

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 F¹⁰³¹ 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

¹⁰³¹ Secs. 951-964.

¹⁰³² Secs. 1291-1298.

¹⁰³³ Secs. 901, 902, 960, 1291(g).

¹⁰³⁴ Sec. 901.

¹⁰³⁵ Secs. 902, 960.

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,

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

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

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.*