Testimony of

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Tax Shelter's and Analysis of Enron's Disclosed Tax Information

Good morning Chairman Grassley and members of the Committee. I appreciate the opportunity to be a part of today's hearing regarding the Joint Committee on Taxation's (JCT) report about Enron. I would like to make some comments regarding tax shelters, disclosure of taxable income, and Enron.

I. Tax Shelters

Given what appears to be the ever increasing use of overly aggressive tax shelters it is fairly clear that shelter promoters and business managers have not demonstrated the ability to determine when a tax shelter crosses the line from a legitimate and ethical tax planning device to an abusive tax shelter. Without some established guidance of where this line is, or where it should be, the line of demarcation will probably continue to drop. On this 'slippery slope,' one shelter will be compared to another in terms of its legality. The prevalence of abusive corporate tax shelters potentially puts corporate managers in compromising positions. They are faced with this question: should management elect to utilize a tax shelter of questionable legal merits in order to better compete with foreign competitors that may have lower tax costs and/or with domestic firms that engage in more aggressive tax sheltering transactions? There needs to be a line to evaluate what is acceptable and what is not acceptable with respect to tax shelters. Given the myriad of facts associated with various court decisions and the inability of tax shelter promoters to self-regulate, legislation may be the only way to establish this line. However, we also must ensure that U.S.-based firms are not placed at a competitive disadvantage in the international economy due to the U.S. income tax system.

II. Disclosure of taxable income

Under current accounting rules (GAAP) and SEC standards there is no requirement that a corporation disclose its reported U.S. taxable income. Statement of Accounting Standards No. 109 (SFAS 109) specifies the method--deferred tax accounting--to compute and to report tax expense for financial accounting purposes. Further, SFAS 109 and SEC pronouncements specify items that should be disclosed in the financial statements. Unfortunately, it is often difficult to accurately estimate a corporation's taxable income from the information provided in the financial statements.[1] Modifying the current disclosure rules to require the disclosure of U.S. taxable income might allow investors, creditors, and other interested parties to assess the extent to which a corporation uses abusive tax shelters to reduce taxable income and/or aggressive accounting methods to increase reported earnings.

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

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[1] Robert Willins, an accounting analyst for Lehman Brothers, states that "…figuring out how much tax a company actually pays is almost impossible" and that "tax disclosure is just inscrutable." [quoted in Tax Dodging: Enron Isn't Alone, Business Week, p. 40]. Willins also states that the tax information provided in financial statements under SFAS 109 is a "total black box" and that he has never met a stock analyst who has any idea what deferred tax accounting is. [I. Carnahan and J. Novack, Forbes Magazine, March 4, 2002 p. 40].

differences may not necessarily indicate abusive tax sheltering or aggressive financial reporting, large differences are consistent with such activity and should result in additional scrutiny of the reported income numbers by outside parties. Given that the magnitude of the divergence between taxable and financial accounting income could raise a red flag, management would have an incentive to voluntarily explain items that created the difference. Failure to adequately explain the difference could result in skepticism about management and the reported income amounts which could increase the firm's cost of capital and negatively affect the corporation's stock price.

Thus, the disclosure of the best estimate of taxable income in the financial statements could mitigate both aggressive financial reporting and abusive tax sheltering. The next section compares Enron's reported pre-tax book income and an estimate of Enron's taxable income. Over the 1996-1999 period the difference between Enron's reported pre-tax book income and taxable income estimate was substantial.

III. Enron

Since there are no requirements that corporate tax returns be publicly disclosed, publicly available information, such as 10-K filings, need to be utilized to draw inferences about a corporation's tax position. This analysis is completed using data from Enron's financial statements.

From Enron's financial statements, it appears likely that Enron paid only a small amount of federal income taxes over the 1996-2000 period. An analysis of Enron's income tax disclosures reveals that Enron generated tax net operating losses (i.e., negative taxable income) in each year from 1996-1999. This observation is based on the fact that Enron discloses a U.S. tax net operating loss (NOL) carryforward in 1996 ($222 million) and that the NOL increases each year through 1999.[2] Absent a corporate acquisition, a tax NOL carryforward will increase only if taxable income is negative for the year. Since it appears Enron's regular taxable income was negative for each year during the 1996-1999 period, it is likely Enron paid little or no regular corporate income tax during these years. The fact that the reported NOL falls from $2.9 billion at the end of 1999 to $65 million at the end of 2000 implies that Enron's taxable income for 2000 was $2.835 billion (1999 NOL carryforward of $2.900 billion less 2000 NOL carry-forward of $65 million).[3] However, Enron was able to use the $2,900 million NOL to offset its 2000 taxable income and therefore likely paid no regular tax in 2000. It appears that Enron paid some federal tax due to the alternative minimum tax provisions.[4] An analysis of Enron's tax footnote suggests that Enron actually paid at least $34 million in federal alternative minimum tax for the 2000 taxable year.[5] Evidence of Enron's $34 million AMT payment comes from the fact that Enron's disclosed AMT credit carryforward increased from $220 million in 1999 to $254 million in

[2] The tax net operating loss rules provide for a carry-back and carry-forward period to eliminate inequities caused by the annual tax-paying period when income fluctuates year-to-year. A tax rebate generated by a NOL carryback simply returns a taxpayer's previously paid taxes (without any interest earned on the tax payment).

[3] The taxable income could exceed this estimate if the remaining $65m NOL relates to an acquired entity. If this is the case, the remaining NOL could be subject to restrictions under IRC §382 which limit the extent to which acquired NOLs can offset taxable income of the acquiring company (i.e., Enron).

[4] The AMT is a parallel income tax system to the regular income tax system. AMT is paid in years where the tax liability under the AMT system exceeds that under the regular tax system.

[5] In a recent article in the Washington Post, Karen Denne, an Enron spokeswoman, states that Enron paid $112 million in federal income taxes in 2000 [G. Kessler, *Enron Appears to Have Paid Taxes*, Washington Post, Feb. 3, 2002, P. A10).

2000.[6] In addition to the AMT payment in 2000, analysis of changes to the AMT credit carryforward suggests that AMT was paid in 1996 and 1997 (see income tax carryforwards section of the attached table).[7] Thus, it appears Enron paid some federal income tax, albeit a relatively small amount, in three of the five years during the 1996-2000 period. The net taxes paid due to the AMT during the 1996-2000 period is, based on the disclosed information, probably around $23 million (compare the 1995 AMT credit carryforward of $231 [not reported on the table] and the 2000 AMT credit carryforward of $254).

The above federal tax payment analysis suggests that Enron, despite recording substantial pre-tax financial accounting income, paid very little federal income taxes during the 1996-2000 period. It is common to have a difference between taxable income and financial accounting income because each system has a different set of objectives and set of rules. What sets Enron apart, however, from a more typical situation are the magnitudes of the annual differences between taxable and financial accounting income. While corporations are not required to disclose taxable income, corporations with significant NOL carryforwards are supposed to disclose the amount of such carryforwards and also whether or not they are subject to tax law restrictions. So for firms with an NOL carryforward, an approximation of reported U.S. taxable income is available by examining the changes in the disclosed NOL carryforward amount.

I use the changes in the reported U.S. NOL to measure Enron's annual U.S. taxable income. The attached table shows the regular U.S. tax NOL for each year during the 1996-2000 period and an implied U.S. taxable income based on these changes. The estimate of Enron's taxable income for each year during the 1996-99 period (beginning with 1996) is -$222, -$523, $-655, and -$1,500 million. These estimated taxable income figures sharply diverge from the reported pre-tax book income amounts during these same years: $855, $15, $878, and $1,128 (see table). The difference between estimated U.S. taxable income and reported pre-tax book income for the 1999 year alone is a staggering $2.628 billion (see table). The cumulative difference over the 1996-1999 period is nearly $5.8 billion. Almost as stunning as the 1996-99 difference is the reversal of this trend in 2000. Enron's implied U.S. taxable income for the 2000 year is $2,835 million (see table), while reported pre-tax total book income is $1,413 million. Thus, fiscal 2000's estimated taxable income exceeds reported pre-tax book income by approximately 1,400 million.

As mentioned above, taxable income may differ from financial accounting income for reasons other than abusive tax shelters and aggressive financial reporting. One important difference between financial accounting and U.S. tax accounting deals with the overall reporting entity. For financial accounting purposes, controlled entities are generally consolidated for financial statement purposes (unless they are unconsolidated special purpose entities). For tax purposes, however, only entities where the parent controls at least 80% are consolidated and foreign subsidiaries are generally not included in the consolidated U.S. tax return. This does not mean that foreign operations of U.S.-based companies permanently escape U.S. taxation. The timing of the tax consequences associated with foreign operations depends on the *type* of entity that is used to conduct the foreign operations. If the entity is not classified as a corporation for U.S. tax purposes, any income (or loss) from the entity flows to the U.S. parent's tax return on an annual basis. If the entity is classified as a corporation for tax purposes, the U.S. tax is deferred until the foreign earnings are actually remitted to the US parent or deemed remitted through the operation of Subpart F (applies to passive sources of income). Unfortunately, it is not a simple

[6] In years where the AMT exceeds the regular corporate income tax a credit is generated that can be used in years in which the regular corporate income tax exceeds the AMT.
[7] The AMT credit carryforward disclosed in the 1995 annual report was $231m.

exercise to compute how much foreign income is included on the U.S. parent's tax return using financial statement data. However, even if all of Enron's foreign source income during the 1996-99 period is not included in financial accounting income (to make it comparable to taxable income if no foreign earnings are subject to tax), which total $1,675 million, the difference between the foreign-income-adjusted pre-tax income and taxable income is still $4,125 million.[8] Another interesting aspect of Enron's international operations is that while recording positive financial accounting income from foreign sources, Enron's tax footnote shows that non U.S. tax net operating losses (i.e., foreign NOLs) increased to $874 million at the end of 1999 ($1,200 million at the end of 2000). Thus, there also appears to be a large difference between reported foreign income and foreign taxable income.

A second significant difference between taxable income and financial accounting income relates to the treatment of certain stock options. For tax purposes, a deduction is allowed for the difference between the exercise price of a nonqualified stock option and the stock's price the day the option is exercised. Under the permissible stock option accounting method used by Enron (and most corporations), no expense is recognized in connection with most stock option awards. The tax benefit associated with the exercise of incentive stock options is reflected in stockholder's equity. The stock option difference, however, does not explain the huge difference between tax and financial accounting income during the 1996-1999 period (see implied federal tax deduction from stock options on the table). Based on a computed stock option tax benefit figure, the total tax deduction associated with stock options over the 1996-99 period was $594 million. Thus, stock option expense represents only a small portion of the $5.8 billion cumulative 1996-99 book-tax difference.

It is not clear what is responsible for the large divergence between financial accounting and taxable income. What is relatively clear is that Enron, given its large regular tax net operating loss during the 1996-99 period, had little incentive to further reduce taxable income. Thus, it seems likely that Enron's large divergence between taxable income and reported income is primarily due to aggressive financial reporting and not abusive tax shelters. The difference could be partly due to the different revenue recognition rules for tax and financial accounting purposes. For financial accounting purposes, Enron used estimates to value long-term energy contracts and changes to these estimated values affected reported book income. In contrast, for tax purposes, gains and losses on these contracts would not have been recognized until the contract was settled.

IV. Summary

Is it possible that information disclosed in tax footnotes could be used to determine firms that are using abusive tax shelters and/or making aggressive financial accounting reporting decisions? Could the disclosure of reported taxable income improve investor ability to detect abusive tax shelter and aggressive financial reporting? If Enron's taxable income was disclosed more prominently, would it's aggressive financial reporting practices been detected sooner?

Given what we know now about Enron (they lost money) it is not surprising that it paid very little in taxes over the 1996-2000 period. What is surprising is the magnitude of the divergence between taxable income and reported book income for Enron. More surprising is the fact that information necessary to compute this divergence was effectively disclosed each year but it raised no red flags. Taxable income is likely to be a more conservative measure of income than financial accounting income because an extra dollar of taxable income costs $0.35 in taxes.

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[8] Enron's reported balance for foreign earnings deemed permanently reinvested ($1,200 million in 1999) suggests that much of Enron's foreign earnings were not repatriated to the U.S.

In Enron's case, taxable income paints a considerably different picture than reported book income does.

If stock analysts utilized information contained in the tax footnote, or alternatively if Enron’s tax information was made more transparent, maybe Enron’s financial accounting gimmicks could have surfaced earlier. Who knows how much wealth could have been preserved by earlier detection? Perhaps analysts and investors should become better equipped to use information in the tax footnote. Perhaps the FASB or SEC should mandate improved tax disclosures and/or require the disclosure of U.S. taxable income. How many more Enrons are out there? Perhaps the tax footnote is a useful place to begin this examination.