C. Proliferation of Foreign Entities in Enron's Ownership Structure[1070]

1. Background

Press reports have suggested that Enron employed an unusually large number of offshore entities, particularly in countries that impose no tax on such entities, in an effort to avoid taxes.[1071] Enron did in fact establish a complex entity structure that included a large number of foreign entities, including many entities in countries that imposed no tax on such entities. It is important to note, however, that the mere existence of a large number of entities, even entities formed in jurisdictions that do not impose an income tax, does not necessarily indicate that Enron was using these entities inappropriately from a U.S. Federal tax perspective. Moreover, the number of foreign entities established by a company does not necessarily bear a significant relationship to the amount of any reduction in U.S. Federal tax that the company might have achieved through the structuring of the company's international activities. In order to evaluate Enron's practices in this regard, the reasons behind its complex entity structure must be examined.

2. General reasons for complex entity structures

It is not uncommon for large multinational business enterprises to organize themselves into complex structures consisting of multiple domestic and foreign corporations, partnerships, and branch entities. Non-tax business considerations such as liability management, regulatory requirements, management accounting, and financing needs may influence the decision to conduct a particular operation or make a particular investment through a certain kind of entity or combination of entities. For example, the laws of a foreign country in which an enterprise wishes to do business may provide that certain activities may be conducted only by a corporation established under local law; or the involvement of a third-party foreign investor or partner in a project may necessitate the use of a certain combination of foreign business entities. Tax considerations generally also factor into the decision, both with respect to the choice of jurisdiction and the choice of entity within a particular jurisdiction. Jurisdictions differ in terms of overall tax burden, special tax rules applicable to certain types of income and activities, and tax treaty networks. Some entities are treated as separate taxable persons (e.g., corporations), some are not (e.g., branches), and some fall somewhere in between (e.g., partnerships). In structuring complex international investments and operations, prudent tax planning typically requires a U.S.-based multinational enterprise to use a combination of many different entities in

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[1070] The information in this section of the report is based on documents provided by the company and by the IRS, and on interviews with Robert Hermann, James A. Ginty, Cullen A. Duke, Edward R. Coats, Leesa M. White, and Stephen H. Douglas.

[1071] *See, e.g.*, David Cay Johnston, *Enron Avoided Income Taxes in 4 of 5 Years*, New York Times, Jan. 17, 2002 ("Enron paid no income taxes in four of the last five years, using almost 900 subsidiaries in tax-haven countries and other techniques, an analysis of its financial reports to shareholders shows"); Glenn R. Simpson, *Enron's Quest to Avoid Taxes Took the Firm to the Netherlands*, Wall Street Journal, Feb. 7, 2002 ("Enron's quest to avoid taxes by using offshore tax havens took the company to some unlikely places").

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many different jurisdictions, even if the enterprise's tax planning goals are limited to the generally unobjectionable ones of deferring U.S. Federal income tax on active, non-subpart-F income until such income is repatriated, and mitigating the double taxation of foreign income to the extent allowable under the foreign tax credit and the U.S. tax treaty network.

For this combination of non-tax and tax reasons, a multinational business enterprise that conducts several lines of business in many different countries cannot avoid developing a somewhat complex organizational structure, as it seeks to manage the potential liabilities of the various businesses, satisfy all applicable local regulatory requirements, facilitate the evaluation of manager performance in the different businesses, arrange the desired mix of debt and equity financing from internal and external sources, and undertake sound tax planning measures with respect to all relevant jurisdictions.

3. The number of foreign entities in Enron's ownership structure

While the number and types of entities in the Enron ownership structure varied over time, as of the end of 2001, this structure included approximately 1,300 different foreign entities.[1072] The vast majority (approximately 80 percent) of Enron's foreign entities were "dormant" -- in other words, inactive shells that did not hold and were not engaged in or associated with any ongoing business, and that were therefore largely irrelevant for tax purposes.[1073] Approximately 20 percent of Enron's foreign entities were associated with ongoing businesses and thus had some potential relevance for tax purposes. Overall, leaving aside the dormant entities, Enron conducted its foreign operations during 2001 through a network of roughly 250 different foreign entities.

Enron created many entities in jurisdictions that imposed no tax on such entities. In particular, as of the end of 2001, the Enron ownership structure included 441 entities formed in the Cayman Islands, a country that has never imposed a corporate income tax.[1074] The majority of these entities were dormant.[1075] The role of the Cayman entities, and the reasons why so many were dormant, are explained in Part IV.C.4, below.

[1072] This figure includes foreign corporations and foreign partnerships that were controlled by Enron, as well as certain other entities in which Enron owned a significant stake (e.g., "noncontrolled section 902 corporations," in which Enron owned at least a ten percent stake). This figure does not include "branch" entities, which are disregarded for Federal tax purposes (e.g., pursuant to a "check the box" election) -- the activities, income, and deductions of branches are treated as those of their owners for Federal tax purposes. The inclusion of foreign branch entities would yield a total count of approximately 1,500 foreign entities for 2000. *See* Enron Presentation to Joint Committee staff, June 7, 2002, at 9 (Appendix B, Part I to this Report).

[1073] *Id.*; Joint Committee staff interviews.

[1074] Enron Submission to IRS Examination Team, Feb. 26, 2002.

[1075] *Id.*; Joint Committee staff interviews.

An article in the New York Times presented some figures in this regard that appear to reflect some confusion regarding certain information set forth the 2000 Form 10-K that Enron filed with the SEC. According to the article, Enron created "881 subsidiaries abroad, including 692 in the Cayman Islands, 119 in the Turks and Caicos, 43 in Mauritius and 8 in Bermuda."[1076] These figures appear to be based on Exhibit 21 of Enron's 2000 SEC Form 10-K, which lists subsidiaries of the filing company. In preparing this list, Enron used a somewhat confusing presentation format in which a single subsidiary would appear on the list multiple times if a number of other Enron subsidiaries held interests in it. Given this format, a simple line-by-line count of list entries would lead to substantial multiple-counting of certain entities, and thus to inflated numbers in some cases. For example, a review of Exhibit 21 of Enron's 2000 SEC Form 10-K suggests that multiple-counting of two Turks and Caicos companies (specifically Smith/Enron Cogeneration Limited Partnership and Smith/Enron O&M Limited Partnership) was largely responsible for the count of 119 Turks and Caicos companies reported in the article. According to materials submitted to the IRS by the company, Enron in fact established only 4 Turks and Caicos companies.[1077]

It is generally difficult to make useful tax inferences from the data that companies file with the SEC in this regard. Companies have considerable flexibility in determining the content and format of Exhibit 21, and the filing generally contains little or no information as to the various subsidiaries' assets, activities, tax treatment, and interrelationships. Moreover, different companies appear to have different standards as to the circumstances under which a subsidiary is regarded as "significant," and therefore required to be reported on Exhibit 21. Some companies may report relatively few of the overall entities in their structure on this form; others may report most or all of their entities. Ultimately, the only reporting regime that yields the information needed to determine the relevance of the various foreign entities to the administration of the Federal tax rules is the information reporting regime required under those rules.[1078]

Most importantly, regardless of the data source (whether it be SEC or IRS filings), it must be noted that relatively little can be inferred from a mere count of a company's foreign entities in various jurisdictions without examining why the entities were established and how they are used transactionally. On the one hand, it is possible for a company to own numerous foreign entities, even many formed in jurisdictions imposing no tax on such entities, without using these entities for any inappropriate Federal tax purposes. (And even if some entities are used for such inappropriate purposes, their sheer number does not necessarily bear a significant relationship to the amount of any reduction in U.S. tax that the company might be attempting to achieve.) On the other hand, it is possible for a company to employ a relatively simple entity structure, with no entities in jurisdictions typically regarded as tax havens, and yet attempt to

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[1076] David Cay Johnston, *Enron Avoided Income Taxes in 4 of 5 Years*, New York Times, Jan. 17, 2002.

[1077] Enron Submission to IRS Examination Team, Feb. 26, 2002.

[1078] Of course, the information provided under this regime generally is not made public. *See* sec. 6103.

achieve significant inappropriate reductions in Federal taxes through the use of its foreign entities.

Even with reference to Enron itself, it appears that the company's most aggressive tax-reduction strategy relating to the international tax rules was the Project Apache structured transaction, which did not require the involvement of any entity created in a jurisdiction generally regarded as a tax haven.[1079] The attempt to draw general conclusions about a company's international tax practices by simply following the trail of Cayman entities thus may focus attention on certain unexceptional practices and yet fail to reveal the company's most aggressive practices.

In sum, Enron undoubtedly had a complex entity structure, but the tax implications of that structure cannot be understood without examining the purposes and functions of the various entities comprising that structure.

4. Sources of complexity in Enron's ownership structure

Number of foreign infrastructure projects

One major component of Enron's international growth strategy over the 10-year period preceding the company's bankruptcy involved bidding for, constructing, and eventually selling foreign infrastructure projects, such as power plants and gas pipelines. Enron began developing its first major foreign project in 1991, which was a power plant project in the United Kingdom. By 1995, the company had undertaken project development activities in over 30 different countries.[1080] The Enron domestic affiliate primarily responsible for this line of business was Enron Development Corporation, which reorganized as Enron International in December 1997.

Foreign infrastructure development was a high risk business, in which each project opportunity represented a relatively small chance of generating very large returns. Enron pursued numerous project opportunities around the world, anticipating that most projects would fail but expecting that a few would be sufficiently profitable to make the overall line of business successful for the company.[1081] Each project, whether successful or not, typically had its own separate entity structure. In view of this practice, and the number of projects that the company initiated, the foreign infrastructure development business became the most significant contributor to the proliferation of entities within Enron's overall ownership structure.

[1079] *See* Part I.D.1, above, for a discussion of Project Apache.

[1080] Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036151.

[1081] According to Enron, the company's success rate in winning project bids was "well under 20 percent." In addition, many projects that Enron pursued encountered serious difficulties or were abandoned either before submitting a bid or well after winning one. Letter from Enron's counsel (Vinson & Elkins) to IRS, Sep. 13, 2001, at EC2 000055688-689.

Multiple entities for each project

Enron generally formed a few separate entities for each foreign infrastructure project that it pursued. As explained in Part IV.B, above, Enron's dominant Federal income tax concern in the structuring of its foreign operations was its persistent inability to use foreign tax credits, and a deferral strategy was the company's principal response to this problem. Enron's typical deferral structure required that a few different entities be created for each project. In addition to a local project entity, the ownership of which might be divided between Enron and an unrelated co-venturer, Enron generally employed a tiered arrangement of foreign holding companies through which it held its own interest in the project entity. These tiered arrangements were established primarily to facilitate potential sell-downs of Enron's interests in the project entities, while to the extent possible maintaining deferral of U.S. taxes on any project earnings.[1082]

The nature of these arrangements changed over time in response to developments in U.S. tax law. In particular, as explained in further detail below, the issuance of the "check the box" entity classification regulations, effective at the beginning of 1997, enabled Enron to implement holding company structures that made use of fewer entities and offered greater flexibility without sacrificing U.S. tax deferral.[1083] Both before and after the issuance of these regulations, however, the practice of establishing multiple entities for each foreign project produced considerable complexity within the Enron ownership structure.

In a typical project structure established prior to the issuance of the "check the box" regulations, Enron would hold its interest in a project through three separate Cayman Islands holding companies, in addition to a project entity formed under local law in the project jurisdiction. The domestic Enron entity responsible for the project would own the stock of the first Cayman Islands holding company ("Cayman Parent"), which would be treated as a corporation for U.S. Federal tax purposes.[1084] Cayman Parent in turn would own all of the stock of a second Cayman Islands company ("Cayman Sub"), which also would be treated as a corporation for U.S. Federal tax purposes. Cayman Parent and Cayman Sub in turn would own 99 percent and 1 percent, respectively, of the ownership interests in a Cayman Islands Limited Life Company ("Cayman LLC"), which Enron would treat as a partnership for U.S. Federal tax purposes. Cayman LLC in turn would directly hold the Enron-side interest in the project entity. If Enron had a partner in the project venture, then that partner also would own an interest in the project entity. Cayman Sub, Cayman LLC, and the project entity typically would be dedicated exclusively to the particular project.

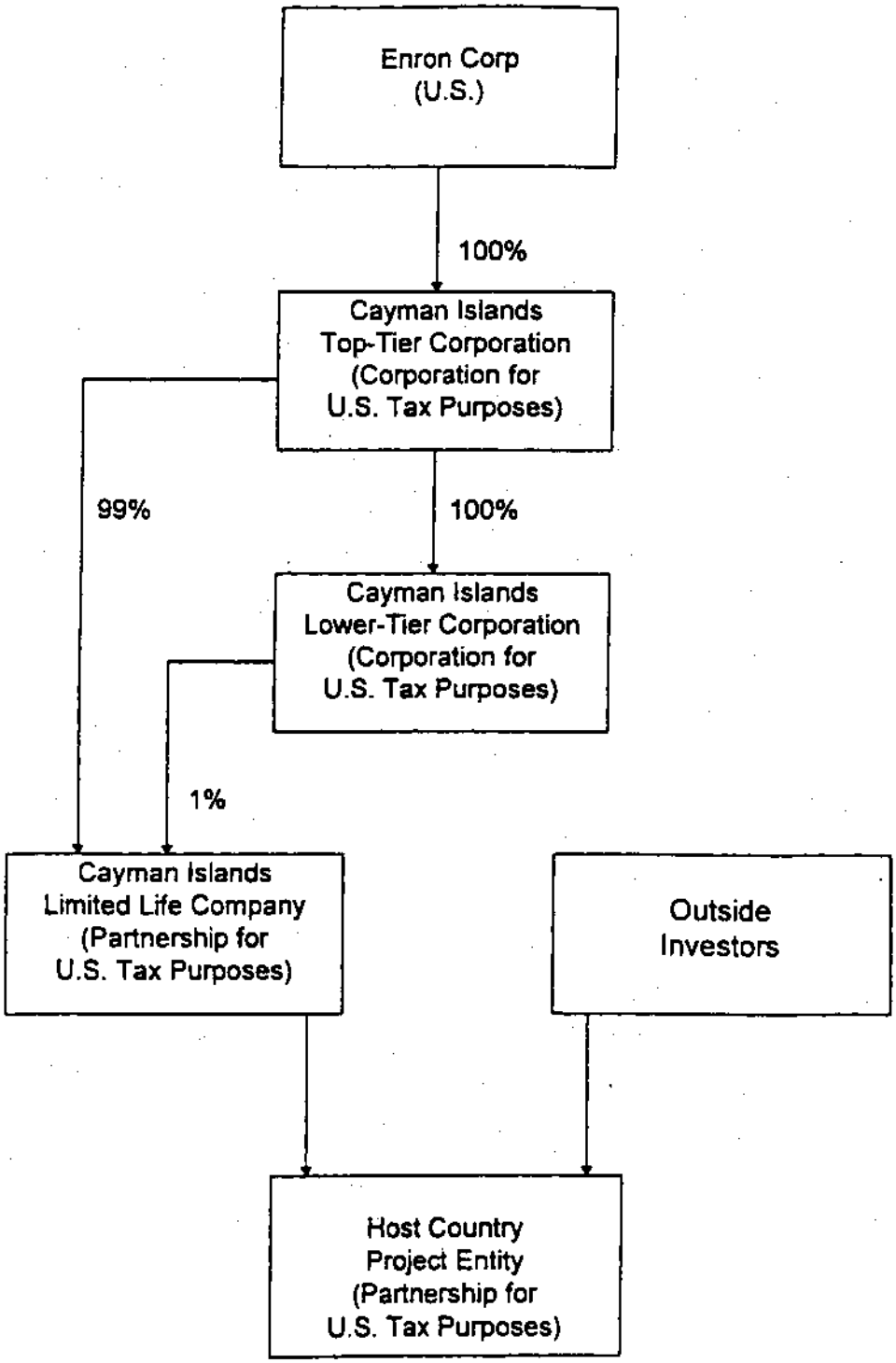
The diagram on the following page depicts this structure.

[1082] Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036159; Joint Committee staff interviews.

[1083] Treas. Reg. sec. 301.7701-1, *et seq.*

[1084] Cayman Parent could also hold interests in lower-tier entities established in connection with other projects.

DIAGRAM OF TYPICAL CAYMAN ISLANDS MULTI-TIERED OWNERSHIP STRUCTURE



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APPENDIX II

The project entity usually was an entity treated as a corporation in the project jurisdiction, due to regulatory requirements under local law, the needs of the venture partner, or both. For U.S. Federal income tax purposes, however, it was desirable to treat the project entity as a partnership, so that Enron's Cayman Islands holding companies could receive distributions of earnings from the project entity without generating subpart F income. Qualifying the project entity as a partnership enabled Cayman LLC to be treated essentially as if it had earned the project income itself. Thus, assuming that the project itself generated active type income that was not subject to subpart F, U.S. Federal taxes on project income generally could be deferred within the Cayman holding company structure until the earnings were repatriated to the United States.[1085]

In order to achieve characterization of the project entity as a partnership prior to the issuance of the "check the box" regulations, the entity could possess no more than two out of the four following corporate characteristics: limited liability, centralized management, free transferability of interests, and unlimited life.[1086] In view of the practical importance of limited liability and centralized management, Enron generally opted to eliminate the characteristics of free transferability of interests and unlimited life, by adding share transferability restrictions and dissolution provisions. Thus, for example, Cayman LLC typically would not be allowed to sell its interest in the project entity without the consent of the venture partner, and the organizing documents of the project entity would provide for dissolution in the event of the bankruptcy of Cayman LLC or the venture partner. The transferability restrictions added to the complexity of the project structure, since it required Enron to add a tier to its side of the structure in order to be able to sell its interest in the project without obtaining the consent of its venture partner.[1087]

The three Cayman Islands entities on the Enron side of the structure comprised a so-called "Cayman Triangle."[1088] The involvement of Cayman Sub, and its nominal level of ownership of Cayman LLC, was intended to ensure that Cayman LLC also would be treated as a partnership for U.S. tax purposes. Treatment of Cayman LLC as a partnership was important to avoid the creation of subpart F income on the distribution of earnings from the foreign project entity up through the Cayman holding company structure. If Cayman LLC were treated as a corporation, then distributions of project earnings from Cayman LLC to Cayman Parent

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[1085] Such deferral was not always possible, however, even with respect to active business income generated by a project. For example, certain income generated by the pipeline transportation of natural gas across national borders could be subject to subpart F as "foreign base company oil-related income." Sec. 954(g).

[1086] Treas. Reg. sec. 301.7701-2, as in effect before 1997.

[1087] In some instances there were other advantages to selling an interest in a Cayman holding company rather than an interest in a local project entity, including avoidance of project-country taxes, ownership registration requirements, and other regulatory or contractual restrictions on the transferability of interests under local law.

[1088] Joint Committee staff interviews; Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036159.

generally would have been dividends treated as subpart F income.[1089] Characterizing Cayman LLC as a partnership for U.S. Federal income tax purposes made it possible for Cayman Parent and Cayman Sub to receive distributions from Cayman LLC without generating subpart F income.[1090]

The advent of the "check the box" entity classification regulations made it possible for Enron to plan for sell-downs and to achieve the desired deferral of U.S. taxes without using a "Cayman Triangle," since these regulations enabled taxpayers to treat eligible single owner entities as disregarded entities, and to elect to treat multi-owner entities as partnerships, without the need to contend with the four-factor test of the old entity classification regulations. Thus, as of 1997, Enron could achieve deferral of U.S. taxes on project earnings through a simpler structure in which Cayman Parent was the sole owner of the interest in Cayman LLC, which in turn held the Enron interest in the project entity. Cayman Sub could be eliminated, and there was no need to include transferability restrictions or dissolution provisions in the project entity's governing documents. In some cases, it might even have been possible for Cayman LLC to be eliminated, and to have Cayman Parent invest directly in the project entity, but project country tax considerations and regulatory or contractual transferability restrictions generally rendered it desirable to invest in the project entity through at least one project specific Cayman Islands entity underneath Cayman Parent.

Formation of project entity structures at early stage of project development

Another contributor to the proliferation of entities within the Enron ownership structure was the company's practice of establishing the separate entity structures described above at a very early stage in the evaluation, bidding, and development process. As a result of this practice, even those project opportunities that were abandoned before reaching any significant level of development would contribute a number of new entities to Enron's overall structure.

The principal reason that Enron established separate offshore entity structures so early in the project development process was a concern that the project opportunity (perhaps reflected in non-binding preliminary agreements, letters of intent, or "memoranda of understanding") could be found to constitute intangible property for tax purposes. Given this possibility, if preliminary project activities were undertaken directly by a U.S. entity, and then the project were later carried out by a foreign entity, the company was concerned that it might be deemed to have made an outbound transfer of the intangible property. Such a transfer would have been subject to the rules of section 367(d), which treat the transfer as a sale for contingent payments and require the U.S. entity to include in income a stream of payments from the foreign entity "commensurate with the income" generated by the intangible. By establishing a separate offshore entity

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[1089] The "same country dividend" exception of sec. 954(c)(3) requires that the dividend paying controlled foreign corporation be engaged in a trade or business in its country of incorporation, and thus would not have been available in the case of a holding company owning an interest in a project entity in another country.

[1090] The relatively small distributions from Cayman Sub to Cayman Parent, however, generally would generate subpart F income.

structure from the outset of a project, and having the project specific entities execute any preliminary agreements, the company sought to mitigate this risk.[1091]

The company recognized that there was a cost to this practice, in the form of the creation of multiple entities for projects that would never advance beyond the preliminary stages of development. These entities would be costly to establish and maintain, but ultimately would serve little or no purpose. Nevertheless, the company evidently concluded that the expected reduction of the company's exposure to IRS adjustments under section 367(d) outweighed these costs.

Retention of dormant entities

The considerations described above explain why Enron's infrastructure project development business, and the manner in which the company conducted this business, led to the creation of not just a large number of foreign entities, but also inevitably to a large number of foreign entities that would become dormant. Indeed, as noted in Part IV.C.3 above, the vast majority of foreign entities in Enron's corporate structure fit this description. This observation suggests that Enron could have achieved a great deal of simplification of its entity structure by eliminating these dormant entities, but that the company chose instead to maintain them.

According to Enron tax department personnel interviewed by the Joint Committee staff, the tax department consistently objected to the practice of maintaining dormant entities, and on several occasions recommended to Enron's legal and commercial groups that these entities be liquidated. The tax department argued that maintaining the dormant entities generally served little purpose other than to create unnecessary administrative and compliance costs for the company (e.g., annual filings of IRS Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations," under section 6038).

[1091] Enron also proposed legislation to eliminate this potential pitfall, but the company's efforts in this regard were not successful. *See* Enron "Non-binding Intent Agreements" Policy Memorandum, March 2000, Appendix B, Part XV to this Report.

The following table shows the number of Enron's filings of IRS Form 5471 by year:

Table 4.–Enron's Information Returns Relating to Controlled Foreign Corporations

Year	Number of Forms 5471 Filed
1992	84
1993	108
1994	128
1995	211
1996	247
1997	378
1998	491
1999	501
2000	564

In addition to controlled foreign corporations, Enron's ownership of other types of entities (e.g., controlled foreign partnerships) [1092] also entailed U.S. Federal tax information reporting on an annual basis, even if such entities were empty shells. On average, the tax department estimated that the company incurred $5,000 to $10,000 of administrative and compliance costs per entity per year.[1093] Given the number of dormant entities within the Enron ownership structure, these arguably unnecessary compliance costs would total several million dollars every year.

Notwithstanding these costs, and the recommendation of the tax department, the company for the most part chose not to unwind its dormant entities. According to the Enron tax department personnel interviewed, if there was even a remote chance that the project for which an entity was created might be revived, the commercial and legal groups preferred that the entity not be liquidated.[1094] This practice seems to have allowed the number of entities within the Enron ownership structure to grow beyond what the tax department viewed as the reasonable needs of the business, with little tax or non-tax effect other than for the company to incur additional compliance costs.

[1092] *See* sec. 6038(a), (e)(1), (e)(3).

[1093] *See* Enron "Non-binding Intent Agreements" Policy Memorandum, March 2000, Appendix B, Part XV to this Report.

[1094] In some cases there may have been a U.S. tax logic to this practice. For example, if the dormant entity had some sort of preliminary agreement relating to the project, then the section 367(d) concerns described above might weigh in favor of leaving that entity and its potential intangible property in place.