the J.L. Kellogg Graduate School of Management, Northwestern University, of nearly 400 publicly traded companies with significant ESOPs both before and after the adoption of the ESOP, compared to non-ESOP companies in similar lines of businesses, showed that the rate of return for the ESOP companies was 2.7% higher, 60% of the ESOP companies experienced share price increases upon announcement of the ESOP program, and 82% indicated that the ESOP had a positive impact on business results.

Though not completely accepted by all experts on corporate performance, many experts believe that employee ownership, and the "ownership culture" that may evolve in a properly-managed company is a major – if not *the* major reason – for the outstanding performance of U.S. corporations in the past decade. For example, Vice President Richard Cheney commented on January 27, 2002, that employee ownership was a good thing, and former Secretary of Labor Robert Reich and his Labor Department cited employee ownership as one common characteristic among high-performing companies.

Skeptics might believe that an interest group, such as The ESOP Association, would be foolish to take issue with any part of the general condemnation of Enron, as it would call unwarranted attention to a section of the Joint Committee's written testimony that was not the focus of the public hearing. But, the great danger inherent in the Joint Committee's attitude toward an ownership culture, and its call to limit employee stock ownership cannot go unchallenged.

As President Bush has said often, the United States should not be a nation where ownership is the privilege of a few.

We can differ as to the specific ownership policies passed by Congress, and subsequently endorsed by five Presidents, and we can debate whether these policies are properly housed under ERISA law; but let us hope that the sweeping condemnation of companies with "ownership cultures" and employee stock ownership on February 13 by the Joint Committee on Taxation is not a reflection of forthcoming national policy, as such a development would be very harmful to the well-being and resilience of our free enterprise economy in the 21st-century.

Sincerely yours,

J. Michael Keeling, CAE
President

