

**WRITTEN TESTIMONY OF THE STAFF OF THE  
JOINT COMMITTEE ON TAXATION  
ON EXECUTIVE COMPENSATION AND  
COMPANY-OWNED LIFE INSURANCE ARRANGEMENTS OF  
ENRON CORPORATION AND RELATED ENTITIES**

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**At a Hearing of the  
SENATE COMMITTEE ON FINANCE  
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# CONTENTS

	<u>Page</u>
I. INTRODUCTION .....	1
II. ENRON'S EXECUTIVE COMPENSATION ARRANGEMENTS.....	2
A. Summary Overview of Enron's Executive Compensation Arrangements.....	2
B. General Observations with Respect to Enron's Compensation .....	4
C. Enron's Executive Compensation Structure .....	6
1. Compensation trends and philosophy .....	6
2. Overview of Enron's executive compensation arrangements.....	9
3. Bonuses .....	9
4. Special compensation arrangements .....	10
D. Discussion of Specific Issues.....	12
1. Nonqualified deferred compensation .....	12
2. Stock-based compensation .....	21
3. Employee loans .....	24
4. Split dollar life insurance arrangements .....	25
5. Limitation on deduction of certain executive compensation in excess of \$1 million.....	27
III. COMPANY-OWNED AND TRUST-OWNED LIFE INSURANCE .....	32
IV. CONCLUSIONS .....	39

## I. INTRODUCTION

My name is Mary Schmitt. I am Acting Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present today the testimony of the staff of the Joint Committee on Taxation (the “Joint Committee staff”) concerning the executive compensation and company-owned life insurance arrangements of Enron Corp. and its related entities.<sup>1</sup>

In February 2002, Senators Max Baucus and Charles E. Grassley, then Chairman and Ranking Member of the Senate Committee on Finance (“Senate Finance Committee”), directed the Joint Committee staff to undertake a review of Enron’s<sup>2</sup> Federal tax returns, tax information, and any other information deemed relevant by the Joint Committee staff to assist the Senate Finance Committee in evaluating whether the Federal tax laws facilitated any of the events or transactions that preceded Enron’s bankruptcy. The Joint Committee staff was also directed to review the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, and to analyze the factors that may have contributed to any loss of benefits and the extent to which losses were experienced by different categories of employees.

In connection with a hearing on the investigation, the Joint Committee staff presented its official Report on the investigation<sup>3</sup> to the Senate Finance Committee on February 13, 2003. This testimony highlights certain aspects of the Report relating to executive compensation and company-owned life insurance. The Report contains more detailed descriptions of Enron’s executive compensation and company-owned life insurance arrangements.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Written Testimony of the Staff of the Joint Committee on Taxation on Executive Compensation and Company-Owned Life Insurance Arrangements of Enron Corporation and Related Entities* (JCX-36-03), April 7, 2003.

<sup>2</sup> Except as otherwise indicated, references to “Enron” refer to Enron Corporation and its affiliates, and references to “Enron Corp.” refer specifically to the parent company.

<sup>3</sup> 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 (the “Report”).

## II. ENRON'S EXECUTIVE COMPENSATION ARRANGEMENTS

### A. Summary Overview of Enron's Executive Compensation Arrangements

Enron's compensation arrangements have received considerable media attention in the aftermath of the Enron bankruptcy. With respect to executive compensation, attention has focused both on the amount of compensation paid to certain executives and on the various forms of compensation used by Enron.<sup>4</sup>

During the period reviewed by the Joint Committee staff, executive compensation at Enron was generally comprised of base salary, annual incentives, and long-term incentives. Certain executives also participated in nonqualified deferred compensation and special compensation arrangements.

Enron's compensation costs for all employees, and especially for executives, increased significantly over the years immediately preceding its bankruptcy. Enron's executives, in particular, were paid substantial amounts. In 2000, total compensation for the 200 highest-compensated employees of Enron was \$1.4 billion, an average of \$7 million per employee. This consisted of \$56.6 million of bonuses, \$1.06 billion attributable to stock options, \$131.7 million attributable to restricted stock, and \$172.6 million of base salary and other income. Incentive compensation was a significant element of Enron's executive compensation arrangements. In 2000, base salary was less than 13 percent of total compensation for the 200 highest-compensated employees.

Notable features of Enron's executive compensation include the following:

- Nonqualified deferred compensation was a major component of executive compensation for Enron. Participants were eligible to defer all or a portion of salary, bonus, and long-term compensation into Enron-sponsored deferral plans. Over \$150 million in compensation was deferred by the 200 highest-compensated employees for the years 1998-2001. In late 2001, in the weeks prior to Enron's bankruptcy filing, early distributions totaling more than \$53 million were made to certain participants from two of Enron's nonqualified deferred compensation plans.
- 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. Enron's deduction for compensation attributable to the exercise of nonqualified stock options increased by more than 1,000 percent from 1998 to 2000.

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<sup>4</sup> Certain aspects of Enron's tax-qualified retirement plans have also received considerable media attention, particularly the extent to which plan assets were invested in Enron stock. These plans are discussed in detail in the Report.

- In the weeks immediately preceding the bankruptcy, Enron implemented two special 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. The combined cost of the programs was approximately \$105 million.
- Enron had certain special compensation arrangements for limited groups of people or for specific individuals. One executive received the use of a 1/8 fractional interest in a jet aircraft Hawker 800 as part of his compensation. A very limited number of employees received loans (or lines of credit) from Enron or split-dollar life insurance arrangements. Enron purchased two annuities from Mr. Kenneth L. Lay and his wife as part of a compensation package for 2001. Enron also had a Project Participation Plan for employees in its international business unit under which employees received interests in certain international projects.

## **B. General Observations with Respect to Enron's Compensation**

Enron's stated compensation philosophy was a pay for performance approach; those who were determined to perform 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-compensated employees of Enron was \$1.4 billion dollars (\$1.2 billion of which was attributable to stock options and restricted stock). For the same year, Enron reported \$979 million of financial statement net earnings.<sup>5</sup>

Enron's approval of compensation packages for its executives rested almost entirely with internal management. Although the Compensation Committee of the Enron Corp. Board of Directors (the "Compensation Committee") 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 accepted 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.

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<sup>5</sup> This was prior to Enron's November 19, 2001, accounting restatement made public in filings with the Securities and Exchange Commission, which resulted in restated net income of \$842 million. A true measure of Enron's net income for the year cannot be determined without a restatement of Enron's financial statements to conform with generally accepted accounting principles.

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 losses 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 made by employees through the Enron Corp. Savings 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. 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. Although some executives suffered losses that appear stunning in amount, many executives also reaped substantial gains from their compensation arrangements.

## C. Enron's Executive Compensation Structure

### 1. Compensation trends and philosophy

#### In general

Enron had a pay for performance compensation philosophy; employees who performed well were compensated well. Enron used a variety of forms of compensation in recent years, including cash, stock, stock options, restricted stock, phantom stock, performance units,<sup>6</sup> and participation interests.<sup>7</sup> Enron also offered employees benefits such as participation in qualified retirement plans and in health and life insurance. The amount of compensation that Enron paid to employees, especially executives, increased significantly over the years immediately preceding the bankruptcy.

Tax return data for Enron Corp. and its subsidiaries show how compensation of officers, salaries and wages, and employee benefit program expenses increased over the years immediately preceding the bankruptcy. Table 1, below, shows the deduction taken by Enron Corp. and its subsidiaries for such expenses on its Federal income tax returns for 1998, 1999, and 2000. Enron's total compensation deduction dramatically increased from 1998 to 2000. The increase in compensation expense was, in part, due to the substantial increase in Enron's deduction attributable to the exercise of stock options.

The deduction for compensation of officers increased exponentially. The compensation of officers doubled from 1998 to 1999 and tripled from 1999 to 2000. As shown in Table 1, below, in 2000, the deduction for compensation of officers was almost twice the deduction for salaries and wages.

**Table 1.—Enron Compensation Deductions for 1998, 1999, and 2000<sup>8</sup>**

<b>Item</b>	<b>1998</b>	<b>1999, as amended</b>	<b>2000</b>
Compensation of officers	\$149,901,000	\$313,312,000	\$952,492,000
Salaries and wages	\$499,746,000	\$702,725,000	\$557,550,000
Pension, profit-sharing, etc., plans	\$628,000	\$834,000	\$20,000
Employee benefit program	\$344,676,000	\$569,278,000	\$1,456,796,000
Total	\$994,951,000	\$1,586,149,000	\$2,966,858,000

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<sup>6</sup> Performance units were granted in the 1990's under Enron's Performance Unit Plan. The value of performance units was determined by reference to the ranking of Enron's shareholder return relative to its peer group.

<sup>7</sup> Participation interests were granted in international projects under the Enron International Project Participation Plan.

<sup>8</sup> The Joint Committee staff was not provided information detailing what was specifically included in each category.



Compensation paid to Enron's 200 highest-compensated employees also increased significantly in the years preceding Enron's bankruptcy. Table 2, below, shows information compiled by the IRS, which is based on information provided by Enron, on compensation of the 200 highest-compensated employees for 1998 through 2000. Compensation for this group increased over recent years, particularly, the amount of compensation attributable to stock options. Base salary and other compensation also increased substantially.

**Table 2.—Compensation Paid to the 200 Highest-Compensated Employees for 1998-2000**

<b>Year</b>	<b>Bonus</b>	<b>Stock Options</b>	<b>Restricted Stock</b>	<b>Base Salary and Other Income</b>	<b>Total</b>
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

The range of total compensation paid to the 200 highest-compensated employees of Enron in the years immediately preceding Enron's bankruptcy is shown in Table 3, below.

**Table 3.—Range of Per Employee Total Compensation Paid to the 200 Highest-Compensated Employees for 1998-2001**

<b>Year</b>	<b>Range of Per Employee Total Compensation Paid to the 200 Highest-Compensated Employees</b>
1998	\$152,000 to \$20,621,000
1999	\$325,000 to \$56,541,000
2000	\$1,270,000 to \$168,741,000
2001	\$1,104,000 to \$56,274,000

In 2000 and 2001, each one of the 200 highest-compensated employees was paid over \$1 million. In 2000, three executives were paid over \$100 million, with the top-paid executive receiving \$169 million. In 2000, at least 26 executives were paid over \$10 million. In 2001, the year of Enron's bankruptcy, at least 15 executives were paid over \$10 million. One executive was paid over \$56 million.

### **Enron's Compensation Committee**

Enron's Compensation Committee (a Committee comprised of Members of the Board of Directors) was responsible for developing the Enron executive compensation philosophy. The Compensation Committee's stated focus was to ensure a strong link between the success of the shareholder and the rewards of the executive. The Compensation Committee made decisions on a wide variety of compensation issues. While the Compensation Committee was principally involved with executive compensation, the duties of the Compensation Committee were not limited to executive compensation. The Compensation Committee approved all qualified retirement plan documents and amendments. The Compensation Committee also approved medical and dental plans, severance pay plans, and flexible compensation plans. The

Compensation Committee approved all stock plans, bonus plans, and deferral plans and approved grants of stock options and other equity compensation. The Compensation Committee was responsible for authorizing bonus pools and often approved accelerated vesting of options and other equity-based compensation. Selected employment agreements were approved by the Compensation Committee.

While the Compensation Committee had responsibility for a wide range of issues, the members of the Compensation Committee were not deeply involved in most issues. Members of the Compensation Committee interviewed by Joint Committee staff were not fully aware of all of the issues for which they were responsible and often made decisions. For example, even though changes to the nonqualified deferred compensation plans were approved by the Compensation Committee, one former member of the Compensation Committee interviewed by Joint Committee staff did not know whether Enron offered nonqualified deferred compensation. Even though reflected in the minutes, one former member of the Compensation Committee interviewed by Joint Committee staff could not recall whether the Committee approved qualified retirement plans issues, while another Compensation Committee member did not know what a qualified retirement plan was. The members of the Compensation Committee did not scrutinize proposed arrangements, but basically approved whatever compensation arrangements were presented to them by management.

### **Role of outside consultants**

Enron stated intent was to use a market pricing approach to compensation. Enron frequently used outside consultants, principally Towers Perrin, to determine compensation practices in the market place. The Compensation Committee relied on outside consultants in making a variety of decisions. Enron frequently obtained analysis from consultants, particularly Towers Perrin, to ensure that the executive compensation program was within its stated philosophy and goals. Towers Perrin periodically issued opinion letters to Enron regarding its compensation programs in general and on specific compensation issues. General compensation studies were also performed. Studies and opinions provided by Towers Perrin are discussed in further detail in the Report.<sup>9</sup>

From Joint Committee staff interviews with many former members of the Compensation Committee, it appears that many members made decisions relying on the opinions of consultants without fully understanding the underlying issue. For example, former Compensation Committee members interviewed by Joint Committee staff could not explain why Enron purchased two annuities from Mr. Lay and his wife in 2001, but knew that Towers Perrin issued an opinion providing justification for the transaction.

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<sup>9</sup> Appendix D of the Report includes studies and opinions provided to Enron by Towers Perrin.

## **2. Overview of Enron's executive compensation arrangements**

Executive compensation at Enron was generally comprised of base salary, annual incentives, and long-term incentives. Base salary levels were targeted at the 50th percentile of the external marketplace, meaning that Enron tried to have its base salary at a level equal to 50 percent of other companies. For total compensation, executives had the opportunity to earn at the 75<sup>th</sup> percentile or higher level, subject to obtaining performance at the 75<sup>th</sup> percentile or higher. In addition to the three principal components of executive compensation (base salary, annual incentives and long-term incentives), certain executives also participated in special compensation arrangements, such as nonqualified deferred compensation programs, split-dollar insurance arrangements, and employee loans.

Annual bonuses were a major component of Enron's executive compensation structure. Annual bonuses were targeted at the 75<sup>th</sup> percentile level compared to the market and could often be larger than base salary for some employees.

In recent years, the long-term incentive program provided for awards of nonqualified stock options and restricted stock. Participation in the long-term incentive plan was available to employees in the vice president job group and above, which generally ranged from approximately 300 to 400 executives. Stock-based compensation was a major component of executive compensation, especially in the years immediately preceding the bankruptcy.

Executives were given the opportunity to participate in nonqualified deferred compensation arrangements. Participants were eligible to defer receipt of all or a portion of salary, bonus and long-term compensation into Enron-sponsored deferral plans. The plans provided an opportunity for executives to choose to delay payment of Federal and State income taxes, and earn tax-deferred return, on deferrals of virtually any form of compensation.

## **3. Bonuses**

### **In general**

There has been much media attention focusing on the magnitude of bonuses paid to Enron executives. In many cases, bonuses were the principal compensation component. Individual executive bonuses paid in 2001, the year of Enron's bankruptcy, were as high as \$8 million dollars. In 2001, at least 48 executives received bonuses of \$1 million or greater. Table 4, below, shows total bonuses for the 200 highest-compensated employees according to information obtained from the IRS. Enron's bankruptcy filing Exhibit 3b.2 shows that bonuses to 144 insiders (managing directors and above) paid during the year preceding the bankruptcy totaled approximately \$97 million.

Enron had two bonus deferral programs, the Bonus Stock Option Program and the Bonus Phantom Stock Deferral Program. The bonus deferral programs gave participants an opportunity to receive stock options and/or phantom stock in lieu of cash bonus payments.

**Table 4.– Total Bonuses for the 200 Highest-Compensated Employees**

<b>Year</b>	<b>Total Bonuses</b>
1998	\$41,193,000
1999	\$51,195,000
2000	\$56,606,000

**Pre-bankruptcy bonuses**

In the weeks immediately preceding the bankruptcy, Enron implemented two bonus programs for (1) approximately 60 key traders and (2) approximately 500 employees who Enron claimed were critical for maintaining and operating Enron going forward.<sup>10</sup> As a condition to receiving pre-bankruptcy bonus payments, employees were required to execute an agreement requiring repayment of any amounts received, plus a 25 percent penalty, if the employee voluntarily terminated employment prior to the expiration of 90 days following the receipt of any payment.

According to Enron, approximately 584 employees received payments totaling approximately \$105 million. Additional information provided by Enron states that 490 employees received key employee (non-trader) bonuses totaling approximately \$50 million, which were paid from general company assets. Trader bonuses were paid to 67 employees totaling approximately \$46 million, which were made from a grantor trust established to fund 2001 performance bonuses. In addition, 27 Canadian employees received bonuses totaling \$8 million, which were paid by Enron Canada Corp.<sup>11</sup> Pre-bankruptcy payments ranged from \$2,500 to \$8 million per employee.

**4. Special compensation arrangements**

Enron had certain special compensation arrangements for limited groups of people or for specific individuals. For example, one executive 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 from Enron and had split dollar life insurance policies. Certain executives were allowed to exchange interests in plans for large cash payments or stock options and restricted stock grants.

One of the most notable special compensation arrangements was the purchase by Enron of two annuities from Mr. Lay and his wife as a part of his compensation package for 2001. Under the transaction, Enron purchased the annuity contracts from Mr. and Mrs. Lay for \$5 million each (a total of \$10 million) and also agreed to reconvey the annuity contracts to Mr. Lay if he remained employed with Enron through December 31, 2005. If Mr. Lay were to leave Enron prior to that date, reconveyance still would take place on the occurrence of one of four events: (1) retirement with the consent of the Board; (2) disability; (3) involuntary termination

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<sup>10</sup> Appendix D of the Report includes a list of employees who received pre-bankruptcy bonus payments.

<sup>11</sup> These payments appear to have been made in connection with the trader bonus payments.

(other than a termination for cause); or (4) termination for “good reason.” Towers Perrin issued a letter regarding the benefits of the transaction. It is unclear whether the contracts have been or will be reconveyed to Mr. Lay.<sup>12</sup> For more detail, see Part Four, III,C.4, of the Report.

Enron Development Corporation, which was later renamed Enron International, used a Project Participation Plan to grant awards to international developers and other employees working on international projects. Under the Project Participation Plan, employees were granted participation interests in particular international projects. Payments with respect to a project were triggered upon the occurrence of certain plan payment dates. Awards for top developers could be as high as \$7 million for single projects.

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<sup>12</sup> The Joint Committee staff was informed by counsel for former Compensation Committee members that the issue of whether Mr. Lay was entitled to receive the annuity contracts given the terms of his departure was under review by Enron and various legal counsel. Enron stated it was unable to give the Joint Committee staff any further information regarding the status of the annuity contracts and whether they had been or would be reconveyed to Mr. Lay. In response to Joint Committee staff written questions regarding the annuity contracts, Mr. Lay’s counsel, Piper Rudnic, responded that “We are not in a position to give a legal opinion about the current status of the annuity contracts.” They also stated their understanding that the characterization of Mr. Lay’s termination for purposes of severance benefits was still under review.

## **D. Discussion of Specific Issues**

### **1. Nonqualified deferred compensation**

#### **Introduction and background**

“Nonqualified deferred compensation” refers to compensation that is deferred other than through a tax-qualified retirement plan or similar arrangement. Nonqualified deferred compensation is a common form of compensation for executives. Nonqualified deferred compensation may be provided through a number of mechanisms. For example, an employer may have a qualified deferred compensation arrangement covering a specified group of executives or may provide for deferral for executives only as provided in individual employment contracts. In contrast to tax-qualified retirement plans, nonqualified deferred compensation arrangements are subject to few restrictions. Nonqualified deferred compensation arrangements are attractive to employees because they offer the ability to defer in effect unlimited amounts of compensation. Employers often make such arrangements available to executives in order to meet the desire of executives for tax deferral. In some cases deferred compensation may also be used by an employer to achieve certain objectives, such as providing a retention incentive.

In contrast to nonqualified deferred compensation arrangements, tax qualified retirement plans are subject to a variety of rules under the Federal tax laws and the Employee Retirement Income Security Act (“ERISA”), including limits on the amount that can be deferred, a variety of employee protections, and nondiscrimination rules that are designed to ensure that the plan covers a broad range of employees, not just highly compensated employees. In exchange for complying with these restrictions, tax-qualified retirement plans receive favorable tax benefits. Employees do not include qualified retirement plan benefits in income until received, even though the plan is funded and the participant is vested in his or her benefit. Employers receive a current deduction, within limits, for contributions to tax-qualified retirement plans, even though the income inclusion on the part of the employee is deferred. Qualified retirement plan assets are required to be held in trust for the exclusive benefit of plan participants and beneficiaries.

Nonqualified deferred compensation arrangements are not subject to the requirements applicable to tax-qualified retirement benefits, and the rules for the timing of the employer’s deduction and the employee’s income inclusion differ. For example, there is no statutory limit on the amount of compensation that can be deferred under a nonqualified deferred compensation arrangement. However, under a nonqualified deferred compensation arrangement, the employer is not entitled to a deduction until the employee includes the compensation in income. Thus, in theory, there is a tension between the interests of the employer in a current deduction and the employee in obtaining deferral of taxes. In practice, in many cases this tension is illusory and does little to impact the amount of compensation that is deferred. As described below, in Enron’s case, the possibility of a forgone deduction appeared to have little, if any, effect on the amount of deferred compensation.

Nonqualified deferred compensation arrangements are also not subject to the nondiscrimination rules applicable to tax-qualified retirement plans. Rather, in order to avoid being subject to ERISA’s requirements, nonqualified deferred compensation arrangements must

be limited to a “select group of management or highly compensated employees”.<sup>13</sup> This means that nonqualified deferred compensation arrangements do not cover a broad range of employees.

Unlike tax-qualified retirement plans, there is no single set of rules governing the tax treatment of nonqualified deferred compensation. The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination.<sup>14</sup>

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. An arrangement is considered funded if there is a transfer of property under section 83. If the arrangement is not considered funded for tax purposes, amounts deferred are includible in income when actively or constructively received. In general, in order for an amount not to be constructively received, there must be a substantial limitation on the individual’s right to receive the amount. If compensation has been deferred under a funded arrangement, then income is includible for the year in which the individual’s rights are transferable or not subject to a substantial risk of forfeiture under the rules for section 83.

Over time, arrangements have developed in an effort to provide employees with greater security for nonqualified deferred compensation and greater control over amounts deferred, while still providing the desired deferral of income. One such arrangement, designed to provide greater security for the employer, is a “rabbi trust.”

A “rabbi trust” is a trust or other fund established by an employer to hold assets from which nonqualified deferred compensation payments may be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer’s general creditors in the case of insolvency or bankruptcy. Terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation

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<sup>13</sup> See, e.g., ERISA section 201(2). Nonqualified deferred compensation arrangements exempt from ERISA are commonly referred to as “top-hat plans”. There is no precise definition of the term “select group of management or highly compensated employees,” however, the term “highly compensated employees” as used in ERISA is not synonymous with such term as used in the Code.

<sup>14</sup> These include the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

arrangement to be funded for income tax purposes.<sup>15</sup> As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi trust provisions.<sup>16</sup> Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

In addition to arrangements to increase security, a variety of practices have developed to provide employees with greater control over deferred amounts. These include providing greater flexibility in distributions, greater flexibility in timing of elections with respect to initial deferrals and payments, and the ability to specify how earnings will be credited to deferred amounts. For example, one practice is to provide that distributions from a nonqualified deferred compensation arrangement may be made at any time, subject to the discretion of the committee or other body with authority over the plan and also subject to a forfeiture of some portion of the amount to be distributed, such as 10 percent. Such forfeiture provisions are often referred to as a "haircut."

While many common practices, when viewed in isolation, may appear to be within the limits of present law, when examined in connection with other plan provisions and features, appear to provide executives with an excessive level of security and control. As discussed below, Enron used a number of these practices in its nonqualified deferred compensation arrangements.

The development of questionable and aggressive practices regarding nonqualified deferred compensation is, at least in part, due to the moratorium on Treasury guidance addressing certain nonqualified deferred compensation arrangements. Section 132 of the Revenue Act of 1978<sup>17</sup> provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation that

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<sup>15</sup> This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

<sup>16</sup> Rev. Proc. 92-64, 1992-2 C.B. 422, *modified in part by* Notice 2000-56, 2000-2 C.B. 393.

<sup>17</sup> Section 132 of the Revenue Act of 1978 was enacted in response to proposed Treasury regulation 1.61-16, which provided that if a payment of an amount of a taxpayer's compensation is, at the taxpayer's option, deferred to a taxable year later than that in which such amount would have been payable but for the taxpayer's exercise of such option, the amount is treated as received by the taxpayer in such earlier taxable year. Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).



were in effect on February 1, 1978. Thus, the Treasury Department has been restricted in issuing new deferred compensation guidance for over 25 years.

### **Enron's deferred compensation programs in general**

Nonqualified deferred compensation was a major component of executive compensation for Enron. Through Enron's nonqualified deferred compensation programs, executives were able to defer more than \$150 million in compensation from 1998 through 2001. Approximate amounts deferred under all deferred compensation plans for the 200 highest-compensated Enron employees for the years 1998-2001 are shown in the following table.

**Table 5.—Amounts Deferred by the 200 Highest-Compensated Employees 1998-2001**

<b>Year</b>	<b>Amounts Deferred Under All Deferred Compensation Plans for the 200 Highest-Compensated (millions of dollars)</b>
1998	\$13.3
1999	19.7
2000	67.0 <sup>18</sup>
2001	54.4

Many executives participated in Enron's deferral programs. In recent years, Enron had two nonqualified deferred compensation plans: the Enron Corp. 1994 Deferral Plan (the "1994 Deferral Plan") and the 1998 Enron Expat Services, Inc. Deferral Plan (the "Expat Deferral Plan"). The plans had almost identical terms and features except that the Expat Deferral Plan was used for expatriates who were ineligible to participate in the 1994 Deferral Plan because they were employed by Enron Expat Services Inc. In addition, a rabbi trust was established in connection with the 1994 Deferral Plan, but no such trust was established in connection with the Expat Deferral Plan. Enron also had older deferral plans that were predecessors to the current plans.

Information provided by Enron shows that for the years 1999-2001, there were approximately 340 participants in the 1994 Deferral Plan and approximately 55 total participants in the Expat Deferral Plan. Under the deferral plans, participants could defer up to 35 percent of base salary, up to 100 percent of annual bonus payments, and up to 100 percent of select long-term incentive payments.

### **Specific features of Enron's deferred compensation plans**

#### **In general**

In the process of reviewing Enron's deferred compensation arrangements, the Joint Committee staff identified a variety of features that allowed the executives to maintain security and control over the amounts deferred. These features are similar to those reportedly used by other employers. While the 1994 Deferral Plan and the Expat Deferral Plan were designed to

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<sup>18</sup> Of the \$67 million, \$32 million was deferred by Mr. Lay.

impose restrictions or limitations on the participant's control of amounts deferred, such restrictions or limitations could be seen as illusory. While these plan provisions may not result in constructive receipt under present law, there is an issue as to whether the mere existence of such features should result in the application of the constructive receipt doctrine. When viewed collectively, the existence of the opportunities for accelerated distributions, participant-directed investment, and changes in participant elections lend credence to the argument that the doctrine of constructive receipt should apply.

#### Accelerated distributions

Normally, distributions of nonqualified deferred compensation were paid to Enron executives upon retirement, death, disability, or termination of employment. Participants were also allowed to receive special purpose deferrals while remaining active employed.<sup>19</sup> In addition, participants could request accelerated distributions from the 1994 Deferral Plan and the Expat Deferral Plan. Such distributions were subject to the consent of the "committee" provided for by the terms of the plan. Upon an accelerated distribution, participants were required to forfeit 10 percent of the elected distribution amount and also would not be eligible to participate in the plan for at least 36 months. The plans were presumably designed with these restrictions to avoid constructive receipt. This provision allowed employees to avoid current taxation while maintaining the ability to request distribution of deferrals at any time.

Under present law, a requirement of surrender or forfeiture of a valuable right is a sufficient restriction to preclude constructive receipt of income. The IRS has not explicitly authorized the use of forfeiture provisions (i.e., "haircuts") in nonqualified deferred compensation plans. Many nonqualified deferred compensation plans utilize a 10-percent forfeiture limitation (like that used by Enron) designed to prevent constructive receipt, based on the 10-percent early withdrawal tax applicable to distributions from qualified retirement plans and IRAs.<sup>20</sup> The Joint Committee staff understands that some employers utilize haircuts of less than 10 percent.

In the weeks preceding Enron's bankruptcy, participants began to request accelerated distributions of amounts deferred under Enron's deferral plan. As a practical matter, the 10-percent forfeiture provision and restriction on future deferrals did not appear to impose much of a deterrent for participants in requesting distributions. In total, 211 participants requested accelerated distributions.<sup>21</sup> Greg Whalley, the newly appointed sole member of the 1994 Deferral Plan Committee, had discretion whether or not to approve accelerated distribution requests from participants in the 1994 Deferral Plan. The Report outlines the process that Mr. Whalley stated that he used in making the determination of whether requests for early

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<sup>19</sup> Special purpose deferrals could be received as soon as three years following the deferral in a lump sum or up to five annual installments and were intended to assist with anticipated expenses.

<sup>20</sup> Sec. 72(f).

<sup>21</sup> Appendix D of the Report includes a chart of all accelerated distribution requests.

distributions should be approved. Under the process, the extent to which requests were granted depended upon the financial position of Enron at the time. In total, accelerated distributions totaling over \$53 million were made to approximately 127 individuals from October 30, 2001, through November 29, 2001.<sup>22</sup>

#### Participant-directed investment

Under the 1994 Deferral Plan and the Expat Deferral Plan, participants could choose to have their deferrals treated as if they had been invested in either of two types of investment accounts -- the Phantom Stock Account or the Flexible Deferral Account. Deferrals treated as invested in the Phantom Stock Account were treated as if the participant purchased shares of Enron Corp. common stock at the closing price on the date of deferral. Participants electing deferrals to be treated as invested in the Flexible Deferral Account were allowed to select investment funds, which in recent years mirrored those of the Enron Corp. Savings Plan, for the crediting of earnings to their account balances. For 2001, participants could allocate deferrals among 17 investment choices that mirrored funds available in the Enron Corp. Savings Plan. Daily changes in election choices within the Flexible Deferral Account were allowed. This allowed participants to direct how earnings on amounts deferred should be credited.

#### Subsequent elections

Distributions from the Enron deferral plans could be made upon the participant's retirement, disability, death or termination of employment.<sup>23</sup> Participants could elect to receive payments in a lump sum or in up to 15 annual installments. Participants in the 1994 Deferral Plan were allowed to change payout elections at any time subsequent to the initial deferral. Elections were effective one year after being received by Enron.

Allowing participants to make subsequent changes to payout elections gives them control over the amounts deferred. Nevertheless, courts have generally been lenient in applying the constructive receipt doctrine with respect to subsequent elections.

#### Rabbi trust

Enron established an irrevocable rabbi trust in connection with the 1994 Deferral Plan. Upon the establishment of the trust, 100 trust-owned life insurance ("TOLI") policies were purchased on the lives of 100 participants in the 1994 Deferral Plan. According to Enron, the assets of the trust were not intended to be sufficient to pay entirely for the nonqualified deferred compensation obligations under the 1994 Deferral Plan.<sup>24</sup> Distributions to participants were not

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<sup>22</sup> In the weeks preceding the bankruptcy, participants also made requests for hardship distributions. There were no hardship requests granted in 2001.

<sup>23</sup> As previously discussed, special purpose deferrals were also allowed.

<sup>24</sup> According to Enron, only initially did Enron direct investments in the rabbi trust to generally correspond with participant elections.

made from the trust, but were made from the general assets of Enron. According to Enron, as of October 28, 2002, the cash surrender value of the remaining insurance policies was \$25 million.

It appears that Enron may have intended the rabbi trust used in connection with the 1994 Deferral Plan to comply with the safe harbor requirements of Revenue Procedure 92-64.<sup>25</sup> It was certainly intended that the trust not result in current income taxation. Even if the trust were a valid rabbi trust when evaluated solely on the basis of the trust document, there is an issue as to whether other provisions under the 1994 Deferral Plan would cause the trust to be considered funded for tax purposes.

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

#### Deferral of stock option gains and restricted stock

Enron's deferral plans allowed for deferral of income attributable to stock options and restricted stock. Under the deferral of stock option gains program, participants could make an advance written election to defer the receipt of shares of Enron Corp. common stock from the exercise of a stock option granted under a stock plan sponsored by Enron, when such exercise was made by means of a stock swap using shares owned by the participant. Under the deferral of restricted stock program, participants could make an advance written election to defer the receipt of shares of Enron Corp. common stock to be released according to a grant of restricted shares under a stock plan sponsored by Enron Corp.

Although these types of programs may be commonly used, there are questions whether they should result in effective income deferral. There is no authority clearly addressing these deferral programs. The programs do not fit within the IRS ruling guidelines on the application of constructive receipt to nonqualified deferred compensation.<sup>26</sup> The favorable tax treatment is achieved by allowing employees to exchange a future right to receive property for an unfunded promise to pay. The Joint Committee staff believes that allowing individuals to control the timing of income inclusion in this way should not be allowed.

The deferral of stock option gains program can be viewed as a manipulation of the rules for deferred compensation and stock-for-stock exercise, which were not intended to be

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<sup>25</sup> Rev. Proc. 92-64, 1992-2 C.B. 422, *modified in part* by Notice 2000-56, 2000-2 C.B. 393.

<sup>26</sup> Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-33 I.R.B. 16.

combined, thus resulting in an unintended and inappropriate result for Federal income tax purposes. In the deferral of stock option gains, the election to defer could be made even after the options were vested. The fact that the favorable tax result on the deferral of stock option gains can only be achieved through a stock-for-stock exercise, rather than a cash exercise, suggests that there is a manipulation of rules in order to achieve the desired tax result.

## **Discussion and recommendations**

### **In general**

The experience with Enron demonstrates that the theoretical tension between an employer's interest in a current tax deduction and an employee's interest in deferring tax has little, if any, effect on the amount of compensation deferred by executives. In Enron's case, because of net operating loss carryovers, denial of the deduction did not have a significant impact on its current tax liability. Despite any possible effect on its tax deduction, Enron's deferred compensation arrangements allowed executives to defer millions of dollars in compensation that would otherwise be currently includible in income. The amount of compensation deferred by Enron's 200 highest-compensated employees increased significantly in the years prior to bankruptcy.

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

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

As previously discussed, there are no precise rules governing many aspects of nonqualified deferred compensation arrangements. As a result, taxpayers may design deferred compensation arrangements based on varying interpretations of authority that may not be strictly applicable to the situation in question. Under present law, a variety of practices have developed with respect to deferred compensation arrangements which are intended to achieve the desired tax deferral, while at the same time attempting to provide some sense of security to executives as well as some degree of flexibility regarding time of payment and other plan features. Many of the practices with respect to nonqualified deferred compensation have developed over time. However, since 1978, the IRS has been precluded from issuing guidance addressing many of

these issues. Thus, the IRS is at a disadvantage in responding to the growth and development of these arrangements. The IRS is unable to adequately address common deferral arrangements that are viewed by many as pushing the limits under present law.

While deferred compensation arrangements vary greatly, many of the plan features used by Enron are not uncommon. A recent article shows that the practice of providing security for amounts deferred is not uncommon.<sup>27</sup> Even though certain aspects of Enron's deferral plans may be within common practices, some issues may be raised with respect to whether they meet the requirements necessary to obtain the desired tax deferral. In addition, even if the present-law rules are satisfied, certain of the arrangements Enron maintained raise broader questions of whether they fall within the spirit of the present-law rules or whether they should, as a policy matter, result in tax deferral.

#### Specific recommendations

The Joint Committee staff believes that some changes to the present-law rules regarding the taxation of nonqualified deferred compensation are appropriate. The Joint Committee staff believes that such compensation should be includible in income no later than the time it is earned unless there is a substantial risk of forfeiture of the rights to the compensation. This rule would tax the income at a more appropriate time than under present-law rules in which, for example, an unfunded promise to pay, even if vested, is not currently taxable.

Because of the difficulty of identifying the precisely correct time to tax nonqualified deferred compensation and the potential hardship to the employee, one possible way to revise current law is to continue existing treatment of the employee but to make sure any income deferral is accompanied by a consequence to the employer that is commensurate with the benefit obtained by the employee. The consequence might arise, for example, regardless of the tax-loss status of the employer. Such an approach, however, would represent a significant change in the law.

In the alternative, specific rules should be provided to limit the circumstances under which compensation will continue to receive deferred treatment in the future. Rules should be developed to require current income inclusion in the case of plan features that give taxpayers inappropriate 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. These provisions give participants control over amounts deferred. The Joint Committee staff also believes that consideration should be given to whether rabbi trusts are appropriate for deferred compensation, or whether additional requirements should be imposed with respect to such trusts. In addition, the Joint Committee staff believes that the use of programs such as Enron's deferral of stock options gains and restricted stock programs should not be allowed.

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<sup>27</sup> See Theo Francis & Ellen E. Schultz, *As Workers Face Pension Cuts, Executives Get Rescued*, WALL ST. J., April 3, 2003, at C1.

The ability of Treasury to issue guidance on deferred compensation should not be restricted. The Joint Committee staff recommends the repeal of section 132 of the Revenue Act of 1978.<sup>28</sup> The restriction imposed by section 132 of the Revenue Act of 1978 has prevented Treasury from issuing more guidance on nonqualified deferred compensation and may have contributed to aggressive interpretations of present law. The existence of the moratorium on Treasury guidance puts Treasury in a disadvantaged position because it cannot respond adequately to forms of deferred compensation not contemplated prior to 1978. This has a chilling effect on the ability of Treasury to enforce the law in a consistent and effective way. Restricting Treasury guidance to the rules in effect more 25 years ago paralyzes Treasury to address current common practices that may be inconsistent with the law.

The Joint Committee staff believes that annual reporting of deferred amounts should be required to provide the IRS greater information regarding such arrangements.

## **2. Stock-based compensation**

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

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

Enron utilized various types of programs to provide its employees with compensation tied to the equity or long-term performance of the company. During the 1990s, Enron had two principal stock plans: the 1991 Stock Plan and the 1994 Stock Plan. In addition, the 1999 Stock Plan was used as a funding mechanism for the issuance of common stock in connection with special circumstances. The stock plans generally allowed awards to be made in stock options, restricted stock, phantom stock units, and in some cases, stock appreciation rights.<sup>29</sup>

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<sup>28</sup> The Joint Committee staff does not intend the repeal of section 132 to include the finalization of Proposed Treasury Regulation section 1.61-16, which section 132 was enacted to prevent.

<sup>29</sup> In addition to stock option grants under Enron's stock plans, Enron periodically made stock option grants to all employees to allow all employees to become shareholders of Enron.

In recent years, Enron used stock options and restricted stock as the long-term component of executive compensation. Stock-based compensation, and stock options in particular, was the principal form of compensation for many executives. The amount of compensation generated from such arrangements increased dramatically in the years immediately preceding the bankruptcy, particularly in 2000.

Table 6, below, shows Enron's deduction attributable to stock options for 1998 through 2000 on Enron's corporate tax returns.

**Table 6.—Enron Deduction Attributable to Stock Options (1998-2000)**

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

Table 7, below, shows the amount of compensation attributable to stock options for the 200 highest-compensated employees for 1998, 1999, and 2000.

**Table 7.—Compensation Attributable to Stock Options for the 200 Highest-Compensated Enron Employees (1998-2000)**

<b>Year</b>	<b>Amount of Compensation</b>
1998	\$61,978,000
1999	\$244,579,000
2000	\$1,063,567,000

Table 8, below, shows the compensation generated from the release, i.e., vesting, of restricted stock for the top-200 most highly paid Enron employees for 1998-2000.

**Table 8.—Compensation Attributable to the Vesting of Restricted Stock for Top-200 Most Highly Paid Enron Employees (1998-2000)**

<b>Year</b>	<b>Amount of Compensation</b>
1998	\$23,966,000
1999	\$21,943,000
2000	\$131,701,000

From a Federal tax perspective, Enron structured its stock-based compensation arrangements with an eye toward tax planning, sometimes from the point of view of Enron, sometimes from the point of view of the executive.

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These grants included the All-Employee Stock Option Program, Project 50, and EnronOptions-Your Stock Option Program. There was an all-employee stock option grant as recently as August 2001.



For example, Enron used nonqualified stock options, but did not use qualified stock options (i.e., incentive stock options and options granted under an employee stock purchase plan). The tax treatment of these two types of options differs for both the employer and the employee. In the case of a nonqualified option, the difference between the option price and the fair market value of the stock (i.e., the “spread”) is generally includible in income as compensation at the time the employee exercises the option. A corresponding compensation expense deduction equal to the amount of ordinary income included in the gross income of the employee is allowable to the employer. In the case of a qualified option, no income is includible in the gross income of the employee on either the grant or exercise of the option.<sup>30</sup> No compensation expense deduction is allowable to the employer with respect to the grant or exercise of a qualified stock option.

The difference in the employer’s deduction for qualified and nonqualified options is one factor in determining what type of option to grant. In the case of qualified options, the employer forgoes a deduction entirely. In the case of nonqualified options, compared to the payment of current compensation, the employer’s deduction is deferred until the option is exercised. The use of nonqualified stock options resulted in tax deductions for Enron that would not have been available if Enron had used qualified stock options. There may be other reasons Enron did not use qualified options, including the restrictions placed on those options under applicable Code requirements.

Enron also made use of techniques that benefited the executives from a tax perspective.<sup>31</sup> For example, the use of stock-for-stock exercises provided a more favorable tax result for the executive than would have resulted if the executive sold Enron stock and used the cash proceeds to exercise options. In addition, the stock option transfer program, which allowed the gifting of stock options to family members and certain other persons, was clearly an estate planning device and was described to employees as such. However, both of these programs appeared to operate in accordance with published IRS rulings. In these cases, Enron appeared to do little more than take advantage of tax planning opportunities provided by clear IRS authority.

The use of stock options by Enron brings renewed attention to discussions regarding the proper treatment of stock options for accounting purposes, and the difference between the treatment of options for tax and accounting purposes. Under APB 25, which Enron followed, no compensation cost is generally required to be recorded in financial statements for stock options issued to employees if the exercise price is equivalent to or greater than the market price on the grant date. FAS 123, the “preferred,” but optional, approach, would require stock option costs to

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<sup>30</sup> If a statutory holding period requirement is satisfied with respect to stock acquired through the exercise of a qualified stock option, the spread, and any additional appreciation, will be taxed as capital gain upon disposition of such stock.

<sup>31</sup> The materials provided in response to the Joint Committee staff’s general request for information regarding Enron compensation arrangements included documents describing a tax shelter technique purporting to defer inclusion of income upon the exercise of an employee’s stock options. It is not clear whether or not any Enron executives entered into a transaction of this type. Appendix D of the Report includes these materials.

be taken into account when options are granted, based on a determination of the value of the option.

Even if the FAS 123 approach is made mandatory, as currently being considered, because of the differences between accounting rules and tax rules, the amount shown on financial statements as a cost attributable to stock options, can be substantially less than a company's tax deduction for stock options. Accounting rules and tax rules have somewhat different purposes, and it may be appropriate for different rules to apply in order to achieve the differing purposes. Nevertheless, the sheer magnitude of the amount of corporate deductions and executive income generated by the exercise of stock options in some cases, such as Enron's, may appropriately focus attention on whether proxy disclosure rules and accounting rules are sufficient to properly inform shareholders.

While some argue that linking shareholder and executive success is beneficial for shareholders, conflicts may arise. Linking compensation of executives to the performance of the company can result in executives taking measures to increase short-term earnings instead of focusing on longer-term interests. 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. Although some executives suffered losses that appear stunning in amount, many executives also reaped substantial gains from their compensation arrangements.

### **3. Employee loans**

Enron did not have a general policy or program relating to executive loans. However, from time to time Enron extended loans to various executives. These loans were individually designed arrangements, and varied considerably. Most prominent among the loans was a noncollateralized, interest-bearing line of credit extended to Mr. Lay. The line of credit was originally set at \$4 million and was later increased to \$7.5 million. The aggregate amount withdrawn pursuant to this 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. The total amount of withdrawals for 2001 was \$77.525 million (of which all but \$7.5 million was repaid). During 1997 through 2001, Mr. Lay repaid principal amounts of \$99.3 million. Over \$94 million of this amount was repaid with 2.1 million shares of Enron stock. Mr. Lay's counsel told the Joint Committee staff that in 2001 Mr. Lay drew down on the Enron line of credit and then repaid it with stock principally because he needed funds to avoid or, if unavoidable, to pay margin calls on secured lines of credit Mr. Lay had established with certain banks and brokerage firms. These lines of credit were secured primarily by Enron stock, the price of which was falling.

The Joint Committee staff also reviewed loans to nine other persons, including loans to Mr. Skilling. These loans ranged in amount from \$200,000 to \$4 million, and generally accrued interest at the applicable Federal rate. In two cases, loan agreements provided that the loan would be forgiven if the executive stayed with Enron for a certain period of time. 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.

Certain of the loan arrangements, particularly those that provided that the loan would be forgiven if the executive worked for Enron for a certain period of time, raise questions as to whether the arrangements were in fact the payment of compensation rather than a real loan. The loan transactions raise corporate governance issues of whether corporate funds were in essence being used for personal purposes.

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

#### **4. Split-dollar life insurance arrangements**

##### **Introduction**

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

Split-dollar life insurance arrangements have been used for several purposes. A principal use has been by employers to provide low-cost life insurance benefits or to provide funds for other compensatory benefits (such as nonqualified deferred compensation) for employees on a tax-favored basis.

##### **Enron’s split dollar life insurance arrangements**

Enron entered into split-dollar life insurance arrangements with three of its top management: Mr. Lay (two arrangements, for \$30 million and \$11.9 million); Mr. Skilling (\$8 million), and John Clifford Baxter (\$5 million). The specific details of these split-dollar arrangements are discussed in the Report.

Another split-dollar life insurance agreement with Mr. Lay for \$12.75 million of life insurance coverage was later approved by the Compensation Committee of the Board of Directors on May 3, 1999, at Mr. Lay’s request. Although Enron purchased the life insurance contract in 2000, Enron and Mr. Lay did not enter into the split-dollar arrangement.

##### **Discussion and recommendation**

Enron’s split-dollar life insurance arrangements with Mr. Lay, Mr. Skilling, and Mr. Baxter were entered into between 1994 and 2000, before the issuance of the series of recent IRS guidance starting with Notice 2001-10 in January, 2001. Under the limited guidance issued by the IRS prior to Notice 2001-10,<sup>32</sup> the cost of current term insurance protection would have been

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<sup>32</sup> In the 1960s, the IRS published rulings providing that the amount includible in an employee’s income under a split-dollar insurance arrangement is the cost of current term

includible in income of the owner of the life insurance contract (less the amount paid by the owner). The value of the current term insurance protection was determined by reference to a table (P.S. 58) based on the age of the insured. This guidance would not affect the tax treatment of an employer that enters into a split-dollar arrangement; thus, Enron would not be permitted to deduct the premiums.<sup>33</sup>

In January 2001, the IRS issued Notice 2001-10.<sup>34</sup> It provided interim guidance for the tax treatment of split-dollar life insurance, including types of split-dollar life insurance arrangements between an employer and employee in which the employee has an interest in the cash value of the contract (equity split-dollar arrangements) that were not addressed by the limited earlier guidance. The Notice provided that split-dollar arrangements would be subject to tax under either a loan approach or an economic benefit approach. Notice 2001-10 provided a new table, Table 2001, to replace the P.S. 58 table for valuing the cost of current life insurance protection.

A year after Notice 2001-10 was issued, it was revoked by Notice 2002-8.<sup>35</sup> Notice 2002-8, however, provides interim guidance applying the general concepts of the earlier Notice, and provides that Table 2001 generally applies for valuation purposes for arrangements entered into after January 28, 2002 (the date Notice 2002-8 was issued).

The IRS issued proposed regulations on split-dollar life insurance arrangements on July 5, 2002.<sup>36</sup> The proposed regulations provide guidance on the income, employment, and gift tax treatment of split-dollar life insurance arrangements. Somewhat like the earlier notices, the proposed regulations generally provide two mutually exclusive regimes for taxing split-dollar arrangements, one taking an economic benefit approach,<sup>37</sup> and the other applying loan treatment.<sup>38</sup>

Under the economic benefit approach of the proposed regulations, the value of economic benefits under the life insurance contract is treated as being transferred from the contract owner

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insurance protection (less the amount, if any, paid by the employee). Any policyholder dividends paid to, or benefiting, the employee are also includible in income. Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12.

<sup>33</sup> Sec. 264; *see* the Report at note 2146.

<sup>34</sup> 2001-5 I.R.B. 459.

<sup>35</sup> 2002-4 I.R.B. 398.

<sup>36</sup> REG-164754-0, July 5, 2002. Regulations are proposed under Code sections 61, 83, 301, 1402, 7872, 3121, 3231, 3306, and 3401.

<sup>37</sup> Sec. 61.

<sup>38</sup> Sec. 7872 (or secs. 1271-1275, if the loan is not below-market).

to the nonowner (reduced by any consideration paid by the nonowner to the owner). The tax consequence of the transfer depends on the relationship of the owner and nonowner;<sup>39</sup> in the employment context, the transfer is regarded as compensation for services.

Under the loan approach of the proposed regulations, the owner and nonowner are treated as borrower and lender, respectively, if the nonowner (e.g., employer) paying premiums is reasonably expected to be repaid from the contract's cash value or death benefits. If the loan does not provide sufficient interest, then interest is imputed under the rules of section 7872. In general, such interest is not deductible by the borrower, but is includible in the income of the deemed lender (generally, the employee) in the arrangement.

Until the issuance of Notice 2001-10 in 2001, the IRS had issued very little guidance on split-dollar life insurance since the 1960s. During this period, the use of split-dollar life insurance became more widespread, and variations on the product proliferated. In the absence of guidance, some taxpayers may have taken a variety of positions as to the includibility in income of benefits under the arrangements, and as to the timing or amount of items that are includible. From a tax policy perspective, taxpayers' failure to include in income the appropriate value of an economic benefit received by an employee from an employer indicates a need for guidance as to the proper tax treatment of split-dollar life insurance arrangements.

Under the recent interim guidance published by the IRS relating to split-dollar life insurance arrangements, the economic benefit received in a split-dollar life insurance arrangement is treated more like other economic benefits received by employees. This recent interim guidance specifies the tax treatment in greater detail than previously in an area in which practices that may not accurately measure income had become increasingly common.

Requiring taxpayers to include in income the economic value of the benefit received in a split-dollar life insurance arrangement (or to treat the arrangement as a loan, if that treatment reflects the nature of the transaction) is consistent with the goal of the income tax system to accurately measure income. The Notices and proposed regulations generally serve the tax policy goal of improving accurate income measurement in the case of split-dollar life insurance arrangements. The Joint Committee staff recommends that the pending guidance relating to split-dollar life insurance should be finalized.

## **5. Limitation on deduction of certain executive compensation in excess of \$1 million**

### **Present law**

Present law generally allows a deduction for ordinary and necessary business expenses, including a reasonable allowance for salaries and other compensation for personal services actually rendered. However, compensation in excess of \$1 million paid by a publicly held company to the company's "covered employees" generally is not deductible.<sup>40</sup> Covered

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<sup>39</sup> For example, depending on the relationship, the arrangement may be a payment of compensation, dividend distribution under section 301, gift under the gift tax rules, or other transfer. Prop. Treas. Reg. sec. 1.61-22(d)(1).

<sup>40</sup> Sec. 162(m).

employees are the chief executive officer and the four other most highly compensated employees of the company as reported in the company's proxy statement.

Subject to certain exceptions, the deduction limitation applies to all otherwise deductible compensation of a covered employee for a taxable year, regardless of the form in which the compensation is paid and regardless of when the compensation was earned. The deduction limitation applies when the deduction would otherwise be taken. For example, in the case of a nonqualified stock option, the deduction is normally taken in the year in which the option is exercised, even though the option was granted with respect to services performed in a prior year.

Certain types of compensation are not subject to the deduction limitation. With respect to compensation paid to Enron executives, the most relevant exception is for performance-based compensation. In general, performance-based compensation is compensation payable solely on account of the attainment of one or more performance goals with and respect to which certain requirements are satisfied, including a shareholder approval requirement.

### **Discussion and recommendation**

Based on the review of Enron's compensation arrangements, the Joint Committee staff found that the \$1 million limitation on the deductibility of certain executive compensation did not appear to have had a substantial impact on either the amount of compensation paid by Enron or the structure of its compensation arrangements.

Table 9, below, shows total compensation, performance-based compensation, additional deductible compensation, and nondeductible compensation for 1998 through 2000.

**Table 9—Application of \$1 Million Deduction Limitation for 1998-2000**  
(Millions of Dollars)

<b>Year</b>	<b>(1) Total Compensation of Covered Employees</b>	<b>(2) Performance- Based Compensation</b>	<b>(3) Additional Deductible Compensation**</b>	<b>(4) Nondeductible Compensation</b>
1998	48.5	20.9	4.0	23.6
1999	124.2	111.6	4.2	8.4
2000	260.9	241.0	3.5	16.5
<b>Total 1998-2000*</b>	433.6	373.5	11.7	48.5

\* Details may not add to totals due to rounding.

\*\*Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of \$1 million.

The existence of the \$1 million deduction limitation does not appear to have had any effect on the total compensation provided to Enron executives. Based on information provided

by Enron to the IRS, as shown in Table 9, above, total compensation for the top-five executives for 1998-2000 was \$433.6 million.<sup>41</sup>

Enron intended certain of its compensation arrangements to qualify as performance-based for purposes of the deduction limitation,<sup>42</sup> and treated substantial amounts of compensation as meeting this requirement. Based on information provided by Enron to the IRS, as shown in Table 9 above, performance-based compensation for 1999 and 2000 was comparable, 90 percent and 92 percent, respectively of total compensation. In those years, seven percent and six percent, respectively, of total compensation of covered employees was not deductible. In the case of certain executives, the amount of performance-based compensation was so great compared to total compensation that less than \$1 million of compensation was potentially subject to the deduction cap.

For 1998, however, performance-based compensation was only 43 percent of total compensation of covered employees, and 49 percent of the total compensation of covered employees was not deductible because of the \$1 million deduction limit. This is due in large part to the compensation provided to two covered employees. The nondeductible compensation for those two employees was 82 percent of the total nondeductible compensation of all five covered employees. Seventy-six percent of the total compensation for those two employees was not deductible.

Although Enron treated substantial amounts of compensation as performance-based, the \$1 million deduction limitation does not appear to have had a significant impact on the overall structure of Enron's compensation arrangements. The arrangements that Enron considered to provide performance-based compensation were generally utilized prior to the enactment of the deduction limitation. Enron made certain modifications to its compensation arrangements in order to meet the Code's definition of performance-based compensation; however, these modifications were generally limited to relatively minor changes needed to meet the requirements rather than changes to the overall structure of its compensation arrangements. For example, in the case of bonuses, the Compensation Committee was advised by its outside consultants to establish a high enough "soft" target that could be approved by the shareholders so that whatever level of bonuses Enron ultimately paid would be within the target and thus would not fail to be performance based. It is possible that certain arrangements might not have been submitted for shareholder approval had this not been required in order to meet the requirements for performance-based compensation.

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<sup>41</sup> Enron also paid compensation in excess of \$1 million to many employees not subject to the deduction limitation. The information regarding the top-200 most highly compensated employees provided by Enron to the Joint Committee staff indicates that 46 employees, 93 employees, and all 200 top-paid employees received compensation in excess of \$1 million in 1998, 1999, 2000, and 2001, respectively.

<sup>42</sup> Enron submitted three plans for shareholder approval in order to meet the requirements of the exception for performance-based compensation: the 1991 Stock Plan, the Performance Unite Plan, and the Annual Incentive Plan.

The Compensation Committee was required to take certain actions in order for compensation to qualify as performance-based. A review of the Compensation Committee minutes indicates that the deduction limitation was discussed from time to time, and the role of the Compensation Committee with respect to approval of performance targets was mentioned. In addition, the annual report of the Compensation Committee in proxy statements discussed the deduction limitation. While the deduction limitation was discussed in Compensation Committee meetings, it appears that more time was spent on broader compensation issues, such as overall compensation targets. One former member of the Compensation Committee interviewed by the Joint Committee staff indicated he had no knowledge of the deduction limitation and did not remember it ever being discussed. This may be an indication that the limitation was not a significant concern for Enron.

The existence of the \$1 million deduction limitation did not prevent Enron from paying nondeductible compensation. From 1998 through 2001, \$48.5 million of nondeductible compensation was paid to covered employees.

Another aspect of the deduction limitation that can be observed from the review of Enron is the discrepancy between the operation of the limitation, which is based on generally applicable tax rules, and compensation as reported in Federal proxy statements. Proxy statements include a summary compensation table for covered employees (referred to as “named officers” under the securities laws) as well as other information regarding executive compensation. Because of timing differences and other factors, compensation as reported for proxy purposes can vary significantly from compensation subject to the \$1 million deduction limitation. The difference in the treatment may cause confusion for persons who are attempting to determine the amount of nondeductible compensation from publicly available sources; it is not possible to make this determination based on proxy information.

The determination of whether a corporation has properly applied the \$1 million dollar deduction can involve a time consuming, labor intensive process. In Enron’s case, the IRS review of the application of the \$1 million deduction involves extensive factual review and determinations, including a review of terms of numerous plans and individual employment contracts, examining materials submitted to shareholders, and the need to reconcile a number of inconsistencies in information.

The Joint Committee staff believes that, in Enron’s case, the \$1 million deduction limitation was ineffective at accomplishing its purpose. The Enron experience raises serious doubts about the effectiveness of the \$1 million deduction limitation. If this experience is widespread among public companies, the Congress should consider repealing the rule. The concerns reflected in the limitation can be better addressed through laws other than the Federal tax laws.

The \$1 million deduction limitation reflects corporate governance issues regarding excessive compensation, rather than issues of tax policy.<sup>43</sup> It is often difficult for tax laws to

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<sup>43</sup> H.R. Rep. No. 103-111, at 646 (1993).



have the desired effect on corporate behavior.<sup>44</sup> Taxpayers may simply choose to incur the adverse tax consequences rather than change their behavior. In Enron's case, due to the existence of net operating losses, the denial of the deduction may not have been an issue.

In Enron's case, the \$1 million deduction limitation appeared to have little, if any, effect on the overall level of compensation paid to Enron executives or the structure of Enron's compensation arrangements. To the extent that performance-based compensation is viewed as being a preferable form of compensation, some may argue that the \$1 million limitation was effective in the Enron case, because such a large part of compensation was structured to be performance-based. However, as noted above, the deduction limitation did not appear to be a motivating factor in the structure of Enron's compensation and the arrangements that it treated as performance-based (or similar arrangements) generally predated the enacted of the limitation. In addition, some may question whether the compensation was truly performance based, particularly given Enron's financial decline; to the extent the limitation affected Enron's compensation arrangements, it may have merely placed more emphasis on the desire to increase reported earnings.

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<sup>44</sup> Another example of tax laws that are aimed at corporate governance issues are the golden parachute rules that limit the compensation that may be paid to certain employees due to the change of control of a company. Sec. 280G. Failure to comply with these rules results in a denial of the deduction to the company and the imposition of a 20 percent excise tax, payable by the employee. Sec. 4999. Commentators generally observe that the golden parachute rules have done little to affect the amount of compensation payable upon a change of control. Rather, the rules are often thought of as providing a road map as to how to structure compensation arrangements. It is not uncommon for employment agreements to provide that, in the event the employee is subject to the excise tax, the tax will be paid by the company, with a gross up to reflect the income tax payable as a result of the employer's payment of the tax.

### III. COMPANY-OWNED AND TRUST-OWNED LIFE INSURANCE

Enron implemented company-owned life insurance (“COLI”) and trust-owned life insurance (“TOLI”) programs. COLI generally has been the subject of considerable publicity due to its Federal income tax and financial accounting benefits,<sup>45</sup> and Congress has sought to limit its use as a tax arbitrage mechanism in Federal tax legislation since the 1940’s.

#### Enron’s COLI and TOLI transactions

During the 1980’s and early 1990’s, Enron bought approximately 1,000 life insurance contracts covering employees. Approximately \$178 million had been borrowed under these life insurance contracts at the end of 1994, after which Enron stopped purchasing life insurance contracts covering employees. Approximately half of Enron’s life insurance contracts covering employees (including a group of 201 contracts purchased June 1, 1986) were purchased before June 20, 1986, the effective date of 1986 legislation limiting the tax deduction for interest on debt under a life insurance contract. A 1999 summary by Clark-Bardes showed that interest rates charged on loans under some of the contracts -- those issued by Massachusetts Mutual and Great West -- ranged from 6.75 percent to 11.75 percent during the period 1983 - 1999. As the cash surrender value of the contracts increased, Enron continued to borrow under the contracts. The summary states, “Enron’s policy blocks retain 100% loan interest deductibility under current legislation; this deductibility is a commodity that is no longer available in the insurance marketplace.” By late 2001, the amount borrowed under Enron’s life insurance contracts had grown to approximately \$432 million.

Portland General Electric, an Enron subsidiary acquired in 1997, also owned life insurance contracts covering its employees. As of 1999, Portland General Electric had approximately \$79 million worth of such life insurance contracts, and its affiliates owned approximately \$59 million worth. Policies covering a total of 2,315 Portland General Electric employees were purchased between 1996 and 1999.

Following Enron’s bankruptcy filing, Enron surrendered its life insurance contracts during 2002. Portland General Electric’s life insurance contracts were in the process of being surrendered as of early 2003.

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<sup>45</sup> See, e.g., Francis, *Bill Seeks Disclosure on Insuring Employees*, Wall St. J., Feb. 5, 2003; Francis, *Insurance Disclosure of S&Ls May Change*, Wall St. J., Jan. 27, 2003; Gettlin, *Tax-Free Earnings: A Life-And-Death Issue*, National J., Oct 26, 2002, at 3140; Clark, *Better off dead?*, U.S. News & World Report, May 6, 2002, at 32; Schultz and Francis, *The Economy: Senator to Target Tax Boon to Firms Insuring Workers*, Wall St. J., May 3, 2002; Francis and Schultz, *Big Banks Quietly Pile Up 'Janitors' Insurance*, Wall St. J., May 2, 2002; Francis and Schultz, *Many Banks Boost Earnings with 'Janitors' Life Insurance*, Wall St. J., April 26, 2002; Francis and Schultz, *Why Secret Insurance on Employees Pays Off*, Wall St. J., April 25, 2002; Schultz and Francis, *Why Are Workers in Dark? Most States Don't Force Firms To Disclose 'Janitors' Insurance, But Congress May Change That*, Wall St. J., April 24, 2002; Schultz and Francis, *Valued Employees: Worker Dies, Firm Profits*, Wall St. J., April 19, 2002.

## Discussion

### Tax arbitrage

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract<sup>46</sup> (“inside buildup”).<sup>47</sup> Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.<sup>48</sup> Because of the nontaxation of inside buildup, life insurance contracts provide an opportunity for tax arbitrage.

Borrowing by a business with respect to a life insurance contract is attractive because the earnings under the policy (i.e., inside buildup) increase tax-free. The loans permit the borrower to have the current use of income that has not been taxed. If the business borrows directly under the policy it owns, interest paid by the borrower is credited to the policy; the effect is equivalent to paying interest to itself. The amount of the loan reduces the death benefit when the insured person dies, if the loan has not yet been repaid; however, this is not a disadvantage to the borrower if another person (such as an employee’s spouse) is the recipient of the death benefit. A further advantage of borrowing with respect to a life insurance policy arises to the extent the interest on the policy loan is deductible. Although 1996 legislation limited the interest deduction on debt under a life insurance, annuity or endowment contract, and 1997 legislation imposed a pro rata interest deduction limitation on debt allocable to unborrowed policy cash values of a life insurance, annuity or endowment contract, tax arbitrage opportunities related to the nontaxation of inside buildup remain under exceptions to the 1997 legislation.

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<sup>46</sup> By contrast to the treatment of life insurance contracts, if an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

<sup>47</sup> This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory “7-pay” test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

<sup>48</sup> Sec. 101(a).

### COLI legislation

Provisions of tax legislation designed to limit the tax arbitrage of deducting interest on borrowings with respect to a life insurance contract date to the 1940's.<sup>49</sup> The deductibility of interest on borrowings that relate to life insurance contracts has been limited most recently by Federal tax legislation in 1986, 1996, and 1997.

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

A pattern then developed of businesses insuring the lives of thousands of their employees to increase the amount of interest to deduct on borrowings under the contracts.<sup>51</sup> In 1996, a broader limitation on deductibility of interest on debt under a life insurance contract was enacted, generally replacing the \$50,000 cap. That rule provided that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance, annuity or endowment contracts owned by the taxpayer, and covering the life of any individual who is or has been (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer.<sup>52</sup> A key person insurance exception was provided. The 1996 legislation applied generally to interest paid or accrued after October 13, 1995, with a phase-in rule. However, the grandfather rule for pre-June 20, 1986, contracts was preserved, with a new interest rate cap based on a Moody's rate.<sup>53</sup>

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<sup>49</sup> Section 129 of the Revenue Act of 1942 (Pub. L. No. 753, 77th Cong., 56 Stat. 798) added Internal Revenue Code section 24(a)(6), which provided that no deduction was allowed for "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract."

<sup>50</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 579. See Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 100 Stat. 2388 (1986).

<sup>51</sup> See Lee Sheppard, "'Janitors' Insurance as a Tax Shelter," *Tax Notes*, Sept. 25, 1995, p. 1526.

<sup>52</sup> Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104<sup>th</sup> Congress* (JCS-12-96), Dec. 18, 1996, p. 365. See Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, sec. 510, 110 Stat. 2090 (1996).

<sup>53</sup> Sec. 264(e)(2).

The interest deduction limitation was further expanded in 1997 when Congress became aware of the practice of businesses insuring the lives of customers or debtors (for example, financial institutions insuring the lives of mortgage borrowers while borrowing under the life insurance policies, or maintaining other debt, and deducting the interest thereon).<sup>54</sup> The 1997 legislation provided that no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual. It also provided that, for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of a life insurance, annuity or endowment contract. An exception is provided under this proration rule for contracts that cover an individual who is a 20-percent owner, officer, director or employee of the taxpayer's trade or business.<sup>55</sup> The pro rata interest deduction limitation applied generally to contracts issued after June 8, 1997. Thus, the phase-in rule under the effective date of the 1996 legislation, and the grandfather rule under the 1986 and 1996 legislation for contracts purchased on or before June 20, 1986, were not affected.

#### Judicial decisions relating to COLI

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

The case of *Winn-Dixie Stores, Inc. v. Commissioner*<sup>56</sup> involved the application of the sham transaction doctrine. In 1993, Winn-Dixie entered into a COLI program on the lives of its 36,000 employees. Under the program, Winn-Dixie purchased whole-life insurance policies and was the sole beneficiary. Winn-Dixie borrowed periodically against the policies' account value at interest rates that averaged 11 percent. The 11-percent average interest rate, when coupled with the administrative fees, outweighed the net cash surrender value and benefits paid on the policy. Thus, although Winn-Dixie lost money on the program each year, the tax deductibility of the interest and fees yielded a benefit of several billion dollars over 60 years. In 1997, Winn-Dixie terminated its participation in the COLI program following the enactment of tax law changes in 1996 that limited the deductibility of interest on COLI policy loans. On audit, the IRS

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<sup>54</sup> See "Fannie Mae Designing a Program to Link Life Insurance, Loans," *Washington Post*, Feb. 8, 1997, p. E3; "Fannie Mae Considers Whether to Bestow Mortgage Insurance," *Wall St. Journal*, April 22, 1997, at C1.

<sup>55</sup> This proration rule applies to policies issues after June 8, 1997. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 111 Stat. 951 (1997), and see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), Dec. 17, 1997, p. 272.

<sup>56</sup> *Winn-Dixie*, 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11<sup>th</sup> Cir. 2001), *cert. denied*, April 15, 2002.

disallowed the deductions for interest and administrative fees that Winn-Dixie claimed on its 1993 tax return with respect to its COLI program and COLI policy loans.

On petition to the Tax Court, Winn-Dixie argued that the deductions relating to its COLI program were proper because: (1) the COLI program satisfied the business purpose and economic substance prongs of the sham transaction doctrine and (2) in any case, the sham transaction doctrine was inapplicable because Congress explicitly authorized the deductions in connection with the COLI program. However, the Tax Court sustained the IRS disallowance of the COLI-related deductions claimed by Winn-Dixie, concluding that the COLI program (including the associated policy loans) was a sham.

Other recent cases have also upheld the disallowance by the IRS of deductions for interest relating to COLI programs. In *Internal Revenue Service v. CM Holdings, Inc.*,<sup>57</sup> Camelot Music had purchased COLI policies in 1990 covering the lives of 1,430 employees. Camelot borrowed under the policies to pay the first three annual premiums and sought to deduct the interest on the borrowings. Camelot subsequently filed a petition under chapter 11 of the Bankruptcy Code, and the IRS filed proofs of claim based on disallowance of the interest deductions. The District Court held that the interest deductions should be disallowed, and also concluded that the application of accuracy-related penalties was appropriate. The court stated that there were two rationales for the interest deduction disallowance. First, the interest deductions were part of a transaction that was in part a factual sham and therefore did not meet the "4-out-of-7" exception to the interest deduction disallowance rule of Code section 264(a)(3). In addition, the COLI plan lacked economic substance and business purpose, and was a sham in substance.<sup>58</sup> On appeal, the Third Circuit affirmed, "based on the . . . reasoning, that the COLI policies lacked economic substance and therefore were economic shams."<sup>59</sup> The Appellate Court also affirmed the assessment of penalties.

In *American Electric Power, Inc. v. U.S.*,<sup>60</sup> the District Court concluded that interest deductions on policy loans under a COLI program covering the lives of over 20,000 employees should be disallowed. The court concluded that the "plan as a whole was a sham in substance,"<sup>61</sup> as well as concluding that first-year policy loans, and the first-year and fourth-through seventh-year loading dividends and corresponding portions of the premiums, were factual shams. The court stated that it had "independently reached many of the same conclusions as the [District]

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<sup>57</sup> *Internal Revenue Service v. CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000).

<sup>58</sup> *Id.* at 583, 654.

<sup>59</sup> *IRS v. CM Holdings, Inc. (In Re: CM Holdings, Inc.)*, 301 F.3d 96 (3d Cir. 2002), at 96.

<sup>60</sup> *American Electric Power, Inc. v. U.S.*, 136 F.Supp. 2d 762 (S. D. Ohio 2001).

<sup>61</sup> *Id.* at 795.

court in *C.M. Holdings*," and that the policies in that case were in all relevant respects identical to those involved in this case.<sup>62</sup>

In another recent District Court case, however, *Dow Chemical Company v. U.S.*,<sup>63</sup> involving two groups of COLI policies (one group of policies covering 4,051 employees and the other covering 17,061 employees), the court held that the IRS improperly disallowed Dow's deductions for interest and expenses in connection with the COLI plans. Although the court held that partial withdrawals under the policies to pay premiums in the fourth through seventh years "were not real and constituted shams in fact,"<sup>64</sup> the court determined that "the policy loans were real transactions consistent with commercial norms, and therefore were not factual shams."<sup>65</sup> The court concluded that Dow's COLI plans were "imbued with economic substance."<sup>66</sup>

#### Enron's grandfathered contracts

Enron's COLI and TOLI arrangements were leveraged, showing approximately \$432 million of debt on \$512 million of life insurance coverage by November, 2001. The purchase of these contracts predated the 1996 and 1997 legislation limiting interest deductions under life insurance contracts and imposing a pro rata reduction on interest deductions in the case of taxpayers that have life insurance contracts but do not borrow directly under the contracts.

The grandfather rule under the 1986 COLI legislation would apply to those contracts Enron purchased on or before June 20, 1986. Under this grandfather rule, neither the 1986 \$50,000 per-contract cap on debt, nor the broader 1996 rule disallowing interest on debt under a life insurance contract, applied to contracts Enron purchased on or before June 20, 1986 (although for interest incurred after the 1996 legislation, those contracts were subject to an interest rate cap based on a Moody's rate relating to corporate bond yields).

This grandfather rule continues in effect, allowing the continued deduction of interest on debt under contracts that were purchased on or before June 20, 1986. As years pass from the 1986 date, the value of this tax treatment increases with the growth of the cash surrender value of the grandfathered contracts (assuming they are not treated as materially changed or otherwise ceasing to be pre-June 20, 1986, contracts). This result could be viewed as inconsistent with Congress' repeated legislation limiting interest deductions with respect to life insurance contracts.

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<sup>62</sup> *Id.* at 769.

<sup>63</sup> Case No. 00-10331-BC, E. D. Mich., Mar. 31, 2003. The court stated that many of the issues in the case were "thoroughly litigated" in the *Winn-Dixie*, *CM Holdings*, and *American Electric Power* cases, *supra*. *Dow Chemical* at 3. The court in *Dow Chemical* reached different conclusions on many of the issues, however.

<sup>64</sup> *Id.* at 139.

<sup>65</sup> *Id.* at 138.

<sup>66</sup> *Id.*

## **Recommendations**

The Joint Committee staff recommends termination of the grandfather rule for pre-June 20, 1986, COLI contracts. Even though Enron did not purchase any additional life insurance contracts after 1994, Enron's debt and deductible interest under life insurance contracts continued to increase throughout the 1980s and 1990s (along with the cash surrender value of the contracts). This result is inconsistent with the legislative limitations imposed by Congress in 1986, 1996, and 1997 on interest associated with the tax-free inside buildup of life insurance contracts. If the 1986 grandfather rule was intended to provide transition relief to businesses that had purchased life insurance contracts before the 1986 date, sufficient time has passed that a redeployment of such businesses' assets could have been possible. The grandfather rule can no longer serve any reasonable need for transition relief.

Although the COLI transactions in which Enron engaged suggest repeal of the grandfather rule for such contracts, there may be other issues relating to COLI that arise from other corporations' practices with respect to ownership of life insurance. Tax arbitrage opportunities that arise in such contexts may suggest other legislative responses.



#### IV. CONCLUSIONS

Some of the issues examined by the Joint Committee staff with respect to Enron's compensation arrangements raise nontax issues, such as issues of corporate governance, which would be better addressed outside of the tax laws. With respect to tax-related issues, as discussed above, the Joint Committee staff finds it appropriate to make the following recommendations:

- Changes should be made to the rules relating to nonqualified deferred compensation arrangements to curb current practices that allow for the deferral of tax on compensation income while providing executives with inappropriate levels of security, control, and flexibility with respect to deferred compensation. These changes include providing that certain plan features result in current taxation, including the ability to obtain accelerated distributions, direct investments, and make subsequent elections. In addition, the Joint Committee staff believes that the use of programs such as Enron's deferral of stock options gains and restricted stock programs should not be allowed. The ability of the Treasury to issue guidance with respect to deferred compensation should not be restricted. Reporting of deferred compensation amounts should also be required;
- Guidance relating to split-dollar life insurance should be finalized;
- Congress should consider whether the limitation on the deduction for compensation in excess of \$1 million should be repealed; and
- With respect to company-owned life insurance, the Joint Committee staff recommends termination of the grandfather rule with respect to interest deductions that is applicable to pre-June 20, 1986, contracts.

The Joint Committee staff notes that there were executive compensation provisions included in the National Employee Savings and Trust Equity Guarantee Act ("NESTEG"), approved by the Finance Committee on July 11, 2002. The provisions included:

- Section 501 of the bill, which repealed the limitation on Treasury guidance regarding nonqualified deferred compensation;
- Section 502 of the bill, which taxed deferred compensation provided through offshore trusts;
- Section 503 of the bill, which treated certain loans as compensation; and
- Section 504 of the bill, which required wage withholding at the top marginal rate for supplemental wages in excess of \$1 million.

The Joint Committee staff recommendation to repeal section 132 of the Revenue Act of 1978 was included in section 501 of the bill. In addition, section 502 of the bill provides current taxation of deferred compensation provided through offshore trusts. The Joint Committee staff

supports this provision, but notes that it would have no direct effect on Enron, as the Joint Committee staff found no evidence that Enron provided assets through an offshore trust. As announced by Senator Grassley, section 503 of the bill, which would treat certain loans as compensation has been mooted by the Sarbanes-Oxley Act. In addition to the executive compensation provisions included in NESTEG, additional steps beyond those contained in NESTEG should be taken to curb the use of certain executive compensation arrangements.