IV. USE OF FOREIGN ENTITIES BY ENRON

Enron owned interests in several hundred entities established in foreign jurisdictions that imposed no tax on such entities. Press reports have raised questions about the number and purposes of such entities. The discussion below begins with an overview of the relevant Federal international tax rules. The discussion then explains Enron's general posture under these rules and addresses Enron's use of the foreign entities. The discussion concludes with a Joint Committee staff recommendation.

A. Overview of Selected International Tax Rules

1. In general

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[1031] and the passive foreign investment company rules.[1032] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[1033]

2. Foreign tax credit

The United States generally provides a credit for foreign income taxes paid or accrued.[1034] In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to a "deemed paid" credit for such taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[1035] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source

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[1031] Secs. 951-964.

[1032] Secs. 1291-1298.

[1033] Secs. 901, 902, 960, 1291(g).

[1034] Sec. 901.

[1035] Secs. 902, 960.

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income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[1036]

Due to this limitation, a taxpayer must allocate gross income and expenses between U.S. and foreign sources in order to determine the amount of allowable foreign tax credits. Under present law, interest expense that a U.S.-based multinational corporate group incurs in the United States is allocated to U.S. and foreign sources based on the gross assets located in the United States relative to those located abroad (measured either by basis or by fair market value).[1037] Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its U.S. interest expense to foreign-source income, which reduces the foreign tax credits allowable (even though the interest expense incurred in the United States is not deductible in computing the actual tax liability under applicable foreign law).

The foreign tax credit limitation is applied separately to different types of foreign-source income, in order to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income. For example, if a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, then the earning of the untaxed (or low-taxed) passive income could expand the taxpayer's ability to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction, by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis.[1038] Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories (or "baskets"), and the low-taxed passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income. Present law provides nine separate baskets as a general matter, and effectively many more in situations in which various special rules apply.[1039]

If a taxpayer generates an overall foreign loss ("OFL") for the year -- whether as the result of business losses or expense allocations under U.S. tax rules -- it will not be able to claim foreign tax credits for that year, since it will have no foreign-source income and thus will have a foreign tax credit limitation of zero. Moreover, if the taxpayer does generate foreign-source income in later years, some portion of such income will be "recaptured," or recharacterized as U.S.-source, thus reducing the foreign tax credit limitation in later years.[1040] The rationale for OFL recapture is that the foreign-source losses offset U.S.-source income in the year generated,

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[1036] Secs. 901, 904.

[1037] Sec. 864(e); Temp. Reg. sec. 1.861-11T.

[1038] Sec. 904(d).

[1039] *Id.*

[1040] Sec. 904(f). These rules also operate on a category-by-category basis.

thereby reducing the U.S. tax collected with respect to U.S.-source income. The U.S. fisc would not be made whole when the taxpayer subsequently earns foreign-source income if the U.S. tax on such income were completely offset by foreign tax credits.

3. Anti-deferral regimes

In general

Generally, income earned indirectly by a domestic corporation through a foreign corporation is subject to U.S. tax only when the income is distributed to the domestic corporation, because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations, in order to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad.

Subpart F

Subpart F,[1041] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[1042] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[1043]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[1044] insurance income,[1045] and certain income relating to international boycotts and other violations of public policy.[1046] Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign

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[1041] Secs. 951-964.

[1042] Secs. 951(b), 957, 958.

[1043] Sec. 951(a).

[1044] Sec. 954.

[1045] Sec. 953.

[1046] Sec. 952(a)(3)-(5).

base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.[1047]

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.[1048]

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[1049] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[1050] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[1051] A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[1052]

Coordination

Detailed rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a passive foreign investment company with

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[1047] Sec. 954.

[1048] Secs. 951(a)(1)(B), 956.

[1049] Sec. 1297.

[1050] Sec. 1293-1295.

[1051] Sec. 1291.

[1052] Sec. 1296.

respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a "U.S. shareholder" as defined in section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules.

4. Transfer pricing

In general

Due to the variation in tax rates and tax systems among countries, a multinational enterprise may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities could be accomplished by establishing artificial, non-arm's-length prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation when necessary to prevent an improper shifting of income between that entity and a commonly controlled entity. The statute generally does not prescribe any specific reallocation rules that must be followed, other than establishing the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

Special transfer pricing rules apply to transactions involving intangible property and services. These transactions present particular challenges to the administration of the arm's length standard, since intangibles and services may be unique, thus rendering a comparison with third-party market transactions difficult or impossible.

Transactions involving intangible property

In the case of a related-party sale or license of an intangible, section 482 requires that the income with respect to such transfer or license be "commensurate with the income" generated by the intangible. Similarly, section 367(d) provides that, if an intangible is transferred to a related foreign corporation in a nonrecognition transaction (e.g., a transfer under section 351), the transaction is treated as a sale for contingent payments, resulting in the inclusion by the transferor of income "commensurate with the income" generated by the intangible. This approach seeks to avoid some of the difficulties of determining a single arm's length price at the time of the transaction by instead determining the appropriate income attributable to the intangible on an ongoing basis, as the intangible generates income.

In view of the uncertainty that this method may impose on taxpayers, regulations under section 482 provide an alternative method for allocating the income attributable to intangibles among the members of a group of related companies, in the form of "qualified cost-sharing arrangements."[1053] Under such an arrangement, if the parties share the costs of developing the

[1053] Treas. Reg. sec. 1.482-7.

intangible in proportion to their reasonably anticipated benefits, make arm's length buy-in payments with respect to any previously developed intangibles contributed to the arrangement, and otherwise comply with the terms of the regulation, then the IRS will not seek to make reallocations under the general rules of section 482.[1054]

Transactions involving services

In the case of services, the regulations under section 482 generally seek to distinguish between services that provide only incidental, or indirect and remote, benefits to a related party, in which case no arm's length charge is normally required, and services that provide more meaningful and direct benefits to a related party, in which case an arm's length charge is required.[1055] Even in the latter case, however, the requirement of an arm's length charge is generally considered met if the recipient of the services pays the provider's costs, unless the services constitute an "integral part" of the business of either the provider or the recipient of the services.[1056] Services are regarded as "integral" under this test if: (1) either the renderer or the recipient is in the trade or business of rendering the same or similar services to third parties; (2) providing services to related parties is one of the principal activities of the renderer; (3) the renderer is "peculiarly capable" of providing the services, the services are a principal element in the operations of the recipient, and the value of the services is substantially greater than the costs or deductions of the renderer; or (4) the recipient has received the benefit of a substantial amount of services from a related party or parties during the year.[1057]

5. Entity classification

Prior to 1997, entity classification for Federal tax purposes was determined on the basis of a multi-factor test provided in regulations under section 7701. In distinguishing between a corporation and a partnership, these regulations set forth four characteristics indicative of a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. If a business entity possessed three or more of these characteristics, then it was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership.[1058] Thus, in order to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these characteristics. For example, a taxpayer desiring partnership classification for an entity might include transferability restrictions and dissolution provisions in order to eliminate the characteristics of free transferability and continuity of life. Partnerships also needed to have at least two members, as the term suggests.

[1054] *Id.*

[1055] *See* Treas. Reg. sec. 1.482-2(b).

[1056] *Id.*

[1057] Treas. Reg. sec. 1.482-2(b)(7).

[1058] Treas. Reg. sec. 301.7701-2, as in effect prior to 1997.

Since January 1, 1997, new entity classification regulations have been in effect that generally allow taxpayers simply to elect the desired classification for many types of entities, including certain limited-liability entities available under the laws of many State and foreign jurisdictions.[1059] These regulations are commonly referred to as the "check the box" regulations. The regulations generally eliminate the need for modifications to the terms of governing documents in order to secure a particular entity classification, and they make it possible for a taxpayer to elect branch treatment for a single-member limited-liability entity, thus enabling the taxpayer to achieve both flow-through taxation and limited liability with respect to a foreign entity without adding a second member.

6. Treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

[1059] Treas. Reg. sec. 301.7701-1, *et seq.*

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.

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.

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").

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.

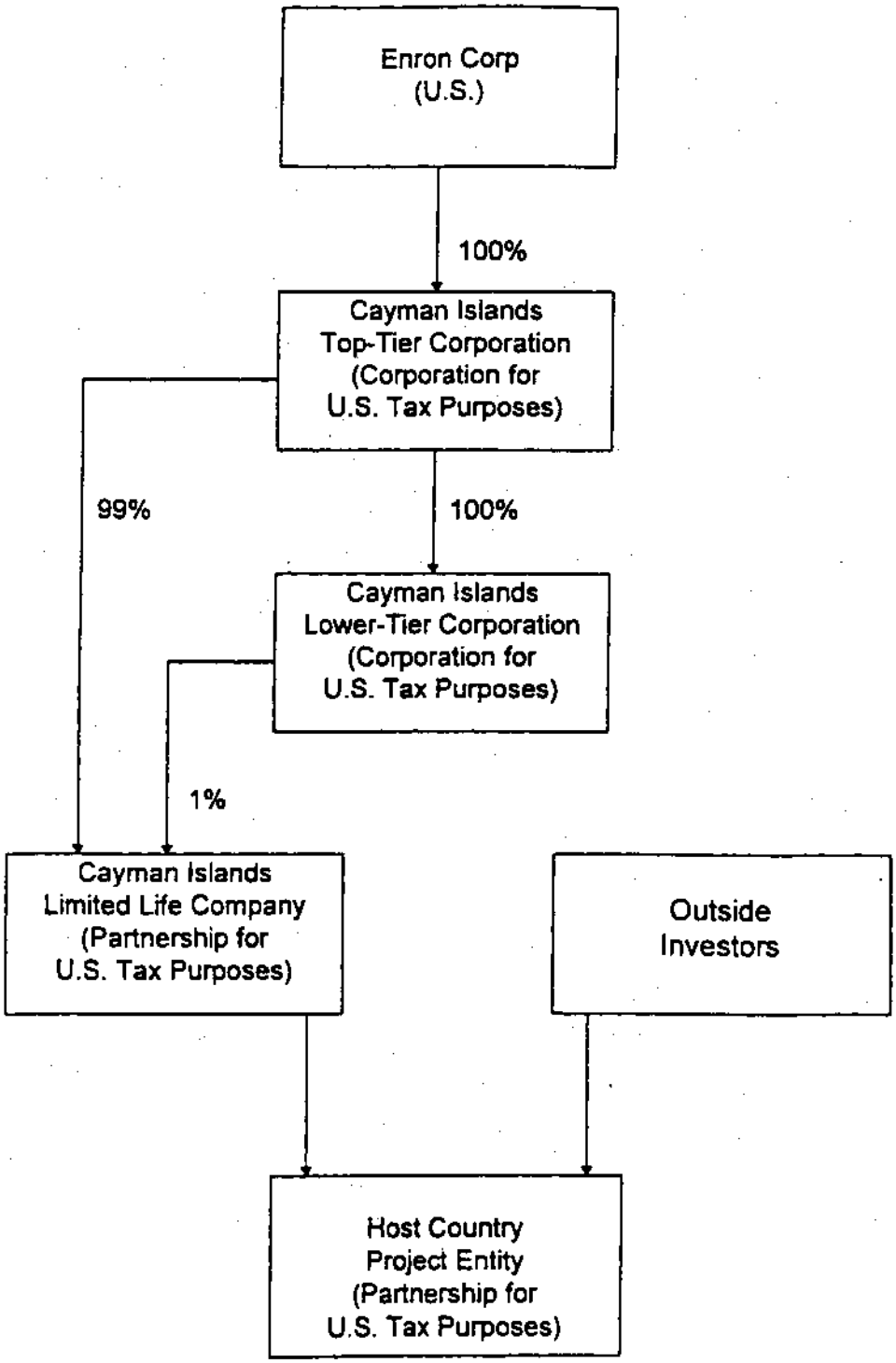
The diagram on the following page depicts this structure.

[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



EC2 000036190

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.

D. Transfer Pricing Issues

In general[1095]

For a multinational enterprise of its size, Enron's activities did not present an unusual level or range of transfer pricing issues. Unlike many other enterprises of its size (e.g., a typical globally integrated manufacturing enterprise), Enron's business generally did not rely on routine related party transactions. The nature of the company's business model thus limited somewhat the potential scope of the company's transfer pricing issues.

Performance of services for the benefit of related foreign entities

One aspect of Enron's business, however, did raise persistent and significant transfer pricing issues. These issues involved the treatment of services performed by Enron for the benefit of related foreign entities in connection with the foreign infrastructure development business.

Enron's foreign infrastructure projects generally were prospected and developed by personnel of Enron Development Corp. and Enron International, companies included in Enron's U.S. Federal consolidated tax return. These personnel identified the project opportunity, performed the financial analysis of the project's feasibility, and negotiated preliminary agreements with the relevant local authorities and other parties, among other development activities.[1096] As described in Part IV.C.4 above, at a very early stage in the project development process, the project typically was handed off to a local project entity that was owned by Enron (often jointly with a third-party co-venturer), with Enron's interest in the project entity typically held under two or more Cayman Islands holding companies. Thus, as of an early stage in the project development process, some portion of the services performed by personnel of Enron Development Corp. and Enron International could be regarded as performed on behalf of the project-specific entities.

Based on Joint Committee staff interviews with Enron and IRS personnel, as well as materials provided by the company, it appears that: (1) the company took the position that it was entitled to take deductions on its U.S. consolidated return for certain salary and other compensation related expenditures that were attributable to services provided by U.S. personnel in support of these foreign projects; and (2) the company did not always receive an adequate fee from either the project entity or the relevant foreign holding companies to reflect the benefit of

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[1095] The discussion in this section of the report is based on information and 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, Stephen H. Douglas, and IRS personnel.

[1096] In the heyday of Enron's foreign infrastructure project development business, these development activities were performed by a team of roughly 30 developers employed by Enron Development Corp. and Enron International, led by Rebecca Mark and Joe Sutton. Joint Committee staff interviews.

the services provided in connection with the foreign projects. In this manner, Enron arguably sought to shift offshore a portion of the income attributable to the services of its U.S. employees.

Enron generally did charge the project specific entities a fee reflecting the cost (with no mark-up) of providing some of these services. Enron did not include all compensation related expenditures relating to project personnel in this charge, however. In particular, the cost of bonuses provided to Enron Development Corp. and Enron International employees was not included in this charge, despite the fact that such bonuses were geared to the anticipated value of particular projects and to the achievement of certain milestones with respect to such projects.[1097] The cost of providing these bonuses was capitalized by Enron when awarded and then deducted on its U.S. Federal consolidated tax return when paid.[1098]

It should be noted that the IRS examination team identified these issues and proposed adjustments in this regard for every taxable year of the company since 1997. Thus, unlike the "structured transactions" discussed in Part I above, the arguably aggressive practices at issue here were readily detectable in the course of a normal audit and did not present the serious problems of tax administration that those transactions did.[1099] It also should be noted that the law in the area of transfer pricing for services and intangible property is unsettled, and that Enron's treatment of these expenditures, while arguably aggressive, was not entirely lacking support in the law. In this regard, the Treasury Department is currently working on a regulation project in an effort to provide more detailed and appropriate guidance in this area, with proposed regulations anticipated in 2003.[1100]

The current regulations under section 482 generally seek to distinguish between services that provide only incidental, or indirect and remote, benefits to a related party, in which case no arm's length charge is normally required, and services that provide more meaningful and direct benefits to a related party, in which case an arm's length charge is required.[1101] Even in the latter case, however, the requirement of an arm's length charge is generally considered met if the recipient of the services pays the provider's costs, unless the services constitute an "integral part" of the business of either the provider or the recipient of the services.[1102] Services are regarded as

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[1097] Joint Committee staff interviews. *See* Part Four, III.B.3, below, for a detailed discussion of the terms of these arrangements, the projects covered, and the compensation related issues that arose in connection with Enron's tax treatment of the arrangements.

[1098] Joint Committee staff interviews.

[1099] These taxable years and issues were still open as of early 2003. In order to avoid interfering with the IRS examination process, the Joint Committee staff provides only a general discussion of these issues in this Report, and does not reach specific conclusions as to particular projects.

[1100] *See, e.g.*, Bob Ackerman, *et al.*, "Global Transfer Pricing Update," 29 Tax Notes Int'l 375, Jan. 27, 2003.

[1101] *See* Treas. Reg. sec. 1.482-2(b).

[1102] *Id.*

"integral" under this test if: (1) either the renderer or the recipient is in the trade or business of rendering the same or similar services to third parties; (2) providing services to related parties is one of the principal activities of the renderer; (3) the renderer is "peculiarly capable" of providing the services, the services are a principal element in the operations of the recipient, and the value of the services is substantially greater than the costs or deductions of the renderer; or (4) the recipient has received the benefit of a substantial amount of services from a related party or parties during the year.[1103]

Enron generally had three main arguments supporting its tax treatment of the services performed by Enron Development Corp. and Enron International personnel. First, depending on the ownership percentages in a project conducted jointly by Enron and a co-venturer, Enron could take the position that the project-specific entities were not under Enron's "control," and that the fees reflected actual arm's length bargaining, rendering section 482 inapplicable.[1104] If that argument failed or could not be made, then Enron could take the position that Enron Development Corp., and later Enron International, was a venture-capital-type operation, and that the services performed by its personnel were in the nature of "stewardship" expenses to protect what was appropriately characterized as an investor's interest in the foreign projects, rather than expenses incurred on behalf of a particular project entity itself. On this theory, the services performed by Enron Development Corp. and Enron International personnel were performed primarily for the benefit of such companies, and not for the benefit of the project-specific entities. Under this theory, the regulations described above would not apply, and no charge at all would be required, since no substantial services would be regarded as provided for the direct benefit of related entities.[1105] If the services were regarded as performed for the direct benefit of a particular project entity, then Enron still could take the position in some cases that the services provided were not "integral," and thus that a fee reflecting cost was sufficient.

[1103] With respect to the second and fourth categories of integrality set forth above (i.e., the "principal activities" and "substantial amount" tests), cost-based safe harbors are available. Under the "principal activities" safe harbor, services generally are not treated as a principal activity of the renderer if the cost of providing such services does not exceed 25 percent of its total costs or deductions for the taxable year. Under the "substantial amount" safe harbor, a recipient of services generally is not treated as receiving a substantial amount of services if the cost of providing such services does not exceed 25 percent of the recipient's total costs or deductions for the taxable year. Manufacturing, production, extraction, and construction services are not eligible for the "principal activities" cost safe-harbor. Treas. Reg. sec. 1.482-2(b)(7).

[1104] Enron's contemporaneous transfer pricing documentation for 1995 through 2000, for example, makes this argument with respect to several different projects (EC2 000039103-39623). Of course, it has long been recognized that it is possible for two otherwise unrelated parties to act in concert to shift income to a jointly held entity, and that section 482 allocations may be made in such situations. *See, e.g., B. Forman Co. v. Comm'r,* 453 F.2d 1144 (2d Cir. 1972).

[1105] *See* Treas. Reg. sec. 1.482-2(b)(2)(i), (ii) (providing that no section 482 allocations are required in cases of certain "indirect or remote" benefits or cases in which the service merely duplicates a service that the renderer is performing for itself).

While the matter is not free from doubt, and cannot be conclusively determined without a detailed analysis of each individual project, on balance it appears that certain project-specific entities related to Enron for purposes of section 482 derived substantial and direct benefits from services provided by Enron Development Corp. and Enron International personnel. Thus, Enron Development Corp. and Enron International probably were required under section 482 to include in income a fee at least reflecting the full cost of providing such services. It also appears likely that in many cases the services provided by Enron Development Corp. and Enron International personnel were "integral" within the meaning of the applicable regulations,[1106] thus requiring an arm's length charge reflecting the value of such services.

[1106] Treas. Reg. sec. 1.482-2(b)(7). Enron's contemporaneous transfer pricing documentation for 1995 through 2000 conceded the "integrality" of the services in many instances, while taking the position that section 482 did not apply due to lack of common control (EC2 000039103-39623).

E. Recommendation: Information Reporting with Respect to Disregarded Entities

Present law requires no ongoing information reporting with respect to entities that are disregarded pursuant to a "check the box" election.[1107] Although the IRS is alerted of the existence and classification of each entity at the time the election is made, there is no regime of ongoing information reporting with respect to these entities. As a result, the IRS encounters considerable difficulty in keeping track of the various foreign entities in a company's structure and monitoring how these entities are being used in transactions. In Enron's case, the company filed 103 "check the box" elections in 1997, 191 in 1998, 151 in 1999, and 97 in 2000.[1108] After the year in which these elections were filed, the IRS would encounter great difficulty in monitoring how these entities were being used transactionally.

On the one hand, this lack of separate information reporting may be seen as appropriate, given that the entities are supposed to be "disregarded" for Federal tax purposes pursuant to the election. Nevertheless, it is also widely recognized that the application of the "check the box" regulations in the international setting has raised a number of issues that the IRS has an interest in monitoring. One example is the range of issues relating to the use of "hybrid entities" (foreign entities that are disregarded for U.S. Federal tax purposes but treated as separate taxable entities under foreign law).[1109] In addition, the IRS recently has focused some attention on the so-called "check and sell" practice, in which a "check the box" election is filed with respect to a lower-tier controlled foreign corporation in order to avoid the creation of subpart F income in connection with the sale of the stock of such corporation by a higher-tier controlled foreign corporation. The "check the box" election in these cases may convert what would have been a sale of stock (which generally creates subpart F income) into a sale of operating assets (which generally does not create subpart F income).[1110] Proposed regulations have been issued to restrict this practice, and the IRS appears to have been actively auditing the issue in the field.[1111] The existence of these and other issues relating to the use of "check the box" entities suggests that, although such entities are generally disregarded in terms of tax treatment, the IRS has an interest in monitoring their use.

The Joint Committee staff believes that a regime of annual information reporting with respect to entities disregarded pursuant to "check the box" elections would enhance the IRS's ability to administer the international tax rules and to identify and address specific issues that arise in applying the "check the box" regulations in the international area. The information to be reported could be similar to that required to be provided on Form 5471 with respect to controlled

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[1107] Treas. Reg. sec. 301.7701-1, *et seq.*

[1108] IRS Forms 8832 filed by Enron.

[1109] *See, e.g.*, Notice 98-11, 1998-6 I.R.B. 18; Notice 98-35, 1998-27 I.R.B. 35.

[1110] *See* sec. 954(c)(1)(B).

[1111] *See, e.g.*, Prop. Reg. sec. 301.7701-3(h) (Nov. 29, 1999); CCA 199937038; FSA 200046008; FSA 200049002.

foreign corporations, and thus could include income-statement and balance-sheet information, as well as such other information as the Secretary of the Treasury may require. The statement also should include information about the entity's classification and tax treatment under the law of its country of organization.