The Enron Debacle:
Lessons for Tax Policy

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Abstract

The Enron debacle had potential implications in three areas of tax policy: tax-favored retirement plans, stock options, and differences in book versus tax accounting. The most important issue relates to the increasing riskiness of retirement plans that (1) can pay in a lump sum amount, (2) are of the defined contribution variety, and (3) may be excessively concentrated in employer stock. Proposals to remedy this issue even in a limited way may be unsuccessful if they do not address the especially favorable tax treatment of employee stock ownership plans (ESOPs). Most stock options do not benefit from preferential treatment, although for both book and tax purposes it may be desirable (and feasible) to recognize compensation payments at the time of grant. Stock options may not be accomplishing their purposes efficiently, and special benefits (such as those for qualified stock options) might either be reconsidered or restricted to plans with desirable features. The spectacle of a purportedly profitable company paying little or no tax has become a common phenomenon. The Enron case suggests the need for more disclosure regarding the sources of book versus tax differences, if not some substantive corporate tax reforms.

Contents

THE ENRON DEBACLE: LESSONS FOR TAX POLICY

I. INTRODUCTION

Many employees lost both their jobs and much of their life savings in the wake of the Enron collapse. The retirement plans of Enron workers containing large shares of company stock were not only permitted by regulation, but were actually sanctioned and actively encouraged by the Internal Revenue Code. When Enron appeared to be profitable, it was paying little or no corporate income tax. Yet the spectacle of apparently profitable companies paying virtually no corporate tax has become so common that no one considers lack of taxable profit a sign of a failing company. Enron deducted stock option spreads from taxable income, but not from profits reported to stockholders. The company also set up hundreds of offshore partnerships that it classified as debt when computing corporate income taxes and equity when reporting to stockholders—exactly the outcomes most beneficial for a company attempting to conceal financial trouble.

Did tax rules facilitate the Enron debacle and its unhappy outcome for ordinary stockholders and employees? And are there lessons to be learned for shaping tax policy as a result? Answering these questions requires examining three major areas of federal tax law: the treatment of retirement plans; the treatment of stock options; and the discrepancy between the treatment of assets, income, and costs for reporting to the Internal Revenue Service (IRS) versus reporting to stockholders. These issues overlap. For example, an important item differentiating Enron's tax and book income was the deduction of exercised stock option spreads for tax, but not for book purposes.

The analysis that follows makes three major points. First, if we wish to discourage excessive concentration of retirement plan investments in employer stock—and there seem to be good reasons to do so—we need to recognize that even if we adopt provisions that encourage more prudent diversification behavior in some types of plans, we are providing the juiciest tax benefits to employee stock ownership plans (ESOPs)—plans that can invest solely (and must invest primarily) in employer stock. To achieve our objective, we need to reconsider those tax benefits—including the one enacted on the eve of the Enron bankruptcy—that encourage employer stock holdings. In other words, to use an old phrase, perhaps the federal government should put its money where its mouth is. Second, providing stock options may not be the best way to encourage executives to act in the best interest of stockholders, but our current tax benefits may encourage the granting of too many stock options. Finally, the tax code can address many book versus tax income discrepancies. A list of possible tax proposals that would address these issues should at least be laid on the table. One such reform might be never to permit capital raised to be treated as debt for tax purposes unless it is also treated as debt for financial reporting purposes. This reform would address many of the activities that contributed to Enron's low tax liability in the face of high reported profits.

II. RETIREMENT AT RISK?

Perhaps the most important public policy issue to emerge from the Enron bankruptcy was the loss of employees' retirement savings as a result of to the large share of investment in company stock, generally put at slightly more than 62 percent of their 401(k) plans. Some of the share reflected matching company contributions made in stock that employees were not permitted to sell until separation or age 55. However, many employees also chose to invest their own contributions in Enron stock. According to Enron, this decision accounted for the bulk of the concentration in own company stock.

Nor were Enron employees alone in relying on their own company's stock. While company plans vary (some companies match in cash, while others direct the allocation of all assets), many firms, particularly large ones, have defined contribution (DC) plans (in which benefits depend on contributions and earnings) similar to that of Enron, with self-direction of own assets and matches in employee stock. Estimates of the average share of stock in company DC pension plans range from 19 to 39 percent, depending on the sample and investigator (Purcell 2002a)—a high average when many investment counselors would advise that no more than 10 percent of a portfolio be held in a single stock. Indeed, for most employees the optimal investment in own company stock is probably less than this average, since performance of the stock is correlated with labor income. Of course, companies often have defined benefit (DB) plans in which benefits are guaranteed as well, so that a high share in the DC plan may not provide a complete picture. Nevertheless, some companies' plans have very large shares of company stock, even among those with *no* DB retirement plan: Procter and Gamble at 91.5 percent, Home Depot at 72 percent, McDonald's at 56.8 percent, and Dell Computers at 53.4 percent (Purcell 2002b).

A recent study of the Fortune 1000 by the U.S. General Accounting Office (2002) found a total share in employer stock of 11.6 percent for *all* pension assets (DC and DB), with considerable variation across industries. The report indicates that this share is probably understated because of the inability to identify underlying assets in master trust agreements. While mining and manufacturing pension plans had employer shares slightly less than 10 percent, shares in retail trade were 32.3 percent and shares in finance, insurance, and real estate were 18.9 percent. By plan type, the highest concentrations of employer shares were in ESOPs (98 percent) and plans that combine ESOPs with other forms, such as 401(k) plans (58 percent). These overall share data suggest that most employees are in plans where reliance on employer shares is too great.

While Enron's failure was perhaps the most publicized in which employees lost assets because of investment in company stock, it is neither the first nor the latest example. Employees of the retail chain Carter Hawley Hale lost assets from their profit-sharing plan invested solely in company stock when the company declared bankruptcy in 1991. Color Tile's bankruptcy in 1997, with 90 percent of its DC assets invested in stock, sparked a Labor Department investigation. Lucent Technologies, which, like Enron, matched in employer stock and restricted sale of its matching contributions, experienced a 90 percent decline in its stock value from 1999 to 2001. Employees sued the firm in mid-2001.

In cases that have gained attention more recently, both Global Crossing and WorldCom had large shares of their retirement assets in company stock that became virtually worthless. The Global Crossing case is similar to the Enron case in that both companies matched their 401(k) plan in stock and locked down their plans to change plan administrators during a time when the stock was falling (although Global Crossing notified employees of the lockdown in advance). WorldCom matched assets in either stock or cash and did not have restrictions on sale, although some employees have filed suit on the basis of claims that the company breached its fiduciary duty by failing to disclose information. Tyco employees lost a smaller fraction of their 401(k) plan, which had only a 20 percent share in company stock at the end of 2000 because Tyco did not match in company stock and restricted the share of company stock in their employees' portfolios to 25 percent. Nevertheless, even 20 percent is a large share. Moreover, Tyco also had a separate stock purchase plan, which allowed employees to purchase stock at a 15 percent discount (and, under an approved plan, this discount is not subject to tax).

The spectacular losses of some employees and the subsequent discussion of legislative restrictions in investment come, ironically, at a time when there has been a dramatic move towards self-directed, tax-favored employer pension plans. One might expect that risky plans with high concentrations of stock would lose some of their charm, especially in the wake of the stock market decline, and that concentrations in own company stock would be seen as excessively risky. However, no wholesale flight from employer stock seems to be occurring. Hewitt Associates reports a decline in company shares in 401(k) plans from a 35 percent peak in September 1999 to 30 percent by September 2000, where it remained as of two months after the Enron failure. Moreover, the firm ascribes most of the reduction to a general decline in the stock market values (Weston 2002).

Legislative proposals have been introduced that include both direct restrictions on the amount of stock in 401(k) plans, and more limited revisions, such as requiring employers to allow contributed stock to be sold within a few years or requiring companies to provide independent investment advice. (A rule requiring notification of a lockdown or blackout period when shares cannot be traded has already been adopted.)

The following discussion is divided into four parts. First, what are the types of employer pension plans and how they have changed over time? Second, what is the role of the tax system in encouraging or discouraging employer stock and risk-taking behavior generally? Third, what fundamental public policy issues should be considered in deciding what the tax system's role should be? And finally, does the consideration of these issues suggest specific changes to be made—and are any of these changes on the table?

Types of Plans

Employer pension plans can be divided into two basic types: DB plans and DC) plans. DB plans are insured, and federal regulations restrict the share of assets invested in company stock to 10 percent. In traditional DB plans, employees earn a pension that reflects age, years of service with the company, and earnings. Employee participation in these plans is mandatory, and the employer bears the risk of investment performance. Some plans that most people would think of as DC plans (plans in which benefits depend on accumulated assets in the fund, making employees rather than employers bear the investment risk) are technically treated as defined benefit DB plans and subject to their restrictions. In fact, many employers, including Enron, converted their traditional DB plans to a DC plan of this type called a cash balance plan, which is still legally a DB plan. The conversion of Enron's DB plan is also intimately connected to ESOPs and tax rules, as discussed below.[1]

DC plans are characterized primarily by a contribution, with the employee bearing the risk of investment performance. These plans include profit sharing, thrift savings, and money purchase plans. But the most important category by far is the 401(k) plan, which allows voluntary participation by employees (and usually direction of the allocation of assets among type of investments).

[1] For a detailed description of Enron's plans, which included the cash balance plan, an older employer stock ownership plan (ESOP with no new participants), and a 401(k) with associated ESOP (KSOP), see Walker (2002). For a discussion of how the conversion took place, see Kandarian (2002).

There has been a sea change in the types of employer plans used. As shown in table 1, the number of people covered by a DB plan, and even the dollar value of contributions, declined between 1979 and 1998. While DB plans accounted for 80 percent of active participants, two-thirds of contributions, and almost three-quarters of assets in 1979, by 1998 they accounted for only one-third of participants, 17 percent of contributions, and slightly less than half of assets.

Table 1. Defined Benefit and Defined Contribution Plans, 1979 and 1998

Year	**Active Participants (millions)**		**Contributions ($ billions)**		**Assets ($ billions)**	
	DB	DC	DB	DC	DB	DC
1979	29	17	41	21	320	126
1998	23	50	35	167	1,937	2,085

Source: U.S. Department of Labor (2001-2002). Active participants refers to workers and does not include retired beneficiaries.

Table 2 shows how coverage is divided among pension plans. Again, a major change has occurred: While similar shares of employees were covered in 1979, 84 percent had a DB plan. By 1998, fewer than half had a DB plan.

Table 2. Percentage of Employees Covered by Pension Plans

Year	**DB Only**	**DC Only**	**DC and DB**	**Total Coverage**
1979	28	7	10	45
1998	7	27	15	49

Source: U.S. Department of Labor, (2001-2002).

What happened to transform the landscape of the pension systems probably includes both social and economic change and changes in tax laws. However, it is clear that a type of plan not even in existence in 1979 (enacted into law in 1978 and first implemented in 1981) is responsible for the bulk of defined contribution DC assets. In 1998, this plan, now popularly known by its Internal Revenue Code section, 401(k), had 37 million participants and $92 billion in contributions, and accounted for $1.54 trillion of assets. The 401(k) plans, which allow for elective deferrals of wages into retirement plans (much like individual retirement accounts [IRAs]), and are also called cash or deferred plans.

Some have argued that the decline in DB plans is due to increasingly complex regulations and administrative costs of these plans. Social change has probably also played a role: Workers are more mobile and employers may be increasingly reluctant to bear risks, particularly in light of a dramatic increase in longevity that was difficult to anticipate. But it is also possible that the shift to DC plans is in part a result of the availability of simple 401(k) plans. is due to their favorable tax status.

A final type of pension plan is the ESOP, a plan that Enron had beginning in the mid-1980s, which it used in later years to provide employer matches to its 401(k) plans (combined plans called KSOPs). The ESOP is a defined contribution DC plan in which assets are invested primarily or solely in company stock. It benefits from special tax breaks. ESOPs can be used as savings and retirement plans, but need not be set up in that form. For some ESOPs, distributions can be made at times other than retirement or termination (e.g., once vested).

Although the pension data cited above do not provide information for comparisons over time, in 1998, ESOPs covered more than 6 million contributors, accounting for $410 billion in assets and $20 billion in contributions. Although ESOPs are often envisioned as plans used by small, closely held companies designed to encourage employee productivity, $375 billion in assets are in firms with more than 100 employees. ESOPs benefit from a unique leveraging provision that allows the ESOP to borrow to purchase stock while the firm makes tax-deductible contributions to repay the loan. This feature, which increases the risk in net assets, is common: $275 billion of assets are in leveraged ESOPs.

ESOPs serve other functions that illuminate a concern raised about the Enron plan: the conflict of interests between employees and owners/managers. The leveraging provision makes the ESOP a corporate finance tool as well as a retirement plan. ESOPs have also been characterized as a way to reduce the likelihood of hostile takeovers. Indeed, Scholey and Wolfson (1989) argue that this attribute is the main reason for their popularity. And although the bulk of ESOP assets are held in plans of large firms, many congressional hearings have also featured small business representatives who have describe how the ESOP feature has permitted small firms to survive by allowing the employees to purchase the firm from retiring owners.

Several large firms with ESOPs have failed in recent years, including Polaroid, whose ESOP was launched to avoid a takeover, and United Airlines, whose ESOP was the second largest in the United States after Public Supermarkets (Countryman and Stewart 2002).

Role of the Tax System

The tax system favors retirement plans over other types of saving: Contributions and earnings on those contributions are not included in taxable income until received as retirement benefits. This treatment is equivalent to exempting the return from income taxes.[2] Pension tax benefits are quite costly. Table 3 lists tax expenditures for employer pension systems and other retirement benefits (such as individual retirement plans and plans for the self-employed). The total tax expenditures exceed $100 billion per year—a benefit that approaches or exceeds 10 percent of all income tax revenues.[3] The largest expenditure relates to employer contributions and earnings, and the Bush administration estimates separately the 401(k) plans, which have now become larger than other plans in terms of revenue costs. The relative sizes of these costs probably reflect the timing effects (new plans have a rising, and then a falling cost). But they also reflect a rough division between plans that are subject to stock restrictions and those that are not. There is a parallel plan for self-employed individuals. Cafeteria plans allow workers to choose fringe benefits, of which pensions are an important element. IRAs are set up by individuals and have the same treatment as pensions, or individuals may choose a Roth IRA where tax exemption is provided directly (i.e., contributions are not deducted when made, but earnings are exempt from tax, as in a tax-exempt bond).

[2] The benefit of the up-front exclusion from income is the same in present value as the tax paid on distribution. Consider a $100 investment that earns a 10 percent rate of return and lasts for one year: After a year the payout is $110. If the return is taxed at 50 percent, the payout is $105, which is a 5 percent return on $100. If the $100 is deducted from income initially, the taxpayer saves $50, leaving a net investment of $50. After a year, the asset yields $110, which is subject to a 50 percent tax and yields an after-tax payment of $55. The $5 increase on the net investment is a 10 percent return, the same as in the no-tax example. In fact, the investor could double his or her gross investment to $200, with a $100 net outlay, and receive exactly the same amount as the $100 investment in the no-tax world.

[3] The tax expenditure measures the cash flow effect in a given year from the deduction of contribution and exclusion of interest net of the taxation of pensions. It may not precisely measure the true benefit, because it does not capture timing effects. That is, the tax expenditure measures the loss of revenue from the excess of the cost of deducting contributions and excluding earnings over tax payments on distributions—an amount that will be large when pension plans are initially established, will then grow, and will finally begin to decline as benefits are paid out. A better way to measure the cost would be the present value of tax savings, a number that would typically be larger than the cash flow effect. At the same time, the benefit could be reduced if one considered tax savings vehicles that are already tax-favored, such as those yielding preferentially taxed capital gains.

Table 3. Tax Expenditure Provisions Associated with Private Retirement Savings

Tax Provision	Administration Estimates ($ billions)	Joint Committee on Taxation Estimates ($ billions)
Net Exclusion of Pension Contributions and Earnings	$112.5	$87.7
Employer Plans Other than 401(k) Plans	53.1	-
401(k) Plans	59.5	-
Keogh Plans (for Self-Employed)	6.8	5.7
Additional Benefits for ESOPs	2.0	1.7
IRA/Pension Tax Credits	2.0	1.9
Cafeteria Plans*	-	12.7
Individual Retirement Accounts	18.7	14.2

* Cafeteria plans can be invested in other fringe benefits, such as health care and child care, and only a portion of this cost relates to retirement.

Sources: Administration estimates from Office of the President (2002); Joint Committee's estimates from U.S. Congress, Joint Committee on Taxation (2002).

ESOPs' special benefits have been significantly increased in the 2001 Tax Act. ESOPs can borrow money to purchase stock, and employers can deduct dividends paid on stock if they are used to repay loans or paid to plan participants. This provision was significantly liberalized in 2001 by permitting employers to deduct dividends reinvested in the plan if the employee had the option of receiving the payment. Thus, ESOPs are the only plans in which earnings on corporate stock can be both deducted by the firm and effectively exempted from individual tax.

Enron received these additional tax benefits for its ESOPs; indeed, the tax rules on ESOPs played a prominent role in the development of Enron retirement plans. At the time of its collapse, Enron had an ESOP used for employer matches to 401(k) plan contributions (this type of plan, called a KSOP, is quite common). Enron also had DB plans that covered three different eras: pre-1987 standard DB plans, a floor-offset ESOP for 1987–1994, and a cash balance plan for post-1994 (see Centurion 2002 for further details).

Enron originally had traditional DB plans inherited from InterNorth and Houston Natural Gas. In 1986, it set up a leveraged ESOP and an Enron DB plan, after splitting out a part of the InterNorth plan for terminated vested participants. In 1987, following the 1986 tax legislation that imposed an excise tax on funds taken out of a pension plan but permitted an excise-tax-free transfer to an ESOP, Enron transferred funds from the InterNorth plan to the ESOP and used the funds to partially repay the loan (resulting in a cash infusion to the company). Then between 1987 and 1994, the firm adopted a floor offset for the Enron DB plan with the ESOP. The 1986 act banned floor offset plans associated with ESOPs, but Enron, along with a number of other firms, was grandfathered. A floor offset normally permits expected earnings in the ESOP to offset benefits in the DB plan, but still guarantees a minimum level of benefits. Enron had an usual floor- offset method (that may have been of doubtful legality): The amount of the offset was determined based on the basis of Enron stock value at particular times when the stock was released—from 1996 to 2000. Although participants could sell the stock, those who kept the ESOP plan lost both their DB offset (which was based on high stock prices) and their ESOP for that period. After 1994, the firm set up a cash balance DB plan, which, in reality was a DC plan. Whether Enron employees really understood what was happening to their DB plan or how their benefits were changing is not clear.

This history is important to the discussion in this paper for several reasons: It illustrates how tax matters can affect pension decisions, it may raise some questions about whether Enron was managing its retirement plans for the benefit of its employees, and it explains one of the reasons for proposals to end grandfathered floor-offset plans and to give employees more information about the effects of conversions (Schultz 2002; Walker 2002).

In addition to enjoying income tax benefits, employer contributions to retirement plans are exempt from social security and Medicare payroll taxes (individual elective contributions, such as 401[k] payments, are not); thus, there is a significant reduction in payroll taxes. According to the National Income and Product Accounts (2002, table 8.17), in 2001 employer contributions totaled there was $190 billion of employer contributions. Measuring the payroll tax benefit is difficult, however, because some workers are already at the ceiling for part of the payroll tax (the part that provides for retirement and disability), and the savings in social security taxes may translate into lower benefits received at retirement.

Public Policy Issues

A great deal of revenue is foregone through tax benefits for pensions—revenue that could otherwise be used to cut tax rates, reduce the deficit, or finance government services. What is the justification for this degree of intervention? Consulting the historical development of the tax treatment does not provide clear rationales. Like many provisions of the tax law, the beneficial treatment for pensions in general began early and at a time when little record was made of the reasons. Indeed, at least one of the reasons was apparently legal and administrative in nature, since the legislated tax provisions followed, and generally confirmed, a variety of regulatory decisions. A key reason was the difficulty in assigning income in DB plans to individuals whose payments depended on earnings and tenure at the firm.

Initially no rules were imposed regarding vesting, funding, plan management, coverage, or limits on benefits, and in particular, there were no investment restrictions. Indeed, stock bonus plans (along with profit-sharing plans) were granted benefits (in the form of tax exemption of earnings) in 1921, several years before the treatment was extended to ordinary pension trusts. However, concerns eventually arose that such funds could be used as tax shelters, that they were primarily used to benefit highly paid employers and managers, and that ordinary employees might never receive the pensions. A series of restrictions (with the most significant ones enacted in 1942 and 1974) addressed these issues. Directed particularly at the security of benefits, the 1974 act provided pension insurance for DB plans; it also restricted those plans to holding no more than 10 percent of assets in a firm's own stock.

No rules were enacted with respect to DC plans in 1974, however. Moreover, the 1974 legislation explicitly recognized ESOPs, and granted some of the first benefits (allowing borrowing) for these plans. However, shortly after 401(k) plans began to be established, there was a dramatic scale-back of limits on plan contributions. One of the reasons was a concern that individuals would come to rely too much on these plans, which would prove to be risky. With regard to this change in the limits on individual account contributions to 401(k)s, the general explanation of the 1986 Tax Reform Act stated: "Congress also believed that excessive reliance on individual retirement savings (relative to employer-provided retirement savings) could result in inadequate retirement income security for many rank and file employees" (U.S. Congress, Joint Committee on Taxation 1987, p. 634).

Nowadays, the argument made for pension tax benefits is that they encourage saving for retirement. There are two potential justifications for this argument: First, some analysts argue that we should not be taxing the return to savings at all; we should have a consumption tax or a wage tax because those taxes are more efficient. Eliminating tax on retirement savings might be seen as one way to accomplish this effect. Yet, it is not really a desirable way, because it favors certain forms of savings and may not even favor them at the margin (because of ceilings and collective decisionmaking).

Second, we may feel that individuals do not engage in optimal planning for retirement because they have imperfect information or are too myopic. Accordingly, we want to encourage them to put funds into retirement plans. Indeed, concern about whether individuals make the appropriate decisions are arguments for social security as well. But social security may actually be better suited to this objective, since it is mandatory and covers all employees. At any one time, pension plans typically cover only about half of workers, and covered workers are the more educated and highly paid ones—the ones most likely to save in any case.

There are other reasons for subsidizing pension plans, although these reasons generally relate to DB plans. DB plans may help address a number of problems that arise in economic markets. For example, mandatory plans and annuities may help address a problem known as adverse selection, where individuals who in good health who expect to live a long time are likely to be the ones to purchase annuities, making them less attractive to people in poor health. Labor economists have traditionally seen DB plans to be as a mechanism that employers use to increase and justify on-the-job training by employers; DB plans help firms retain workers so that employers can recoup their training investments. DB plans may also be used to encourage older workers to leave, which may have been an advantage in the past. The effect of pension plans in reducing adverse selection is rapidly disappearing as DC plans displace DB plans and as DB plans tend increasingly to allow lump sum payout options.

The effect on employer training has been reduced not only because of the demise of DB plans, but also because of changes (often mandated by federal regulation) requiring more vesting and portability.

If the government is stepping in to influence decisions based on the assumption that individuals do not make the optimal choices, the crux of this argument also suggests that intervention to make desirable choices should extend to portfolio choices, not only in DB plans but in DC plans. Moreover, if the firm's objectives conflict with those of employees, perhaps the firms should not be making allocation decisions. No investment advisor would recommend holding a large fraction of retirement savings in a single stock, since a mixture of stocks can provide roughly the same expected return with much less risk.[4]

Portfolio choices, and new rules to regulate them through the tax system, relate to two different issues. First, should favorable tax treatment be allowed for employer contributions (or matches to 401[k] plans) in employer stock that cannot be sold, in most cases, until retirement? Certainly, the popularity of ESOP matches to 401(k)s by among many firms, as well as Enron's use of a floor offset plan to transform its DB plan assets into holdings of risky Enron stock, may be viewed as examples of potential conflicts of interest, since employees would be better served by a mixed stock portfolio. There is a fair degree of agreement that such major restrictions should not be allowed (as evidenced in

[4] Of course, some employees have done very well in plans with a large investment in employer stock—better than they would have with funds invested in safer, lower-yielding assets. Moreover, if holdings of employer stock—whether required or encouraged in retirement plans—offset a tendency of employees to take on too little risk in their plans, the allocation of assets to employer stock may not have been entirely undesirable. But this outcome is still not optimal. An even better portfolio would be one with a share in diversified stocks. With their ability to share risk and to benefit from expert management, DB plans may be better suited to this optimal risk allocation, as long as proper regulation occurs to prevent abuses—pointing up one of the problems of excess reliance on self-directed plans. Addressing this issue while maintaining benefits for self-directed DC plans is not easy, particularly since individuals' risk preferences vary and it is difficult to determine whether a portfolio is optimally invested. Education and investment advice may be the best tools for achieving this objective.

legislation proposed by President Bush, passed by the House, and considered in the Senate in 2002). Nevertheless, in most cases, freestanding ESOPs were exempt from changes.

More controversy surrounds the intervention into individual choices for own contributions in circumstances where employees make choices (most parties agree that ensuring some choice or the ability to sell employer-contributed stock in a few years is probably desirable). Here, the essential issue is whether tax benefits should be extended to plans in which individuals can choose to invest in employer stock, or whether there should be restrictions as in the case of DB plans.

Evidence is accumulating evidence that individuals do not appear to make optimal portfolio decisions. Researchers studying individual behavior have reached some disturbing conclusions about what factors affect individual investment choices: For example, employees actually invest more—not less—of their own money in company stock when the company match is in employer stock; the share they invest in employer stock becomes larger as the number of investment options they are offered decreases; and individuals tend to acquiesce to the default choice.[5] Studies also suggest that individuals view other plan restrictions as providing cues about desirability of purchasing company stock. A number of other studies show that people see employer stock contributions as an endorsement and that individuals have a tendency to extrapolate past returns forward. Employees also may feel that they

[5] See VanDerhei (2002), whose study found that plans with an employer match in corporate stock had a larger elective investment in that stock. See also Purcell (2002a), who found that individual contributions correlated with employer stock matches, prior returns, and size of firm. Liang and Weisbenner (2002) found a tendency to invest 1/n of assets in a plan, where "n" is the number of investment choices. They also surveyed other studies that indicated that participants do not offset employer matches in stock in their own choices. Liang and Weisbenner's study also suggested that people tend to see employer stock matches as an endorsement and that individuals have a tendency to assume that past high performance indicates future high performance. Choi et al. (2001a, 2001b) found that individuals tend to stay with defaults in investment levels and allocations.

know their own company better and that investing in its stock is better than investing in other firms' stock. All of these findings support the case for intervention into portfolio choice.

There are generally two types of objections to further restrictions—particularly major restrictions, such as limiting the share of employer stock in a plan. The first objection is that these restrictions interfere with freedom of choice (a similar argument to that made for privatizing social security through individual accounts). This argument is a tail-biting one: If encouraging pension plans via tax subsidies is justified because individuals do not make optimal choices, then it is hard to accept an argument that individuals cannot make their own decisions with regard to saving, but, once they are doing so, can make the optimal investment choices.

The second objection is that additional restrictions may reduce employers' participation in plans, and in particular, may make them less likely to match 401(k) contributions. Employers like making contributions in the form of stock because it involves no immediate reduction in cash flow (and may even increase cash flow through tax benefits). Moreover, if most employees may not sell stock, there is little immediate downward pressure on stock prices. A response to this objection is that it does not really serve either stockholders in the company (whose stock is diluted) or individuals (who receive an asset that they are locked into for a long period of time), and that the government (and its tax subsidies) should be looking out for both. Moreover, if the objective of subsidizing retirement plans is to provide a safe and adequate retirement, subsidizing inherently risky portfolios does not seem justified.

A more legitimate concern might be that imposing additional administrative costs (such as costs of investment advice) would make plans less attractive, particularly for small firms.

Proposals for Change

The legislative reaction to the Enron crisis has included major and minor proposals in 2001 and 2002, but at present, no plans have been approved by both houses. Some bills introduced in the 107th Congress would place significant restrictions on the share of stock in plans. For example, H.R. 3463 (Congressman Duetsch) would limit cash or deferred arrangements (such as 401[k] plans) to holding no more than 10 percent of assets in employer stock. S. 1838 (Senators Boxer and Corzine) would limit the amount of employer stock in DC plans to 20 percent, allow employees to sell matching stock after 90 days, and discourage employer stock contributions by allowing employers only a 50 percent deduction. ESOPs would be exempt from these rules. However, there is also a provision in S. 1838 to allow diversification in ESOPs after employees participate for five years and attain age 35 (compared to current rules that allow diversification only after 10 years of participation and age 55). S. 1992 (Kennedy) would allow firms to offer stock as a match or an investment option in individual account plans, but not as both. This bill would also permit sale of matching stock within three years and has other proposals relating to disclosure and investment advice. (This and some other proposals also include provisions aimed at limiting the lockdown period that occurred in the Enron plan while plan administrators were being changed, which prevented access to accounts while the stock price was falling.)

Other bills, including bills that have been reported out of a committee or passed by one of the chambers, have tended to be much narrower. The House passed H.R. 3769, a bill similar to President Bush’s plan, which allows individuals to sell matching stock after three years (and those from own contributions immediately), with at least three investment options provided. There have been a series of proposals to provide investment advice, require disclosure, and ensure that employees are notified well in advance of a blackout or lockdown period. There were two different pension plan proposals in the Senate: S. 1992, reported out by the Labor Committee (discussed above), and S. 1971, which is similar to H.R. 3769, reported out by the Finance Committee. S. 1992 had the more stringent provisions, since it disallowed employer stock as both a match and an option.

A common characteristic of all of these bills is that they exclude freestanding ESOPs from the new rules (even when those rules apply to all other DC plans). Also, with rare exceptions, they make no changes in ESOPs.

Are ESOPs the Fly in the Ointment?

With the exception of the Boxer-Corzine plan, all of these proposals would leave freestanding ESOPs completely untouched, and thus employees could still be in plans that would tie up all of their pension assets in employer stock. Moreover, ESOPs would not only be excluded from new restrictions, but would continue to be especially favored by the tax law. One of the most important of these benefits is probably the one most recently created in 2001: the ability of corporations to deduct dividends on their stock paid into retirement plans. No one really knows to what extent this provision will spur adoption of ESOPs.

Because of such favorable treatments, firms with KSOPs might prefer to drop their employee matches and divert funds into freestanding ESOPs (so as to maintain the deductibility of dividends). Virtually every type of legislative proposal creates an incentive for this change, which would reduce the incentives to contribute to 401(k) plans since the employer match is an inducement to save (or at least to save in this form). Similarly, firms could avoid restrictions on asset shares held in employer stock by setting up or expanding freestanding ESOPs.

An obvious remedy appears to be to scale back the ESOP benefits, and particularly the recently enacted one. Yet no move has been made in that direction. Why? And why does the tax code simultaneously encourage and discourage holding retirement assets in employer stocks?

At least part of the answer may be found in history and in entrenched interests. The story of ESOPs begins with a man named Louis Kelso, who argued that having employees own their own company stock would increase productivity. During a dinner in 1973, he gained a supporter in Senator Russell Long, chairman of the Senate Finance Committee. A series of legislative benefits for ESOPs began in 1974 (allowing borrowing in order to purchase stock). This provision was followed by some very generous benefits for ESOPs during the years that Senator Long was chairman. (Republicans controlled the Senate beginning in 1981, and the Senator did not run for office in 1986.) Legislation permitting an investment tax credit for amounts deposited into ESOPs (basically a free ride for the firm) was adopted in 1975 and revised in 1976. In 1981, the credit was altered to be based on payroll. In both 1981 and 1984, ESOPs were given additional advantages: deductions for contributions to repay loans, deductions for dividends paid directly to participants, exclusions of a portion of interest on ESOP loans by lenders, and deferral of recognition of gain for the sale of stock to an ESOP. In 1986, benefits for ESOPs were scaled back when the explicit credits were repealed (although some smaller benefits were added, including allowing the deduction of dividends used to repay loans and the exclusion of part of the proceeds of a sale of stock to ESOPs from the estate tax). This legislation also allowed employees to diversify at age 55. Legislation in 1989 and 1996 eliminated some additional provisions (the estate tax provision and the exclusion for loan interest). Despite this retreat from favoring ESOPs, a major liberalization of benefits (which received little attention) was provided in the 2001 tax cut, when dividend deductions were allowed as long as the participant could elect to receive them in cash. This provision meant that dividends could be kept in the pension plan and reinvested with no tax at either the corporate or individual level. And, according to Countryman and Stewart (2002), ESOP advocates engaged in an aggressive lobbying campaign to limit proposed changes to the law regarding ESOPs in the wake of the Enron collapse.

Are the current special benefits for ESOPs the result of sponsorship by a powerful legislator, with provisions that eventually became difficult to change because of entrenched interests? Or is there merit to establishing ESOPs? The reason given by Mr. Kelso and still argued by ESOP supporters is that employee ownership increases productivity. Theoretically, employee ownership might have an effect in a small firm, where an increase in profit resulting from harder work has a significant effect on the income of the worker. However, as the firm gets larger, the benefit shrinks: If there are 100 employees, an additional dollar of productivity may increase each employee's income by a penny; if there are 1,000 employees, an additional dollar increases each employee's income by one-tenth of a penny. There is an enormous free-rider problem in expecting this incentive to work for rational employees.

Many managers seem to feel that ownership boosts employee morale and causes them to work harder, even if it is not rational for them to do so. A plethora of research has examined this question. Although some studies have found productivity effects, the overall evidence is not clear, and is not easily separated from other managerial effects.[6] For example, firms may simultaneously adopt employee ownership and new management styles that independently affect productivity. ESOPs may also be attractive to managers because they make takeovers less likely. But this effect tends to undermine economic efficiency, because firms with bad management should be susceptible to takeover by managers who can run the firm more efficiently. For that matter, some critics of United Air Lines have charged that the ESOP (which owned a majority share of the company, but excluded flight attendants) contributed to the company's problems by eventually allowing excessive compensation levels for some workers, given the firm's financial circumstances.

Very small businesses have used ESOPs to stay in operation by selling the firm to its employees, but this activity is probably best facilitated by allowing leveraged ESOPs. There seems no obvious reason to provide additional benefits, such as the deduction of dividends, to achieve this purpose.

On the whole, therefore, the economic case for ESOPs does not seem very strong, particularly in the case of the large firms that hold the majority of ESOP assets. And it is clear that special ESOP provisions constitute a barrier for any plan in achieving greater portfolio diversification. Even if ESOPs are allowed to continue (i.e., not placed under the same diversification rules as other plans), eliminating the special benefits—particularly the deduction of dividends enacted in 2001—would make it easier to achieve the objective of less risky investments. Abandoning this special provision for ESOPs would at least eliminate a powerful tax incentive to retain freestanding ESOPs in the face of restrictions on portfolio diversification in other DC plans.

[6] See Doucouliagos (1995) and Mayer (1999) for surveys.

Summing Up

Current federal policy toward pension risk appears to be pursuing two conflicting objectives: employee retirement security and employer ownership of stock to help small businesses or increase productivity. A huge amount of tax revenue is foregone in the name of encouraging pension plans and retirement income. However, these plans cover only half of employees and are increasingly being invested (in DC plans and employer stock) and distributed (in lump sums) in ways that may provide less security than could otherwise be achieved. It is not even clear that these tax subsidies increase overall savings. One might ask whether it would be better to use these funds to provide a mandated supplementary pension plan that could be an adjunct to social security, with universal coverage and portfolio security. But if pension systems are to stay in the private sphere, there seems to be justification for regulating them in ways that discourage, if not prevent, excessive investment in employer stock.

This objective runs head-on into the existence of favored ESOPs—plans that received one of their most desirable additional benefits just a few months before the Enron scandal. Congress could require firms to permit divesting employer stock in a match. But if at the same time, Congress maintains favorable benefits for freestanding ESOPs, what is to prevent companies from shifting to these plans—and explaining to their employees that such an approach, despite tax regulations on 401(k)s, is best because it is more favored by federal tax law? To argue as a matter of public policy that employees should diversify investments away from employer stock, and yet to maintain incentives for doing that very thing must undermine the credibility of the government's position. While it may not be desirable or politically feasible to do away with ESOPs, it surely makes sense to give them no more benefits (except perhaps the leveraging benefit) than other pension plans enjoy.

III. STOCK OPTIONS

The issue of stock options attracted a good deal of attention during the Enron collapse. Enron's top management accumulated a wealth of personal assets, partly through the use of stock options. But these stock options did not reduce book profits (they were deducted for tax purposes when exercised, although not when granted). Some argued that the most important change suggested by the Enron experience was to require a deduction on the books for the value of stock options when granted (and some voluntary movement in that direction is being made by firms such as Coca-Cola. Arguments (and legislative proposals) were also advanced that would require conformity between tax and book accounting. S. 1940, the Levin-McCain bill, would allow a tax deduction only if a deduction were taken from book profits.

This attention to stock options may have been driven in part by the dramatic growth in options. Hall and Leibman (2000) found that while salary and bonuses for executives have doubled since 1980, the value of options has increased by 683 percent. Mehran and Tracy (2002) show a particularly dramatic rise in the 1990s, reporting that the estimated ratio of option grants to cash for the top five executives of firms increased from 0.5 in 1992 to 2.5 in 1999. Some of this increase may be due to a 1993 tax change that prohibited deductions for non-performance-based compensation in excess of $1 million.

Part of the difficulty with stock options is that they should, in theory, be reflected as compensation in the value of the option when granted—as if employees were paid a certain amount of money and then used that money to buy the option. It is very difficult to value an option when there is no ongoing market for it. One can, however, at least estimate the value of stocks when there is a history on their returns.

Tax Treatment of Stock Options

What role does the tax system (aside from the deduction ceiling) play in the decision to provide stock options? Tax consequences could occur at three possible points: when the option is granted, when it is exercised (stock purchased at the option price), and when the stock is sold. Theoretically, tax consequences should occur when the option is granted.

For tax purposes, there are two kinds of stock options: qualified and nonqualified. But neither triggers tax consequences when options are granted. (Qualified stock options are also referred to as incentive stock options, or ISOs.) Qualified options never allow a tax deduction for the firm, not even when the option is exercised, and are thus more desirable for firms with low or no tax liability. They have been popular with new, rapidly growing high-tech firms. They are limited to $100,000 per employee, per year. Employees pay capital gains taxes on the difference between their cost and the value when the stock is sold. The value of the lower capital gains tax rate and deferral has been estimated by the Joint Committee on Taxation as $0.5 billion in 202 and is projected to rise to $1 billion in 2006.

Qualified options are also not effectively subject to payroll taxes. (Although the IRS had announced an intent to require payroll tax withholding, there was a firestorm of protest, including legislative language in the House pension bill, and the plan was dropped.) Qualified option spreads are subject to the alternative minimum tax (AMT) when granted. This exposure to the AMT triggered legislative interest when many individuals in high-tech companies were exposed to the AMT apparently without being aware of it and were left with no cash to pay the tax as their stock failed. According to Hall and Leibman (2000), qualified options account for about 5 percent of stock options.

Nonqualified options (the form Enron had) are much more common and are, in a sense, treated as compensation, in that income deducted by the firm is taxed to the employee. However, if the option cannot be directly valued when granted—which is typically the case—no deduction by the firm or inclusion in income occurs; the deduction is taken when the option is exercised (i.e., when stock is purchased). In general, from the point of view of revenue, the delay in taxation is probably not very costly because recipients' tax rates tend to be about the same as the firm's tax rates. (Some firms have no tax liability, while most executives receiving options probably do, but the differences are largely a matter of timing.) Qualified options are most attractive to firms such as new entrants, that do not have tax liability and cannot benefit from the deduction in any case. Of course, any time a choice is allowed, a revenue loss tends to occur.[7]

Issues in Tax and Accounting Treatment of Options

In theory, it would be possible to estimate the value of options when granted (and allow deductions and inclusion in employee income), and then settle up in a sense when options are exercised or expire. Such an estimate would not be precise, could be very complicated if dividends were paid or if there were a lot of choice as to when to exercise the option, and would be especially complicated with new entrants. Nevertheless, it would probably be feasible to estimate options values when granted, and any errors would be less important if there were a settling up. As Warren Buffet (2002) argues, it is far more difficult to calculate the useful life of machines or measure whether pensions are covering liabilities

[7] There are also two related forms of stock compensation that are rarely used, probably because unlike options, they do not receive favorable book accounting treatment. Restricted stocks are shares (not options) that vest over time and typically include voting rights and dividends. Stock appreciation rights (SARs) allow cashing out without buying and selling. See Hall and Leibman (2000) for further discussion. Companies may also offer stock purchase plans that permit any employee to purchase stock at a discount.

than it is to price options, and yet we make these calculations all the time. (He also responds to another argument against deducting options—that there is no cash outlay—but points out that transfers of stocks that also involve no cash outlay are deducted.) Thus the tax policy question has two parts: Is it desirable to explicitly subsidize options? And is there a need to use the tax system to police book income (by requiring conformity in treatment)?

Generally, the economic purpose of stock options is thought to be aimed at reducing agency costs. The principal-agent problem arises in many economic contexts, but is particularly problematic in large corporations owned by many stockholders. The stockholders want to maximize profits (or wealth), but cannot monitor their managers directly (and managers may have inside information). Also, managers may have other objectives. This problem would not arise if the manager were the owner, and one action that might bring the manager's interest more in line with that of stockholders is making the manager's compensation dependent on the company's profitability.

Some argue that stock options are not so much performance incentives as reflections of rent-seeking behavior—managers compensate themselves through options that are cloaked from the stockholder's view. Hanlon, Rajgopal, and Shevlin (2002) review the literature examining this issue; their study does not, however, support the rent-seeking view.

Stock options do not place the manager in the same position as the stockholder—that would require holding stocks, not stock options. Someone granted a stock option exercises it only if stocks increase in value; unlike the owner of stock, the holder of a stock option is not exposed to downside risk. In fact, it is that lack of exposure to downside risk that gives the option part of its value. Ignore dividends for a moment and suppose a stock has a 50 percent chance of growing at 30 percent and a

50 percent chance of declining by 10 percent over the next year. Its expected growth is, therefore, 10 percent. Requiring a person to purchase the stock for $1 would yield a benefit of $0.10 a year from now. However, giving that person a right to purchase that would be exercised only if the price rose would yield a return of $0.30 times a probability of 0.5, or $0.15.

As this example suggests, for a given expected rate of return, the more risky the asset, the more valuable the option. Thus, one of the difficulties of trying to solve the principal-agent problem with stock options is that this form of compensation encourages more risky investments than the firm's owners would prefer. Biggs (2002) suggests some other problems as well. Holding options discourages managers from paying dividends because dividends reduce the value of stock. Options also cause managers to focus excessively on market prices, which can have consequences such as discouraging whistle-blowers.

What's more, Biggs (2002) suggests that modern stock options are not designed as efficiently as they should be. Since most options are granted at a fixed price, managers are rewarded during a general rise in the market. A better choice would be a price set at some industry or peer average. Options are frequently repriced (when prices decline, the purchase price is reduced). Biggs also suggests that academic research indicates that because stock options are concentrated in risky assets, employees value options at less than their actual cost to the firm, making them an inefficient form of compensation. Muelbroek (2001a) estimates that managers in the average New York Stock Exchange firm value options at 70 percent of cost, while managers in new, rapidly growing firms value them at only 53 percent of cost. Muelbroek (2001b) also finds that the spread between cost and value to a manager is higher for options indexed to industry averages, and suggests that savings from using these options be provided as cash compensation rather than as more options.

New companies with limited cash flow also use stock options to attract employees; it is not clear what market failure would justify providing tax subsidies to this activity.

The current tax treatment of nonqualified options is probably reasonable for tax purposes and avoids the need for complicated calculations. One might argue that the stock option issue is one of accounting, not tax policy. Nevertheless, it might be desirable as a matter of public policy to conform tax and book accounting and then require estimates of options at grant, while subsequently settling up at exercise of the option (or expiration of exercise rights).

Incentive stock options are another matter, and the issue of whether these options should be continued is legitimate. One alternative might be to condition beneficial tax treatment for incentive stock options on efficient design, such as indexing to the market or peers, and not to permit resetting of price.

IV. BOOK VERSUS TAX CONFORMITY

At least up to this point, there is no evidence that Enron did anything outside the tax law in calculating its federal taxes, although reports by a court-appointed bankruptcy examiner and by the Joint Committee on Taxation should be available in February of 2003 (Behr and Johnson 2003). Perhaps the main reason Enron's federal taxes were low is that its profits were low, and the real problem was that the firm was overstating book profits. Nevertheless, studies of the differences between tax and book profits indicate a growing discrepancy of which Enron is simply one illustration.

Sources of Book versus Tax Differences

Differences between income for tax and book purposes can arise from several different sources: explicit tax subsidies, consolidation differences, differences in accrual versus realization accounting, and inconsistent treatment for accounting as well as tax purposes.

A traditionally important source of book versus tax differences is explicit subsidies in the tax law, such as accelerated depreciation or depletion rules for mining and extraction. Actually, neither tax nor book depreciation is likely to reflect true changes in economic value, because of the failure to index assets for inflation. But in general, tax depreciation rules allow costs to be deducted more quickly than book depreciation rules do. Since this effect is a matter of timing, its importance varies not only from firm to firm, but also with the amount of time that has elapsed since a change and changes in investment growth. The cash flow effect of depreciation liberalization rises for some period of time as more and more vintages of investment receive favorable treatment, and declines as tax depreciation is exhausted and book depreciation continues. In general, one would not expect accelerated depreciation to be nearly as important currently as it was in the late 1980s after shorter lives were adopted in 1981.

A second source is differences in consolidation rules, especially with regard to foreign operations. For tax purposes, a company does not consolidate with its foreign incorporated subsidiaries (even if they are wholly owned) because the U.S. tax system does not apply to foreign corporations and the taxes it levies on foreign-source income are deferred until profits are repatriated as dividends. Thus a firm could have a loss on its U.S.-source income and still have worldwide income, because its foreign subsidiaries were profitable. Moreover, for subsidiaries that are not wholly owned, general consolidation rules differ for tax and book purposes—in some cases, the financial statement is more inclusive and in others, the tax statement is (for a discussion, see Mills, Newberry, and Trautman 2002). The deferral of tax on earnings of foreign subsidiaries typically plays an important role in book versus tax differences.

A third reason is that a firm's accounting system reflects the accrual of income and expense, while taxable income often reflects a realization principle. This difference interacts with consolidation rules. For example, firms recognize dividends earnings from foreign subsidiaries and other nonconsolidated entities for tax purposes because it uses a realization principle rather than an accrual principle.

Finally, there are cases when neither the tax nor the book accounting rules are correct in an economic sense. An example is nonqualified stock options, where book expense is typically not recognized at all, and where tax expense is recognized at the wrong point. Hanlon and Shevlin (2002) found that the tax benefits of stock options lowered effective tax rates by about half.

The lack of a broad-based consolidation and accrual system for the tax law, combined with a variety of specific tax benefit provisions, has also been used to construct elaborate tax shelter deals that essentially have no economic substance, but are difficult for tax authorities to police.

Evidence on Book versus Tax Differences

Mills, Newberry, and Trautman (2002) review a number of studies that examine book versus tax differences. Manzon and Plesko (2002) report a growing discrepancy between book and tax income throughout the 1990s, which is confirmed in other studies. Desai (2002) finds that traditional explanations of book and tax discrepancies (such as stock options, deferral of income abroad, and depreciation differences) account for less than half of this growing discrepancy. He also finds that reinvestment abroad as a source of book versus tax discrepancy—which arises from deferral of income of foreign subsidiaries—is growing. Mills, Newberry, and Trautman (2002) similarly find growing book versus tax differences that are particularly pronounced for multinational firms, firms in the financial services and communication industries and very large firms.

The unidentified discrepancies found by Desai (2002) may reflect either illegal activities or simply the opportunities in the current tax code to manipulate income and deductions.

Enron's Experience

Can the Enron experience shed any light on these issues? An article by Fleischer (2002) suggests that while in some cases at Enron, the fault lay with book accounting (i.e., the tax treatment was perfectly appropriate in an economic as well as a legal sense), in other cases deductions were taken that were perhaps not economically appropriate, although they were legal. Both cases, however, relate to the same issue: whether an asset can be characterized as debt or as equity. Payments to equity holders are not deductible for tax purposes, while payments to debt holders are.

One case was the setting up of partnerships, when the firm took an asset of uncertain value, contributed it to a partnership, and took back 97 percent of the partnership interest. In this case, the problem was that accrual methods were used for accounting and realization methods for taxes. The partnership borrowed money and gave the cash to Enron, with the partnership loan secured by partnership assets, but also guaranteed by Enron stock. This case, Fleischer argues, was clearly a loan for tax purposes, and the payments should have been deducted; it was the accounting that was wrong, not the tax treatment.

The second case is much more interesting: the case of monthly income preferred securities (MIPS). Enron created a special purpose-entity, an offshore limited liability corporation (LLC), and the LLC in turn issued preferred shares to the public. The proceeds were lent back to Enron. Enron took tax deductions but did not treat the asset as debt on its books. (Because of consolidation rules, debt deductions were washed out on the financial books.)

MIPS are hybrid securities with attributes of both debt and equity, but they have been treated as equity by rating agencies and accountants. The IRS initially challenged MIPS as really being preferred stock (and Fleischer suggests that in hindsight, because of the deep subordination of this debt, they were more like stock) but reversed itself. McKinnon and Hitt (2002) detail the Treasury Department's extensive attempts to prevent the emergence of MIPS, including regulation, court battles, and legislative attempts to deny deductions if they are not treated as debt for book purposes.

In some ways, the differences between debt and equity are not always clear. But the practice of allowing securities to be treated as debt for tax purposes and equity for book purposes suggests that there is a flaw in either the tax rule or the accounting rule, as the objective of both systems is to classify debt and equity properly.

Possible Remedies

One problem with tax shelters and activities like MIPS is that there is a continual battle on the part of tax administrators to deal with new ideas that financial advisors are constantly developing.

The MIPS case suggests one approach that would deal with a number of tax avoidance techniques that lead to book versus tax discrepancies: allowing a firm to treat an asset as debt for tax purposes only if the firm treats it the same way for book purposes. The Treasury Department sought such a legislative remedy when dealing with the MIPS issue. Indeed, the proper characterization of an asset as debt or equity should be the aim of both tax accounting and book accounting. Perhaps there are other cases where there is no discrepancy between the objectives and practices of tax systems and accounting systems, where conformity could be required.

There are a variety of other ideas to reduce tax sheltering and tax avoidance activities (many culled from discussions of the Enron issue). Some would involve substantive tax revisions, while others relate to greater disclosure and resources for battling tax shelters.

Tax shelter legislation has been proposed in the 107th Congress to provide offsetting revenue for Ways and Means Committee Chairman Thomas's bill relating to multinational firms' tax issues (H.R. 5095), as well as for a bill reported out of the Senate Finance Committee providing tax benefits for charity (S. 1924). The tax shelter legislation would address generic tax shelter operations in several ways. One part of the legislation would strengthen and clarify the economic substance doctrine often used in common law and by the courts to determine whether a tax benefit that may conform to a literal interpretation of the tax law is allowable. The revisions would require both a change in economic position and a nontax motive to allow an activity to be permitted under the economic substance doctrine. The exact definition of these rules is left to tax administrators, but the bill provides guidance with respect to congressional intent (e.g., the change in economic position must not be minimal). The other main focus of this tax shelter legislation addresses another problem that has hampered the ability to deal with tax shelters—reporting and disclosure—largely by imposing penalties.

Some proposals for dealing with tax versus book discrepancies and sheltering operations would involve fundamental changes to the tax law. For example, the discrepancies between book and tax income would be reduced for multinationals if all foreign-source income were included as earned in the tax base. Such a proposal would require expanding a provision in the tax law called Subpart F, which taxes passive income in foreign subsidiaries. However, current tax proposals, both in Congress and alluded to by the Bush administration, are generally to relax, not tighten, these rules. Tax sheltering and discrepancies might also be reduced if problems of income allocation and transfer pricing between multinationals and their subsidiaries were reduced. One approach is moving to a system of unitary accounting for multinationals (allocating worldwide profits on the basis of worldwide sales, capital stock, and employment).

A proposal for a minimum tax on book income also involves a fundamental change in tax treatment. Such a tax was in place in the mid- and late 1980s as part of the corporate alternative minimum tax. One reason for abandoning it was a concern that firms would distort their book profits to avoid the tax. Ultimately, the tax was imposed on earnings and profits rather than on book profits—a tax measure closer to accounting measures of income. Presumably this problem remains a barrier to a minimum tax approach.

In the aftermath of the Enron failure and the difficulties arising with Arthur Andersen (Enron's accountants), considerable attention was focused on firms that simultaneously provide accounting services and tax consulting, and whether these firms could perform both functions without a conflict of interest. One proposal that has been made is to separate the auditing and tax consultation activities of accounting firms. Although this action would involve regulatory changes rather than changes in the tax code, a result might be to reduce aggressive tax planning by consultants since such plans would come under the scrutiny of an unrelated auditor.

An issue that has been raised in many discussions of tax shelters is the lack of information on tax details, both on the part of tax authorities and the public. Part of the problem with information is that many activities are netted against each other. This issue has led to proposals for more detailed accounting and reporting of discrepancies between book and tax income on the reconciliation statements provided on tax returns. Some proposals also call for more detail on the reports provided to the public and the Securities and Exchange Commission. In particular, detailed reconciliation tables that identify the tax versus book differences from the basic sources—consolidation rules, special tax benefits, and accrual versus realization—and provide considerable detail would help reveal why a company that appears to be profitable is paying little or no tax. Some have also proposed make the tax returns of publicly held corporations available to the public.

A final proposal is to make more resources available to the IRS to audit and challenge the tax-sheltering operations of large corporations, including challenges in court. IRS activities in this area may be hampered by the direction of resources into other areas (such as customer service and compliance with earned income tax credit rules).

V. CONCLUSION

It is probably fair to say that the most important tax issue raised by the Enron debacle is the one that affects many ordinary taxpayers in important ways: whether the tax system is using its $100 billion of retirement tax subsidy dollars wisely. The discussion in this paper suggests there is some doubt.

Retirement plans, always focused on higher-income individuals, are increasingly moving in the direction of features that put adequate old-age pensions at risk: lump-sum payouts and DC plans that contain no restraints on employer stock. Moreover, tax policy is not only permitting (and some would say encouraging) DC plans, but is particularly favoring plans solely invested in employee stock, with provisions including a powerful new benefit granted on the eve of the Enron collapse. The Enron failure indicated just how much these risky plans can undermine retirement security. No plan for redressing this issue that has been seriously considered has confronted the tax treatment of ESOPs, and unless ESOPs are treated rationally by the tax system, it is hard to see how any plan can succeed.

The growth of stock options may also be an issue for public policy, although most stock options are nonqualified ones that do not benefit from tax preferences. Since stock options as commonly designed do not appear to be the best instruments for addressing principal-agent problems, some consideration might be given to withdrawing special benefits for qualified stock options (or allowing benefits only when desirable design characteristics apply). It would also seem feasible to provide for recognition of options upon grant, and conform this treatment with book income treatment.

There are many proposals on the table for attacking the issue of book versus tax conformity, including proposals that will involve substantive changes to the tax law. More disclosure to tax authorities and the public might be the least politically controversial way of addressing the circumstances illustrated by Enron, a supposedly profitable company with little or no tax liability.

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