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).