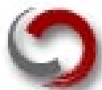
CORPORATE TAX BULLETIN



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Calls for Tax Law Changes in the Wake of Enron

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Introduction

On February 13, 2003, following an extensive investigation of Enron Corp. and its affiliates, the Joint Committee on Taxation released a multi-volume official report, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations,* prepared at the request of the Senate Finance Committee. In general, the report focused on (i) Enron's aggressive use of numerous tax-motivated structured finance transactions, (ii) its lavish executive compensation arrangements and (iii) problems associated with its broad-based qualified retirement plans. In response to the perceived abuses identified in the report, the Joint Committee recommended a number of changes to the tax law that would, if enacted, have potentially far-reaching consequences for many types of very common tax planning techniques.

In response to the Joint Committee's Enron report, and clearly frustrated by the perception that the report identified abuses that were widespread and not merely unique to Enron, Senate Finance Committee Chairman Grassley and Ranking Member Senator Baucus pledged to enact legislation that would shut down these tax-avoiding and earnings-inflating transactions. Furthermore, in order to discourage taxpayers from using the report as a "road map" for creating their own abusive transactions pending the expected change in law, Senators Grassley and Baucus promised that any remedial legislation would be retroactive to February 13, 2003 (even if such legislation ultimately takes several years to enact).

While Enron clearly appears to have engaged in extremely complex and (in some cases arguably improper) cutting-edge tax planning, the Joint Committee recommendations, if enacted, would almost certainly have a fundamental impact on the way taxpayers would be required to approach the tax planning relating to many common transactions. This bulletin identifies a number of the Joint Committee's legislative proposals that would prohibit a number of well-known and commonly used structured transactions and compensation arrangements. As described in further detail below, these proposals include requests for new legislation designed to create more transparency in corporate and partnership transactions, eliminate tax-motivated transactions that arguably satisfy the technical requirements of current law but lack a legitimate business purpose, and change the rules relating to nonqualified deferred compensation arrangements in an effort to eliminate practices that allow for the inappropriate deferral of tax on executive compensation.

Legislative Change Recommendations to Address Perceived Areas of Abuse

Some of the specific recommendations included in the Joint Committee report are as follows:

- *Strengthened Business Purpose Requirements.* In general, a transaction must have a non-tax business purpose in order to be respected for tax purposes. This business purpose requirement would be strengthened by making it clear that the enhancement of GAAP earnings based solely on a federal income tax savings would not be considered a valid business purpose.
- *Penalties.* Substantially increased penalties would be imposed on taxpayers engaging in illegitimate tax-motivated transactions, including transactions in which related parties (*e.g.*, employees, consultants or advisors) serve as accommodation parties.

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- *Additional Disclosure Requirements.* "Tax-motivated" transactions would have to be disclosed on a timely basis, regardless of whether they have any immediate tax effect.
- *Loss Duplication Transactions.* The rules relating to tax-free transfers to controlled corporations would be modified to prevent taxpayers from being able, in some limited situations, to duplicate losses. This change would be accomplished by limiting a corporation's basis in property acquired in a tax-free reorganization to such property's fair market value.
- *Tax-Motivated Equity Acquisitions.* While existing law disallows certain tax benefits if a taxpayer acquires direct or indirect control of a corporation for the principal purpose of tax evasion or avoidance, these rules would be expanded to cover the acquisition of non-controlling equity interests as well. Given the lack of clear standards as to what constitutes "tax evasion or avoidance" under current law, this proposed expansion could create significant tax risk for many seemingly routine equity investments.
- *Extraordinary Dividend Transactions.* Although the current rules already prevent a corporate shareholder from structuring redemption transactions with related parties to take advantage of the dividends received deduction, the rules would be broadened to cover *pro rata* redemptions.
- *Partnership Disguised Sale Transactions.* The rules relating to the disclosure under the partnership disguised sale provisions would be extended from two to seven years in order to enable the IRS to police these transactions better.
- *Extension of Partnership Anti-Abuse Rules.* The existing partnership anti-abuse provisions would be extended to cover the manner in which income is allocated between related partners, even if such allocations otherwise comply with relevant regulatory requirements, if those allocations generate "unwarranted" tax benefits. Any such change could produce tremendous uncertainty as to the validity of many very common partnership allocation arrangements.
- *Partnership Basis-Shifting Transactions.* In order to prevent a corporation from "shifting" tax basis from its own stock to depreciable assets through certain partnership transactions, either the partnership basis step-up rules or the rules granting corporations nonrecognition treatment on sale of their own stock would be modified.
- *Tax-Motivated Financing Arrangements Using Controlled Foreign Corporations.* The highly mechanical rules relating to the allocation of earning and profits of "controlled foreign corporations" would be amended to prevent taxpayers from being able to direct taxable earnings to tax-indifferent parties. As in the case of the proposed extension of anti-abuse provisions to certain partnership allocations, any such change could introduce a large degree of uncertainty into the application of the CFC rules to many common situations.
- *Debt/Equity Classification Issues.* In order to prevent taxpayers from exploiting the differences between the tax and financial reporting rules relating to hybrid securities, the current rules relating to the classification of debt and equity for tax purposes would be clarified, and could possibly be conformed to match the financial accounting rules. Any such changes would likely have very significant consequences to taxpayers who have issued or purchased almost any type of hybrid financial instrument.
- *Nonqualified Deferred Compensation Plans.* Existing rules allowing executives to escape current tax exposure on deferred compensation arrangements would be modified to the extent that deferred compensation plans allow such executives an inappropriate degree of security and control of the underlying funds. This change could create significant tax costs to plan participants of some of the more typical nonqualified deferred compensation plans such as rabbi trusts.

Materials Available On-Line

The Joint Committee's *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* is available at the portion of the Government Printing Office's website entitled Joint Committee on Taxation Committee Prints, 108th Congress, under the heading "JCS-3-03." Each of the three volumes of the report has been broken up into a series of separate Acrobat pdf files. You can also obtain the following items directly:

- Volume I, Report [1,927K]
- Table of Contents for Volume I [17K]
- Table of Contens for Volume II, Appendix A [28K]
- Table of Contens for Volume II, Appendix B [212K]
- Table of Contens for Volume III, Appendix C [92K]
- Table of Contens for Volume III, Appendix D [159K]
- Written Testimony of the Joint Committee Staff on the Report, JCX-10-03, February 13, 2003 [118K]
- Written Testimony of the Joint Committee Staff on Executive Compensation and Company-Owned Life Insurance, JCX 36-03, April 7, 2003 [131K]