B. Enron's General International Tax Posture[1060]

1. Foreign tax credit problems arising from interest allocation rules

From the time that Enron began significant foreign expansion in the early 1990s, its tax posture in the international area was defined in large part by one major problem: as a result of large allocations of U.S. interest expense against foreign source income under section 864(e), Enron was persistently unable to use foreign tax credits. The company thus faced the possibility of significant double taxation of its foreign source income. This potential for unmitigated double taxation was of paramount concern in Enron's international tax planning and significantly influenced the structures of Enron's international operations and transactions.

Enron was not unique among companies of comparable size in facing foreign tax credit utilization problems arising from the interest allocation rules of section 864(e). U.S.-based multinational corporations have long complained about the impact of these rules on their capacity to use foreign tax credits, and legislation has been considered by Congress from time to time addressing this concern.[1061] In Enron's case, the adverse impact of the interest allocation rules was particularly acute as it expanded its activities abroad, due to Enron's high level of investment in foreign assets (e.g., power plants in foreign countries) and comparatively low level of foreign income. The high levels of foreign assets generated a large allocation of interest expense against relatively low levels of foreign source income, thus generating an ever expanding, and eventually nearly insurmountable, overall foreign loss account.[1062]

Enron's overall foreign loss account first arose in 1992 and grew at a rate of $20 million to $25 million per year.[1063] As early as 1993, Enron appears to have concluded that it would not be able to claim foreign tax credits at any time in the foreseeable future.[1064]

[1060] The information in this section of the report is based on documents provided by Enron and the IRS, and on interviews with Robert Hermann, James A. Ginty, Cullen A. Duke, Edward R. Coats, Leesa M. White, and Stephen H. Douglas.

[1061] *See, e.g.*, H.R. 285, 108th Cong., 1st Sess., sec. 310 (2003); H.R. 5095, 107th Cong., 2d Sess., sec. 311 (2002); Taxpayer Refund and Relief Act of 1999, H.R. Conf. Rep. No. 106-289, sec. 901 (1999) (vetoed by President Clinton).

[1062] For example, according to a company memorandum, EOG Canada's asset basis of $86 million attracted an allocation of U.S. interest expense of $7 million against income of only $400,000 for 1992. Memorandum, "Enron FTC Position," June 26, 1992, at EC2 000036091.

[1063] Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036150.

[1064] Memorandum, "Structuring for Enron's Foreign Operations," Mar. 11, 1993, at EC2 000036120.

AUTHENTICATED U.S. GOVERNMENT INFORMATION GPO

2. Planning techniques addressing the foreign tax credit problem

In general

Enron determined relatively early in its international expansion that it would not be feasible to attempt to eliminate the overall foreign loss account and thereby regain the ability to use foreign tax credits.[1065] Instead, the company accepted the fact that it would not be able to use foreign tax credits and sought to structure its international investments and activities in such a way as to minimize the impact of this problem. The company employed two main strategies in this regard: deferral and deconsolidation.

Deferral strategy

Under the deferral strategy, Enron conducted many of its international operations under a holding company and planned never to repatriate the earnings from a foreign project back to the United States. As long as the subpart F and passive foreign investment company rules did not apply to the earnings, U.S. tax on the foreign earnings generally could be deferred indefinitely, and double taxation would be avoided, albeit at the cost of losing the flexibility to repatriate funds to the United States.

Under applicable financial accounting standards, deferred U.S. taxes on foreign earnings need not be accrued for book purposes if the company has plans for permanently reinvesting the earnings offshore.[1066] In other words, to the extent that Enron could avoid actual or deemed repatriations of its foreign earnings, the company's inability to claim foreign tax credits would have no direct financial statement impact.

Thus, in Enron's case, the U.S. international tax rules (particularly the interest expense allocation rules), combined with the relevant financial accounting standards, created a significant incentive for the company not to repatriate foreign earnings to the United States. It is impossible to determine the extent to which this incentive may have caused the company to invest more heavily in foreign assets, and less heavily in U.S. assets, than its non-tax business strategy otherwise would have dictated. In this regard, it appears that the company anticipated major growth opportunities abroad, and that the foreign reinvestment encouraged by this incentive may not have been inconsistent with the company's non-tax business strategy -- indeed, it appears that the company's foreign investment plans called for more funds than the company was generating in its international operations.[1067] In addition, in cases in which the repatriation of funds was considered desirable, the company had the option of using the deconsolidation strategy.

[1065] *Id.*

[1066] *See Accounting Principles Board (APB) Opinion No. 23; Statement of Financial Accounting Standards (FAS) 109.*

[1067] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, Jan. 13, 2003, answer 133.

Deconsolidation strategy

Under the deconsolidation strategy, Enron was able in some cases to circumvent its foreign tax credit limitation problem by investing in a foreign project through a U.S. entity that was not a member of the Enron consolidated group. The interest allocation problem, large overall foreign loss account, and resulting inability to use foreign tax credits pertained only to the Enron consolidated group. In cases in which Enron was willing to allow an unrelated party to take an ownership interest exceeding 20 percent in the U.S. entity through which a foreign project was conducted, the entity's ability to use foreign tax credits would not be affected by the foreign tax credit problems of the Enron consolidated group.[1068]

The deconsolidation strategy entailed a number of costs to the company, however, which rendered the strategy unsuitable in many cases. First, it required significant equity participation on the part of an unrelated investor, which Enron may not have considered desirable from a non-tax perspective. Second, the strategy caused dividends paid by the deconsolidated entity to Enron to qualify for only the 80-percent dividends-received deduction under section 243, instead of the 100-percent deduction that would apply to dividends from an 80-percent-or-greater-owned company. Finally, the strategy involved greater transaction and compliance costs than comparable investments made in a more straightforward manner through the Enron consolidated group. In light of these considerations, Enron employed this strategy only in a few situations in which repatriation of earnings was considered highly desirable -- i.e., in connection with high-income projects in high-tax foreign jurisdictions, in which case substantial foreign tax credits would be generated, and any benefit of deferral would be small. Generally, however, the deconsolidation strategy was regarded as too costly and cumbersome, and thus the deferral strategy was by far more commonly employed.[1069]

[1068] For example, Enron held its interests in certain projects that were subject to higher rates of foreign tax through Enron Equity Corp. Enron held all of the common stock of Enron Equity Corp., and an institutional investor (John Hancock Insurance Co.) held all of the preferred stock, which carried sufficient voting power and value that the company was not a member of the Enron consolidated group for tax purposes. Enron Tax Deconsolidation and Foreign Tax Credit Planning Discussion Paper, April 30, 1998, at EC2 000036194.

[1069] Joint Committee staff interviews.