XIV. STRUCTURED FINANCING TRANSACTIONS

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MINUTES
MEETING OF THE BOARD OF DIRECTORS
ENRON CORP.
December 10, 1996

Minutes of a meeting of the Board of Directors of Enron Corp. ("Company"), held pursuant to due notice at 8:30 a.m., C.S.T., on December 10, 1996, in the Enron Building in Houston, Texas.

The following Directors were present, constituting a quorum:

Mr. Kenneth L. Lay, Chairman
Mr. Robert A. Belfer
Mr. Norman P. Blake, Jr.
Mr. John H. Duncan
Mr. Joe H. Foy
Dr. Wendy L. Gramm
Dr. Robert K. Jaedicke
Dr. Charles A. LeMaistre
Mr. John A. Urquhart
Dr. Charls E. Walker
Mr. Herbert S. Winokur, Jr.

Directors Ronnie C. Chan, Richard D. Kinder, and Lord John Wakeham were absent from the meeting.

The Chairman, Mr. Lay, presided at the meeting, and, excluding the executive session of the Board, the Secretary, Ms. Peggy B. Menchaca, recorded the proceedings.

Mr. Lay convened the meeting in executive session. During the executive session, Dr. LeMaistre reported on meetings held by the Compensation Committee on October 8, 1996 (jointly with independent members of the Executive Committee), and November 19, 1996 (with independent members of the Executive Committee invited to attend), primarily to consider extending contracts for the Chairman and the President of the Company, but also to review material related to the Company's visions and values, the results of the recent employee opinion survey, and issues related to succession planning. He stated that, in addition, a meeting was held on November 25, 1996, to approve the termination arrangement with Mr. Kinder, who had announced that he would resign from the Company

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effective February 16, 1997, involving termination of his duties as President effective December 31, 1996. Mr. Lay joined Dr. LeMaistre in the discussion and recommended that Mr. Jeffrey K. Skilling be elected President and Chief Operating Officer, in addition to his current duties as Chairman of Enron Capital & Trade Resources Corp. ("ECT"), effective January 1, 1997. The Board agreed with the recommendation, and the following resolution was adopted:

> RESOLVED, that Jeffrey K. Skilling be, and he hereby is, elected President and Chief Operating Officer of the Company, effective January 1, 1997, to serve at the pleasure of the Board of Directors during the ensuing year and until his successor is duly elected and qualified.

Mr. Lay stated that minutes of the meeting of the Board held on October 1, 1996, had been distributed to the Directors and were included in the meeting material. He called for additions, corrections, or comments. There being none, the Board approved the minutes of the meeting held on October 1, 1996, by consensus of those present.

Following the executive session at 9:20 a.m., Messrs. William D. Gathmann, Rodney L. Gray, Forrest E. Hoglund, Stanley C. Horton, Robert C. Kelly, Mark E. Koenig, Lou L. Pai, Edmund P. Segner, III, Jeffrey K. Skilling, Joseph W. Sutton, and Thomas E. White and Mesdames Rosalee Fleming, Rebecca P. Mark, Peggy B. Menchaca, and Elizabeth A. Tilney, all of the Company or affiliates thereof, and Mr. Kenny L. Harrison, of Portland General Corporation, joined the meeting.

Mr. Lay amended the order of the agenda in order to allow Dr. LeMaistre to finish the report of the Compensation Committee. Dr. LeMaistre stated that in addition to the meetings reported in executive session, the Compensation Committee had met on November 7, 1996, and on December 9, 1996. He stated that at the November 7 meeting, the Compensation Committee approved payouts to Enron Development Corp. ("EDC") employees on financial close of the Turkey project. He stated that at the December 9, 1996, meeting, the Compensation Committee heard an extensive report on ECT's compensation philosophy and approved recommendations with regard thereto. He noted that, in addition to general Compensation Committee matters handled at the December meeting, it had approved two items for recommendation to the Board. The first, he stated, was the amendment to the 1994 Deferral Plan to add deferral of stock option exercise proceeds and to address state source tax issues. The second recommendation to the Board related to amendments to the 1991 and 1994 Stock Plans to allow transferability of stock options, to expand provisions related to use of stock to satisfy tax withholding requirements, and, for the 1994 Stock Plan, to authorize additional shares. He moved approval of each item. Dr. LeMaistre's motion was duly seconded by Mr. Blake, carried, and the following resolutions were adopted:

Amendment to the 1994 Deferral Plan

WHEREAS, the Company has heretofore established the Enron Corp. 1994 Deferral Plan; and

WHEREAS, the Company desires to amend the Deferral Plan to provide that with respect to Participants who are employed in states which impose state income tax on Plan benefits, the Committee may determine the amount, manner, and/or time of payment of benefits under the Plan, and to provide for the establishment of a new Stock Option Deferral Account in which Participants, designated by the Committee, may elect to defer receipt of shares of Enron Corp. common stock from the exercise of a stock option granted under a stock plan sponsored by Enron Corp., when such exercise is made by means of a stock swap using shares owned by the Participant;

NOW, THEREFORE, IT IS RESOLVED, that the proper officers of the Company be, and they are, authorized and directed to prepare and execute such amendment to the Enron Corp. 1994 Deferral Plan on behalf of the Company;

RESOLVED FURTHER, that upon execution of such amendment prepared according to the above provisions, such amendment shall be deemed adopted by this Board and is hereby ratified and approved; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

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Amendment to the 1991 Stock Plan

WHEREAS, the Company has heretofore established the Enron Corp. 1991 Stock Plan, as amended and restated effective May 3, 1994 (the "Plan");

WHEREAS, the Company desires to amend the Plan;

NOW, THEREFORE, IT IS RESOLVED, that the proper officers of the Company be, and they hereby are, authorized and directed to prepare and execute an amendment to the Plan on behalf of the Company substantially in the form of amendment presented at this meeting;

RESOLVED FURTHER, that upon execution of such amendment prepared according to the above provisions, such amendment shall be deemed adopted by this Board and is hereby ratified and approved; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered and directed to take all such further action, to amend, execute and deliver all such instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses, as in their judgment may be necessary, appropriate or advisable in order fully to carry into effect the purposes and intentions of this and each of the foregoing resolutions, including the execution of any further amendments, forms or documents recommended by counsel or required by any governmental agency, and to do anything necessary to effect compliance with applicable law or regulation.

Amendment to 1994 Stock Plan

WHEREAS, the Company has heretofore established the Enron Corp. 1994 Stock Plan (the "Plan"); and

WHEREAS, the Company desires to amend the Plan;

NOW, THEREFORE, IT IS RESOLVED, that the proper officers of the Company be, and they hereby are, authorized and directed to prepare and execute an amendment to the Plan on behalf of the Company substantially in the form of the amendment presented at this meeting;

RESOLVED FURTHER, that upon execution of such amendment prepared according to the above provisions, such amendment shall be deemed adopted by this Board and is hereby ratified and approved; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered, and directed to take all such further action, to amend, execute, and deliver, all such instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses, as in their judgment may be necessary, appropriate, or advisable in order fully to carry into effect the purposes and intentions of this and each of the foregoing resolutions, including the execution of any further amendments, forms, or documents recommended by counsel or required by any governmental agency, and to do anything necessary to effect compliance with applicable law or regulation.

Dr. LeMaistre concluded his report by directing the attention of the Directors to the summary of Securities Exchange Act of 1934 Section 16 changes which was provided in the Board material, a copy of which is filed with the records of the meeting.

Mr. Duncan reported on meetings held by the Executive Committee since the last meeting of the Board. He stated that the Executive Committee had met three times: October 4, November 12, and November 20, 1996. He stated that at the October 4, 1996, meeting, the Committee approved the submission of a bid to build a power plant at Ilijan in the Philippines by EDC or an affiliate thereof.

Mr. Duncan reported that at the meeting of the Executive Committee on November 12, 1996, it approved (i) the Trust Originated Preferred Securities offering by Enron Capital Trust I, which was expected to result in proceeds of approximately $200 million which would be used for the payment of debt; (ii) the monetization of the Company's ownership of Enron Oil & Gas Company ("EOG") stock in the form of an economic equity swap which would entail the Company's sale of up to 13,000,000 shares of EOG; (iii) an ECT acquisition of a small privately-held energy information service company, OmniComp, Inc., for

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approximately $10 million in value, using a combination of the Company's common stock and cash for the stock of OmniComp, Inc.; and (iv) a new Credit Agreement with Chase Manhattan Bank providing for borrowings by the Company of up to $1 billion which would replace and supersede the previous revolving credit agreement with Chase Manhattan Bank.

Mr. Duncan reported that at the November 20, 1996, meeting of the Executive Committee, it approved the submission of a bid by an EDC affiliate, jointly with an affiliate of Shell Oil Company, to acquire an equity position in the Yacimentos Petrolieferos Fiscales Bolivianos ("YPFB") pipeline in Bolivia, within certain parameters, and authorized Mr. Lay to approve the final bid before submission. He noted subsequent to the meeting that the EDC affiliate and its Shell partner had won the bid and had acquired a 50 percent stake in all of the transportation assets of YPFB for $263.5 million.

Mr. Duncan noted that minutes of the November 12 and 20, 1996, meetings of the Executive Committee had not been distributed to the Board because they had not yet been cleared by corporate counsel. He moved that the Board accept his report, approve the October 4, 1996, minutes, and ratify and approve all actions taken by the Committee at the meetings reported, including, but not limited to, the issuance of the Company's common stock for the acquisition by ECT, or its affiliate, of OmniComp, Inc. Mr. Duncan's motion was duly seconded by Mr. Blake and carried.

Mr. Winokur reported on the Finance Committee meeting held just prior to the Board meeting. He stated that the Committee had approved nine items for recommendation to the Board: (i) monetization of Enron Global Power & Pipelines L.L.C. ("EPP") common shares through a sale of up to three million of such shares combined with a total return equity swap; (ii) an amendment and extension to the JEDI bank revolver which would increase availability from $450 million to $750 million and would extend the maturity date from December 20, 1996, to June 15, 2001; (iii) an increase from $50 million to $75 million in the Company's guaranty of ECT's line of credit with Banque Paribas to finance margin calls, necessitated by increased trading volumes; (iv) a Company guaranty associated with the monetization of the Teesside Operating and Maintenance Agreement estimated at $26 million; (v) a bridge loan in the amount of $51 million to Hainan Holdings, the joint venturer with Singapore Power Corp. in the Hainan Island, China, power plant; (vi) new lease agreements for the Enron Building and the Omaha Building to replace current leases; (vii) new lease agreement for financing of the Cessna Citation 560's to replace the current lease which would expire at year-end 1996; (viii) amended hedging resolutions to limit authority of

Company officers to enter into derivative transactions; (xi) an increase in the Company-provided credit facility to EOTT Energy Corp., general partner of EOTT Energy Partners, L.P.; and (x) a recommendation that management of the Company be authorized to sell assets up to a value of $10 million without the necessity of seeking Board approval. Mr. Winokur reviewed each of the items and moved approval of each item recommended by the Finance Committee. His motion was duly seconded by Mr. Urquhart, and the following resolutions were adopted:

Monitization of EPP Shares

RESOLVED, that the sale by the Company of up to an aggregate amount of 3,000,000 Common Shares of Enron Global Power & Pipelines L.L.C., a Delaware limited liability company and an affiliate of the Company (the "Shares"), from time to time from the date hereof through December 31, 1997 (whether one or more sales, the "Secondary Offering"), be, and hereby is, authorized;

RESOLVED FURTHER, that the Chairman of the Board, the Vice Chairman of the Board, the President, and any Vice President (the "Authorized Officers") be, and each hereby is, authorized to (i) select any underwriters, dealers, agents, or other purchasers (the "Purchasers") to which the Shares may be sold by the Company pursuant to any Secondary Offering and (ii) approve, prepare, negotiate, execute, and deliver at any time and from time to time, one or more forms of underwriting agreements, purchase agreements, agency agreements, registration rights agreements, indemnification agreements, or other contracts in connection with the sale of the Shares (any such agreement being referred to herein as a "Shares Agreement") and other agreements such Authorized Officers may deem necessary or appropriate in connection with the arrangements for the sale of Shares to be sold pursuant to any Secondary Offering;

RESOLVED FURTHER, that pursuant to any Agreement, when the same shall be executed and delivered by all parties thereto, the Company shall sell the number of Shares in the amount, on the terms and conditions, and for the consideration provided for therein, and that the Authorized Officers be, and each hereby is, authorized in the name and on behalf of the Company to approve, prepare, negotiate, execute, and deliver such documents as may be required to evidence and consummate such sale of the Shares to the Purchasers;

RESOLVED FURTHER, that the purchase price to be paid to the Company by the Purchasers and, if appropriate, the initial price to the public for Shares sold pursuant to any Secondary Offering, shall be such price as shall be determined by the Authorized Officers, or any one of them, from time to time;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company related to or in connection with the transactions contemplated by these resolutions be, and hereby are, adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Amendment and Extension of the JEDI Revolver

RESOLVED, that the Chairman of the Board, the Vice Chairman of the Board, the President, and any Vice President be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone), for and in the name and on behalf of the Company, to negotiate, execute, deliver, and perform a parent performance agreement (the "Performance Agreement"), together with all such instruments, certificates, agreements, or other documents as are required in connection with the Performance Agreement, to support certain obligations of Enron Capital Management Limited Partnership and its successors and assigns ("ECM"), including but not limited to those obligations of ECM (1) to Joint Energy Development Investments Limited Partnership ("JEDI") with respect to a $50,000,000 committed revolving credit facility that will be made available to JEDI by ECM in connection with a revolving credit facility (as amended or modified from time to time) to be obtained by JEDI with the outstanding principal amount thereof not to exceed $750,000,000 at any time (the "JEDI Facility") and (2) under a General Partner Undertaking to be executed by ECM in connection with the JEDI Facility;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, related to or in connection with the transactions contemplated by these resolutions, including without limitation the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

ECT's Corporate Guaranty with Banque Paribas

WHEREAS, the Company made a guarantee (the "Guarantee") dated March 29, 1996 to Banque Paribas in consideration of Banque Paribas agreeing to advance funds for margin calls related to futures and options contracts (the "Advances") to Enron Capital & Trade Resources Corp. ("ECT"), a direct, wholly owned subsidiary of the Company;

WHEREAS, because of an increase in the volume of ECT's futures and options contracts, ECT needs to have additional Advances available and, as a condition to making such Advances available, Banque Paribas has requested that the Company amend the Guarantee to increase the maximum aggregate amount of ECT's obligations guaranteed from $50,000,000 to $75,000,000 (the "Amendment"); and

WHEREAS, it would be in the best interests of the Company to provide, and the Company would benefit directly or indirectly from providing, the Amendment;

NOW, THEREFORE, IT IS RESOLVED, that the Company be, and hereby is, authorized to provide the Amendment;

RESOLVED FURTHER, that the Chairman of the Board, the Vice Chairman of the Board, the President, any Vice President, the Treasurer, any Deputy Treasurer, or any Assistant Treasurer of the Company be, and each of them hereby is, authorized in the name and on behalf of the Company, under its corporate seal or otherwise, to negotiate, execute, deliver, amend, perform, and consummate the Amendment and such other agreements, instruments, or documents as such officer may deem necessary or desirable to carry out the purposes and intent of the foregoing resolutions, in such forms as shall be approved by the officer executing the same, such approval to be conclusively evidenced by the execution thereof by such officer;

RESOLVED FURTHER, that each such officer be, and each such officer hereby is, authorized in the name and on behalf of the Company to take or cause to be taken such action as such officer may deem necessary or desirable in connection with the performance by the Company of its obligations under any agreement, document, or instrument related to these transactions to which the Company is a party;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, related to or in connection with the transactions contemplated by these resolutions, including, without limitation, the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Guaranty Associated with Teesside Operating and Maintenance Agreement

RESOLVED, that the Chairman of the Board, the Vice Chairman of the Board, the President, and any Vice President be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone), for and in the name and on behalf of the Company, to negotiate, execute, and deliver a guaranty (the "Guaranty"), together with all such instruments, certificates, agreements, or other documents as are required in connection with the Guaranty, to support the obligations of Enron Power Operations Limited and Enron Power Operations Teesside in connection with the monetization of the operations and maintenance agreement associated with the Teesside power plant;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, related to or in connection with the transactions contemplated by these resolutions, including without limitation the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Hainan Holdings Bridge Loan

RESOLVED, that the guaranty required of the Company to secure a loan requested by Hainan Holdings Ltd. of US$51,000,000 from Credit Suisse for a term of three (3) months, be, and hereby is, approved;

RESOLVED FURTHER, that the Chairman of the Board, the Vice Chairman of the Board, the President, and any Vice President of the Company be, and each of them hereby is, authorized in the name and on behalf of the Company, under its corporate seal or otherwise, to negotiate, execute, deliver, amend, perform, and consummate such agreements, instruments, certificates, resolutions, or documents as such officer may deem necessary or desirable to carry out the purpose and intent of the resolutions herein, including subject guaranty, in such forms as shall be approved by the officer executing the same, such approval be conclusively evidenced by the execution thereof by such officer;

RESOLVED FURTHER, that all actions heretofore taken by any such officer of the Company, related to or in connection with the transactions contemplated by these resolutions, including without limitation the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, appropriate, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Enron Building Lease

RESOLVED, that it being in the best interest of Company, the Company is hereby authorized to:

(1) terminate its lease and purchase rights relating to the Enron Building, 1400 Smith Street, Houston, Texas (including the parcel(s) of land on which it is situated and any improvements thereon as well as certain related personal property (the "Houston Property"), pursuant to the Lease and Participation Agreement (and related agreements) dated as of March 15, 1994 between State Street Bank & Trust Company of Connecticut, National Association, as Trustee and Lessor, and the Company; and

(2) terminate its lease and purchase rights relating to Two Pacific Place, 1111 S. 103rd, Omaha, Nebraska (including the parcel(s) of land on which it is situated and any improvements thereon as well as certain related personal property (the "Omaha Property"), pursuant to the Lease and Participation Agreement (and related agreements) dated December 13, 1991 between State Street Bank & Trust Company of Connecticut, National Association, as Trustee and Lessor, and the Company (the Houston Property and the Omaha Property to be hereafter collectively referred to as the "Properties");

RESOLVED FURTHER, that in connection with the termination of its existing leases on the Properties, the Company and its subsidiaries are authorized to enter into a lease or leases and related financing agreements with such entity or trust, or other third party lessors, financial institutions, or other entities, as the Company and its subsidiaries may deem appropriate;

RESOLVED FURTHER, that the Chairman of the Board, the Vice Chairman of the Board, the President, any Vice President, the Treasurer, or any Assistant Treasurer of the Company be, and each of them hereby is, authorized and empowered for and on behalf of the Company (and any of the Company's subsidiaries) to negotiate such terms and conditions for the above-described financing transactions as any of said officers may deem best, and to execute, deliver, and perform or otherwise acknowledge and consent to for and on behalf of the Company a participation agreements, credit agreements, lease agreements, guaranties, mortgages, security agreements, assignments of leases and rents, agreements to pay fees and facility fees, and such other instruments or written obligations of the Company as may be desired or required by lessors, financial institutions, or other entities in connection with the above-described lease financing transactions and containing such terms and conditions as may be acceptable or agreeable to any of said officers, such acceptance and agreement to be conclusively evidenced by any of said officers' execution and delivery thereof;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, in the name and on behalf of the Company, related to or in connection with the transactions contemplated by these resolutions, including without limitation the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Approval of Aircraft Lease

WHEREAS, the Company has previously entered into (1) an Aircraft Leasing Agreement dated as of January 12, 1992 with the Bank of Tokyo Trust Company, as amended by an amendment dated as of January 18, 1996 and as assigned in part to Enron Oil & Gas Company by an Assignment and Assumption Agreement dated as of January 18, 1996, relating to a Cessna Citation 560 aircraft with FAA Reg. No. N 5734 (the "First Cessna Citation") and (2) an Aircraft Lease Agreement dated as of March 2, 1992 with The Bank of Tokyo Trust Company relating to a Cessna Citation 560 aircraft with FAA Reg. No. N 5735 (the "Second Cessna Citation"); and

WHEREAS, it would be in the best interests of the Company to enter into new lease agreements with respect to the First Cessna Citation and the Second Cessna Citation;

NOW, THEREFORE, IT IS RESOLVED, that the Company be, and hereby is, authorized to enter into new lease agreements (the "Lease Agreements") with respect to the First Cessna Citation and the Second Cessna Citation;

RESOLVED FURTHER, that the Chairman of the Board, the Vice Chairman of the Board, the President, any Vice President, the Treasurer, any Deputy Treasurer, or any Assistant Treasurer of the Company be, and each of them hereby is, authorized in the name and on behalf of the Company, under its corporate seal or otherwise, to negotiate, execute, deliver, amend, perform, and consummate the Lease Agreements and such other agreements, instruments, or documents as such officer may deem necessary or desirable to carry out the purposes and intent of the foregoing resolutions, in such forms as shall be approved by the officer executing the same, such approval to be conclusively evidenced by the execution thereof by such officer;

RESOLVED FURTHER, that each such officer be, and each such officer hereby is, authorized in the name and on behalf of the Company to take or cause to be taken such action as such officer may deem necessary or desirable in connection with the performance by the Company of its obligations under any agreement, document, or instrument related to these transactions to which the Company is a party;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, related to or in connection with the transactions contemplated by these resolutions, including without limitation the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such

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further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Amendment to Interest Rate Hedging Resolutions

WHEREAS, at a meeting held on October 1, 1996, the Board of Directors of the Company adopted four resolutions with respect to Hedging Instruments (the "Prior Resolutions);

WHEREAS, such resolutions authorized the Chairman of the Board, the President, or any Vice President designated by the Chairman of the Board or the President to take certain actions with respect to Hedging Instruments; and

WHEREAS, it is in the best interests of the Company to supersede and replace the Prior Resolutions for the sole purpose of limiting the officers who may take actions with respect to Hedging Instruments to the Chairman of the Board and Chief Executive Officer, the President and Chief Operating Officer, the Executive Vice President and Chief of Staff, the Senior Vice President, Finance, and the Vice President, Finance and Treasurer;

NOW, THEREFORE, IT IS RESOLVED, that the Prior Resolutions be, and they hereby are, superseded and replaced by the following resolutions:

RESOLVED, that the Company is hereby authorized to convert fixed rate obligations to floating rate obligations or to convert floating rate obligations to fixed rate obligations in an aggregate notional amount not to exceed $1,000,000,000.00 for a period not to exceed 12 years by entering into any of the following transactions with financial institutions approved by the Finance Committee of the Board or rated at least A- or A3 (the "Hedging Instruments"): (i) interest rate swap transactions, cap transactions, floor transactions, collar transactions, and forward rate transactions, which transactions described in this clause (i) may include embedded options such as reset, put, knock-out, or knock-in provisions; (ii) options on the transactions described in clause (i); (iii) basis swap

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transactions; (iv) currency swap transactions; (v) treasury futures; (vi) eurodollar futures; (vii) options on futures; and (viii) other similar transactions; *provided, however,* that the Company may not enter into any transaction described in clauses (i) through (viii) that: (x) requires an exchange of principal (except for any transaction entered into to convert an obligation from one currency to another); (y) is a leveraged transaction (the unbundled components of which have a notional principal that exceeds the notional principal of the transaction); or (z) that can not be priced internally or for which quotes from three approved counterparties cannot be obtained;

RESOLVED FURTHER, that the Chairman of the Board and Chief Executive Officer, the President and Chief Operating Officer, the Executive Vice President and Chief of Staff, the Senior Vice President, Finance, or the Vice President, Finance and Treasurer be, and each of them hereby is, authorized and empowered to negotiate, enter into, execute, and deliver on behalf of the Company any and all agreements and documentation required in connection with the Hedging Instruments with such counterparties on such additional terms as the officers executing such agreements shall approve, such approval to be conclusively evidenced by such execution;

RESOLVED FURTHER, that all actions heretofore taken by the Chairman of the Board and Chief Executive Officer, the President and Chief Operating Officer, the Executive Vice President and Chief of Staff, the Senior Vice President, Finance, or the Vice President, Finance and Treasurer, in the name and on behalf of the Company, related to or in connection with the transactions contemplated by these resolutions, including, without limitation, the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to execute and deliver all such further instruments and documents, for and in the name of and on behalf of the Company, under its corporate seal or otherwise, to pay all such expenses, and to do or cause to be done any and all such further things as may in their discretion appear to be necessary, proper, or advisable in order to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Asset Sales Procedures

RESOLVED, that management of the Company be, and hereby is, authorized to make asset sales of up to $10 million, and that all asset sales in excess of $10 million will be submitted to the Board of Directors for approval.

Mr. Segner began the presentation of the 1997-2001 Operating Plan (the "Plan"). He presented an overview, which included the current financial and earnings report. He discussed total return to shareholders for the periods from 1992 through third quarter 1996, 1989 to date, and 1996 year-to-date, compared to the S&P 500 and the Company's peer group. He reviewed net income by business unit, adjusted income from operations, earnings per share, and net income estimated for 1996 and projected for each year of the Plan.

Mr. Segner discussed Plan assumptions for oil and gas prices and for the merger with PGC. He reviewed other key operating assumptions and presented net income projections both on a consolidated and individual business unit basis. He reviewed capital expenditures and equity investments projected during each year of the Plan, compared to 1992-1996, and he discussed funds flow and debt-to-total capitalization ratios.

Mr. Segner next discussed the status of 1996 corporate objectives and explained variances from the 1996 Operating Plan ("1996 Plan"). He called upon Mr. Horton to begin the business unit presentation of the Plan on behalf of Enron Operations Corp. ("EOC").

Mr. Horton described major accomplishments in the pipelines and liquids operations in 1996. He was joined by Mr. White who discussed the accomplishments of the engineering and construction activities of EOC. Mr. White then listed the 1997 major objectives for the engineering and construction group, and Mr. Horton listed the 1997 objectives for the pipelines and liquids operations (which included the completion of the divestiture of all liquids assets).

Mr. Horton listed the 1997 major objectives of Enron Americas and described asset sales that were underway or planned and the expected results from such sales. He reported on the explosion which had occurred in Puerto Rico in the Huberto Vidal Building. He explained the extent of the tragedy and reported the results of the ongoing investigation, noting that litigation had been filed as a result of the explosion. Mr. Lay stated that the Directors and management should treat the report with strict confidentiality in light of litigation which had been filed in the case. Mr. Foy joined in the discussion in support of Mr. Lay's statement.

Mr. Skilling began the presentation of the Plan on behalf of ECT. He reviewed performance on 1996 goals and other accomplishments. He presented ECT's strategies for the Plan years and challenges thereto by each of its business segments. He reviewed other business strategies and called upon Mr. Pai for a discussion of ECT's retail business ("Enron Energy Services") projected for the years 1997-2006.

Mr. Pai discussed assumptions used for a business plan overview for the years stated. He discussed the building of a retail organization and achieving a percentage of market share in the industry. He discussed required employees, regional locations, and estimated customers served. He noted total gas and electricity markets and estimated the value which could be realized by achieving a percentage of the market share. Mr. Pai discussed the potential for an initial public offering of the shares of Enron Energy Services and explained the rationale for that strategy. An extended discussion ensued, and Messrs. Skilling and Pai answered questions from the Directors. Mr. Pai stated that the Board would hear more about the retail business in ECT's extended report to be a part of the February Board meeting.

Mr. Hoglund next presented the Plan on behalf of Enron Oil & Gas Company ("EOG"). He reviewed the 1996 Plan strategic goals and discussed variances from said goals based on crude and natural gas price volatility and the current status of the industry. He discussed oil and gas prices, indicating that North American gas supplies could be tight through 1998. He described EOG's increasing production on a worldwide basis at lower operating and interest costs. He described the outlook for the industry during the Plan years and projected net income for each year of the Plan for the North American market and the international market.

Mr. Hoglund reviewed the status of the project in India in each of the fields where EOG has or is developing operations, and he noted that EOG had obtained partner support for a proposed $1 billion development plan in India. He discussed net margins projected per thousand cubic foot equivalent in India and Trinidad, international reserve growth, projected net income and natural gas, crude, and condensate volumes, and exploration expenditures and available cash for each year of the Plan. He reported EOG's debt-to-total capital ratio for each year of the Plan and discussed the stock price potential based on such results. He reviewed major 1997 challenges to the Plan and answered questions from the Directors.

Ms. Mark presented the Plan on behalf of EDC. She discussed 1996 goals and accomplishments. She updated the Board on the India project, noting that construction had restarted on Phase I and that financing was complete. She directed the attention of the Board to resolutions relating to a proposed increased equity loan to Dabhol Power Company ("DPC") of up to $500 million, which would require a corporate guaranty of the repayment of the Company's pro rata share of the increased equity loan. Following discussion, upon motion duly made by Mr. Blake, seconded by Mr. Winokur, and carried, the following resolutions were adopted:

> WHEREAS, this Board has previously approved resolutions on May 3, 1994, October 11, 1994, and May 7,1996 (the "Prior Resolutions"), related to the financing, development, construction, start-up, ownership, operation, and maintenance (collectively, the "Project Financing") by Dabhol Power Company, a private company with unlimited liability incorporated in India under the Companies Act, 1956 ("DPC") and an indirect, partially owned subsidiary of the Company, of an approximately 695-megawatt power plant together with certain ancillary facilities, including a fuel unloading and storage facility, near Dabhol in the State of Maharashtra, India, 170 km south of Bombay (the "Project") in order to implement Phase I (as defined in the Power Purchase Agreement, as hereinafter defined) pursuant to that certain Power Purchase Agreement, dated December 8, 1993 between DPC and the Maharashtra State Electricity Board (the "Power Purchase Agreement");
>
> WHEREAS, as the terms of the Project Financing have been modified since the Prior Resolutions were adopted, the Prior Resolutions need to be expanded to authorize the Company to perform its obligations in connection with the Project Financing, and it is appropriate to amend the Prior Resolutions;
>
> WHEREAS, DPC sought to obtain debt financing (the "Debt Financing") to fund approximately $650 million in project costs from certain lenders, which included the Export-Import Bank of the United States, the Overseas Private Investment Corporation, the Industrial Development Bank of India, and associated Indian financial institutions, and a group of commercial banks led by BA

Asia Limited, as Agent and as Lead Arranger, and ABN AMRO Bank N.V., as Lead Arranger, and the institutions providing or arranging for such debt financing (the "Senior Lenders") required DPC (or its affiliates) to obtain (a) approximately $280 million in equity financing (the "Equity Financing"), (b) approximately $120 million in project completion support from creditworthy affiliates of DPC stockholders ("Project Sponsors"), and (c) additional credit enhancement from Project Sponsors;

WHEREAS, to facilitate the Equity Financing, the Company and the other shareholders of DPC, which other shareholders are affiliates of Bechtel Enterprises, Inc. (10%) and General Electric Capital Corporation (10%) ("GECC"), formed DPC Holdings C.V., a limited partnership (commanditaire vennootschap) formed under the laws of The Netherlands, which is indirectly owned 80% by the Company and which indirectly owns a non-voting 98.9% interest in DPC ("DPC Holdings");

WHEREAS, affiliates of the Company and GECC decided to fund their aggregate 90% equity by having DPC Holdings enter into a Credit Agreement dated as of January 25, 1995, with NationsBank of Texas, N.A., as Administrative Agent, Citibank, N.A., as Funding Agent, and the Banks named therein, to provide up to $252 million (90% of $280 million equity requirement) for the Equity Financing plus $63 million for interest, fees, and expenses related to the financing of the Project for a total of $315 million (the "Equity Loan");

WHEREAS, the Credit Agreement now needs to be amended to increase the amount of the Equity Loan to $500 million (the "Increased Equity Loan"); and

WHEREAS, it is a condition precedent to the making of the Increased Equity Loan that the Company provide a guarantee (the "Increased Equity Loan Guarantee") of the repayment of the Company's pro rata share (8/9) of the Increased Equity Loan;

NOW, THEREFORE, IT IS RESOLVED, that the Company be, and it hereby is, authorized to provide the Increased Equity Loan Guarantee to guarantee to the banks providing the Increased Equity

Loan the repayment of up to the Company's pro rata share (approximately $445,000,000 million) of the Equity Loan;

RESOLVED FURTHER, that the Chairman of the Board, the Vice Chairman of the Board, the President, and any Vice President of the Company be, and each of them hereby is, authorized in the name and on behalf of the Company, under its corporate seal or otherwise, to negotiate, execute, deliver, amend, perform, and consummate such agreements, instruments, certificates, resolutions, or documents as such officer may deem necessary or desirable to carry out the purpose and intent of the resolutions herein, including without limitation the increased Equity Loan Guarantee, in such forms as shall be approved by the officer executing the same, such approval to be conclusively evidenced by the execution thereof by such officer;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, related to or in connection with the transactions contemplated by these resolutions, including without limitation the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, appropriate, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Ms. Mark continued with her report on 1996 Plan goals and accomplishments. She also reviewed other accomplishments achieved during 1996. She reviewed business strategies for the Plan years and specific goals for 1997. She presented a project timetable indicating the financial close and commercial start-up date for each of EDC's current projects.

Mr. Gray presented the Plan on behalf of EPP. He discussed 1996 goals and accomplishments, and he presented projects he expected to be acquired by EPP during each year of the Plan and the resulting income.

Following Mr. Gray's presentation, Mr. Lay called for approval of the Plan. Upon motion duly made by Mr. Duncan, seconded by Dr. Walker, and carried, the 1997 Plan, a copy of which is filed with the records of the meeting, was approved as presented to and discussed at the meeting.

Mr. Horton recommended that a corporate guaranty of the indemnity obligations of the Company's affiliates, Enron Gas Processing Company and Enron Gas Liquids, Inc., under a purchase and sale agreement with TransCanada Pipelines, be approved. Following discussion, upon motion duly made by Mr. Blake, seconded by Mr. Foy, and carried, the following resolutions were adopted:

WHEREAS, the Company owns indirectly all of the capital stock of Enron Gas Processing Company ("EGP") and Enron Gas Liquids, Inc. ("EGLI");

WHEREAS, EGP owns all of the capital stock of Enron Louisiana Energy Company ("ELEC") and EGLI owns a wholesale propane marketing business;

WHEREAS, EGP, EGLI, and the Company desire to enter into an agreement (the "Purchase and Sale Agreement") with TransCanada Energy USA, Inc. ("Buyer"), a wholly owned subsidiary of TransCanada PipeLines Limited ("TransCanada"), pursuant to which EGP will sell all of the outstanding capital stock of ELEC, and EGLI will sell its wholesale propane marketing assets, to TransCanada Energy Management Inc.;

WHEREAS, TransCanada will enter into the a Guaranty and Indemnity Agreement in order to guaranty the indemnity obligations of TransCanada Energy Management Inc. thereunder;

WHEREAS, in order to induce Buyer and TransCanada to enter into the Purchase and Sale Agreement and the Guaranty and Indemnity it is necessary for the Company to execute the Purchase and Sale Agreement for the limited purpose of performing certain tax covenants in Article 7 thereof and to execute a Guaranty and Indemnity Agreement in order to guaranty EGP's and EGLI's indemnity obligations, which are contained in Article 12 of the Purchase and Sale Agreement and to indemnify Buyer and TransCanada against certain liabilities that could arise out of a leveraged lease financing pertaining to ELEC's gas processing plant (the "Obligations"); and

WHEREAS, the Company is reasonably expected to benefit, directly or indirectly, from the consummation of the transactions contemplated by the Purchase and Sale Agreement and it is therefore in the best interests of the Company to enter into the Purchase and Sale Agreement and to guaranty and indemnify Buyer and TransCanada from and against the Obligations;

NOW, THEREFORE, IT IS RESOLVED, the Chairman and Chief Executive Officer, the President and Chief Operating Officer, or any Vice President of the Company be, and they hereby are, authorized to negotiate, execute, and deliver the Purchase and Sale Agreement and the Guaranty and Indemnity Agreement and the officers of the Company are hereby authorized to take any and all such further action necessary to consummate the transactions contemplated by the Purchase and Sale Agreement and the Guaranty and Indemnity Agreement; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and the foregoing resolution.

Mr. Kelly presented the business strategy and operating budget for Enron Renewable Energy Corp. ("EREC") during the Plan years and beyond. He presented an overview of EREC and described the world renewable energy market from 1990 through 2015. He discussed global energy demand, concern about carbon emissions and energy independence, improvements in technology, and expansion of EREC (through the acquisition of Zond Corporation) into wind energy. He stated that EREC would be an excellent candidate for a future initial public offering, and he estimated results of such an offering in 1998. He also updated the Board on the status of the solar energy partnership with Amoco, including development activities, market share, and return on solar investment.

Mr. Kelly reviewed in detail the proposed acquisition of Zond Corporation ("Zond"). He discussed Zond's financial highlights, business strategy, and operating projects. He reviewed the purchase price, which consisted of cash, common stock of the Company, an EREC note, and 21 percent of EREC stock. He also discussed transaction costs, working capital requirements, and a potential sale of certain Zond assets. He projected net income based on wind energy, coupled with a possible public offering. In requesting approval of the transaction, Mr. Kelly noted that the Company had the right and could elect to make loans or equity contributions to EREC for the purpose of permitting EREC to either (i) deliver cash at closing in lieu of the Notes (as defined in the transaction documents), or (ii) prepay such Notes following closing. Following discussion, upon motion duly made by Mr. Foy, seconded by Mr. Urquhart, and carried, the following resolutions were adopted:

> RESOLVED, that, it being in the best interests of the Company, the undertakings by the Company set forth in (i) that certain Purchase Agreement by and among the Company, Enron Renewable Energy Corp. ("EREC"), and certain stockholders of Zond Corporation, a California corporation ("Zond"), and (ii) that certain Credit Agreement by and between the Company and Zond, each of which is dated December 9, 1996, a copy of each of which was presented to and discussed at the meeting (respectively, the "Purchase Agreement" and the "Credit Agreement"), be, and hereby are, approved;
>
> RESOLVED FURTHER, that the execution and delivery of said Purchase Agreement by an officer of the Company, and the performance by the Company of its obligations thereunder, is hereby approved, adopted, ratified, and confirmed in all respects; which approval, adoption, ratification, and confirmation shall include all of the obligations of the Company contemplated by the Purchase Agreement, including, without limitation, (i) the acquisition by the Company of a portion of the issued and outstanding preferred and common stock of Zond (the "Zond Stock") in exchange for common stock of the Company, (ii) the filing by the Company with the Securities and Exchange Commission of a registration statement covering the resale of such common stock by the holders thereof (the "Resale Registration Statement"), (iii) the contribution of the Zond

Stock to EREC in exchange for common stock of EREC, (iv) the guaranty by the Company of $40,000,000 of promissory notes to be issued by EREC (the "EREC Notes") to certain of the stockholders of Zond as partial consideration for the common and preferred stock of Zond owned by such stockholders, which guarantees shall be made pursuant to the forms of guarantees attached to the Purchase Agreement as exhibits, (v) the acquisition by the Company, pursuant to separate Option Exchange Agreements and Option Purchase Agreements in the forms attached to the Purchase Agreement as exhibits, of all of the issued and outstanding options to purchase common stock of Zond (the "Zond Options") in exchange for issuance by the Company of options to purchase common stock of the Company, (vi) the filing by the Company with the Securities and Exchange Commission of a registration statement on Form S-8 registering the offering and sale of Company common stock issued in connection with a stock option plan and stock options to purchase Company common stock delivered in exchange for the Zond Options (the "Employee Plan Registration Statement"), and (vii) the contribution of the Zond Options to EREC in exchange for common stock of EREC, in each case as more fully set forth in the Purchase Agreement;

RESOLVED FURTHER, that the execution and delivery of said Credit Agreement by an officer of the Company, which provides for the Company to make loans to Zond in an aggregate principal amount not to exceed $10,000,000, and the performance by the Company of its obligation thereunder, be, and hereby are, adopted, ratified, confirmed, and approved in all respects;

RESOLVED FURTHER, that the officers of the Company be, and each of them hereby is, authorized to prepare or cause to be prepared and/or filed such documents and instruments as may be necessary to (i) effect the filing of the Resale Registration Statement and the Employee Plan Registration Statement; (ii) cause the Resale Registration Statement and the Employee Plan Registration Statement to be declared effective by the Securities and Exchange Commission; (iii) effect any required listing applications to the New York Stock Exchange, Inc.; (iv) effect any state "Blue Sky" filings or applications; and (v) effect any other required regulatory filings;

RESOLVED FURTHER, that the Chairman of the Board, the President, and any Vice President of the Company be, and each hereby is, authorized, empowered, and directed to take such further actions as such officer deems necessary and appropriate to carry into effect the transactions contemplated by the Purchase Agreement and the Credit Agreement;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company related to or in connection with the transactions contemplated by these resolutions be, and hereby are, adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Mr. Lay stated that it would be in order to approve the date, place, and time of the 1997 Annual Meeting of Stockholders and the record date to determine stockholders entitled to vote at such meeting. Upon motion duly made by Mr. Blake, seconded by Dr. Gramm, and carried, the following resolutions were adopted:

RESOLVED, that the meeting date, location, and time of the 1997 Annual Meeting of Stockholders be, and it hereby is, set for May 6, 1997, at the Doubletree Hotel at Allen Center, 400 Dallas Street, Houston, Texas, at 10:00 a.m., C.D.T.; and

RESOLVED FURTHER, that the close of business on March 10, 1997, be, and it hereby is, approved and fixed as the record date for determining stockholders entitled to vote at the 1997 Annual Meeting of Stockholders.

Mr. Segner recommended that the Bylaws be revised to provide for a "Deputy Corporate Treasurer," and that Ms. Susan Hodge be elected to such position. Upon motion duly made by Mr. Winokur, seconded by Mr. Duncan, and carried, the following resolutions were adopted:

> RESOLVED, that Article V, Section 11 of the Bylaws is hereby amended by deleting same in its entirety and substituting the following therefor:
>
> > Section 11. Deputy Treasurer and Assistant Treasurers. Each Deputy Treasurer and each Assistant Treasurer shall have the usual powers and duties pertaining to such offices, together with such other powers and duties as designated in these Bylaws and as from time to time may be assigned to a Deputy Treasurer or an Assistant Treasurer by the Board of Directors, the Chairman of the Board, the President, the Vice Chairman of the Board, or the Treasurer. Any Deputy Treasurer may exercise the powers of the Treasurer during that officer's absence or inability or refusal to act. During the absence or inability or refusal to act of the Treasurer and each Deputy Treasurer, any Assistant Treasurer may exercise the powers of the Treasurer. Each Deputy Treasurer shall have the power and authority on behalf of the Corporation to sign as an Assistant Treasurer any instrument that an Assistant Treasurer has authority to sign, and for such purposes each Deputy Treasurer shall be deemed to be an Assistant Treasurer of the Corporation; and
>
> RESOLVED FURTHER, that Susan Hodge be, and she hereby is, elected the Deputy Treasurer, Corporate Finance of the Company, to serve in such capacity at the pleasure of the Board during the ensuing year and until her successor is duly elected and qualified, effective immediately.

Mr. Lay updated the Board on the *J-Block* litigation. He noted that the February Board meeting would be held in New York and would include a reception for bankers the evening before.

There being no further business to come before the Board, the meeting was adjourned at 12:40 p.m., C.S.T.

Secretary

APPROVED:

Chairman

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MINUTES
MEETING OF THE EXECUTIVE COMMITTEE
OF THE BOARD OF DIRECTORS
ENRON CORP.
DECEMBER 18, 1996

Minutes of a meeting of the Executive Committee ("Committee") of the Board of Directors of Enron Corp. ("Company"), held pursuant to due notice at 2:00 p.m., C.S.T., on December 18, 1996, at the Enron Building in Houston, Texas.

The following Committee members were present by telephone conference connection where each could hear the comments of the other meeting participants and join in the discussions:

Robert A. Belfer
Joe H. Foy
Kenneth L. Lay
Charles A. LeMaistre

Committee members John H. Duncan, Richard D. Kinder, and Herbert S. Winokur, Jr. were absent from the meeting. Messrs. James M. Bannentine, Joseph G. Kishkill, Edmund P. Segner, III, Jeffrey K. Skilling, Joseph W. Sutton, and Robert H. Walls and Mesdames Rebecca P. Mark and Peggy B. Menchaca, all of the Company or an affiliate thereof, also attended the meeting.

In the absence of Committee Chairman Duncan, Dr. LeMaistre presided at the meeting, with concurrence from the Committee, and the Secretary, Ms. Menchaca, recorded the proceedings.

Dr. LeMaistre called the meeting to order and called upon Mr. Lay to present the business of the meeting. Mr. Lay inquired and received confirmation that each Committee member had received the material for the meeting, a copy of which is filed with the records of the meeting. He stated that the meeting was called to consider bid proposals by Enron Development Corp. ("EDC"), or an affiliate thereof, for the hydroelectric power stations in Colombia known as the Betania and Chivor plants. He called upon Ms. Mark to present the details of the proposed bids.

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Ms. Mark referred the Committee members to the meeting material for a description of each plant and presented an overview of the transactions. She stated that the bid on the Chivor plant was due December 20, and that the bid on the Betania plant was due on December 19, hence the urgency of the meeting. She described the size and location of each plant and discussed the minimum bids required. She called on Mr. Sutton to present the details and strategy of the proposed transaction.

Mr. Sutton stated that Chilgener had asked EDC to join them as a partner in the acquisition and other projects in Latin America, and he provided background information on Chilgener. He described the immediate earnings and value to be created on purchase of the two plants. He discussed in detail the hydroelectric generation business in Colombia, energy trading potential, credit rating, and other background information. He stated that the plants would be jointly owned by Chilgener (60%) and EDC or its affiliate (40%), but noted that major decisions would be made on a 50-50 basis. He stated that Chilgener would provide the general manager for the plants and that EDC, or its affiliate, would provide the chief financial officer. He indicated that EDC had received firm financing authority from Bank of America for approximately 60% leverage of Chivor and Betania.

Mr. Sutton presented transaction assumptions, a summary of the economics (using the Betania plant as the example), and sensitivities. He discussed in detail the risks inherent in the proposed transactions. He led a discussion related to political risk insurance and stated that EDC would bring a recommendation to Messrs. Lay and Skilling related to whether or not to acquire such insurance for the plants, if the bids were successful. He indicated that the Chivor and Betania plants would cost an estimated $650 million and $430 million, respectively. He discussed the financing of the proposed transactions, which he stated would be accomplished through nonrecourse financing, with 80% of the principal financed in a 5-year balloon note with Bank of America.

Mr. Sutton requested that EDC or an affiliate thereof be authorized to participate 40% in bid bonds with Chilgener of $18 million for Betania and $65 million for Chivor. In response to a question, he explained that the bid bonds were based on 10% of the value of each plant, hence the difference in amounts. A thorough discussion ensued. Messrs. Skilling and Ms. Mark joined in the discussion. Mr. Skilling indicated that he thought the project was worthwhile particularly if immediate efforts were initiated to monetize the plants. In response to a query by Mr. Belfer, Mr. Sutton indicated that EDC would know the results of the bidding immediately. Mr. Lay pointed out and discussed Mr. Belfer's concerns about disproportionate asset allocations in certain regions. Following discussion, Mr. Belfer moved approval of the bid submission by EDC or its affiliate, subject to approval of the final bid formulation by Messrs. Lay and Skilling prior to submission, and provided that, if EDC's bids were accepted, management begin immediate efforts to monetize the acquisitions after financial close. Mr. Belfer's motion was duly seconded by Mr. Foy, the motion carried, and the following resolutions were approved:

RESOLVED, that authority to submit bids for the hydroelectric power stations in Colombia known as the Betania and Chivor plants be, and it hereby is, granted to management of EDC, or an affiliate thereof, subject to final approval of the bids by Kenneth L. Lay and Jeffrey K. Skilling prior to submission; PROVIDED, HOWEVER, that management of EDC, or its affiliate, will make good faith efforts to monetize said acquisitions immediately after financial close;

RESOLVED FURTHER, that the submission of a bid or bids by the Company's subsidiary, Enron Servicios de Electricidad Colombia Ltd., a Cayman Islands company, for the stock of Chivor S.A. E.S.P. and/or Central Hidroelectrica de Betania S.A. E.S.P. (the "Bids"), pursuant to that certain Information Memorandum dated October, 1996, prepared by CS First Boston, Inverlin, and Schroders and as amended or supplemented as of the date hereof (the "Tender Documents"), be, and hereby is, approved, subject to the restrictions set out in the above paragraph;

RESOLVED FURTHER, that the Company be, and hereby is, authorized to provide security for Enron Servicios de Electricidad Colombia Ltd.'s obligations relating to its pro rata portion of the bid bonds required for the Bids, and the same be, and hereby is, authorized and approved; and

RESOLVED FURTHER, that the directors and officers of Enron Servicios de Electricidad Colombia Ltd. be authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of Enron Servicios de Electricidad Colombia Ltd. (including, without limitation, all instruments and documents necessary, proper, or advisable to effectuate a joint bid with Energy Trade and Finance

Company or an affiliate thereof), under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions, and that all actions heretofore taken by the Directors and officers of Enron Servicios de Electricidad Colombia Ltd. with respect to the transactions contemplated above be, and hereby are, in all respects, approved, confirmed, and ratified.

Mr. Segner stated that management requested authority to offer and sell up to $200 million of additional Trust Originated Preferred Securities, similar to an offering recently approved by the Board and undertaken by management. Ms. Menchaca noted that powers of attorney would be sent to each member of the Board authorizing certain officers to sign the required registration documentation. Following discussion, upon motion duly made by Mr. Foy, seconded by Dr. LeMaistre, and carried, the following resolutions were approved:

WHEREAS, the Executive Committee of the Board of Directors of Enron Corp. (the "Company") deems it advisable and in the best interests of the Company to take such actions as shall be required of it in order to enable a Delaware business trust to be created by the Company (the "Trust") to effect the offer and sale of up to $200 million Trust Originated Preferred Securities ("Trust Preferred Securities"), to be offered and sold pursuant to a Registration Statement on Form S-3 to be filed with the Securities and Exchange Commission (the "Commission") by the Company, such Trust, and a Delaware limited partnership to be formed (the "Partnership"), under the Securities Act of 1933, as amended (the "Securities Act");

NOW, THEREFORE, IT IS RESOLVED, that the actions of the officers of the Company in connection with the preparation, execution, and filing with the Commission of a Registration Statement are hereby ratified and approved, and the officers of the Company be, and each of them hereby is, authorized and directed to file such Registration Statement and amendments or supplements to the Registration Statement and to do or cause to be done any or all other things as may appear to them to be necessary or advisable in order to cause such Registration Statement, as amended, to become effective and otherwise to effect the registration under the Securities

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Act of the securities covered by the Registration Statement, as amended; and

RESOLVED FURTHER, that the designation of Rex R. Rogers as the agent for service of process in connection with the Registration Statement is hereby approved; and

RESOLVED FURTHER, that the actions of the officers of the Company in connection with the formation of the Trust and the Partnership are hereby ratified and approved, and that each of the Chairman of the Board, the Vice Chairman of the Board, the President, the Executive Vice President and Chief of Staff, and the Chief Financial Officer or the Vice President, Finance and Treasurer of the Company is hereby authorized to execute and deliver on behalf of the Company an Amended and Restated Declaration of Trust and an Amended and Restated Agreement of Limited Partnership of the Partnership conforming substantially to the description thereof in the Registration Statement with such changes as the officer executing the same shall approve; and

RESOLVED FURTHER, that, in connection with the offering of the Trust Preferred Securities, each of the Chairman of the Board, the Vice Chairman of the Board, the President, the Executive Vice President and Chief of Staff, the Chief Financial Officer, or the Vice President, Finance and Treasurer of the Company is hereby authorized to execute and deliver on behalf of the Company the Trust Guarantee, the Partnership Guarantee, and the Investment Guarantees (each as defined in the Registration Statement), on terms conforming substantially to the description thereof in the Registration Statement, with such changes as the officer executing the same shall approve; and

RESOLVED FURTHER, that, in connection with the offering of the Trust Preferred Securities, each of the Chairman of the Board, the Vice Chairman of the Board, the President, the Executive Vice President and Chief of Staff, the Chief Financial Officer or the Vice President, Finance and Treasurer of the Company is hereby authorized to execute and deliver on behalf of the Company an indenture to provide for the issuance of the Company Debenture (as defined in the Registration Statement), on terms conforming substantially to the description thereof in the Registration Statement, with such changes as the officer executing the same shall approve; and that any such officer is hereby authorized to execute and deliver the Company Debenture in an aggregate principal amount not to exceed $200 million; and

RESOLVED FURTHER, that, in connection with the offering of the Trust Preferred Securities, each of the Chairman of the Board, the Vice Chairman of the Board, the President, the Executive Vice President and Chief of Staff, the Chief Financial Officer, or the Vice President, Finance and Treasurer of the Company is hereby authorized to execute and deliver on behalf of the Company, as guarantor, indentures of two or more subsidiaries of the Company (the "Affiliate Indentures") on terms conforming substantially to the description thereof in the Registration Statement, with such changes as the officer executing the same shall approve, provided that the total amount guaranteed under all such Affiliate Indentures shall be limited to an aggregate principal amount not to exceed $200 million; and

RESOLVED, that each of the Chairman of the Board, the Vice Chairman of the Board, the President, the Executive Vice President and Chief of Staff, the Chief Financial Officer, or the Vice President, Finance and Treasurer of the Company is hereby authorized to execute and deliver on behalf of the Company (in its individual capacity, as the General Partner of the Partnership, and as the Sponsor of the Trust) a Purchase Agreement among the Company, the Trust, the Partnership, Merrill Lynch & Co., Merrill Lynch, Pierce, Fenner & Smith Incorporated, and other underwriters (the "Purchase Agreement"), in connection with the proposed offering of the Trust Preferred Securities, on such terms as the officer executing such Purchase Agreement shall deem necessary or appropriate (including any pricing terms therein);

RESOLVED FURTHER, that the actions of the officers of the Company in applying to the New York Stock Exchange, Inc. (the "NYSE") for the listing thereon of the Trust Preferred Securities are hereby ratified and approved, and the officers of the Company be, and each of them hereby is, authorized, empowered, and directed to execute and deliver to the NYSE such agreements, applications, and documents in such form as may be necessary to effect the aforesaid listing and to take any and all such actions and to do and cause to be done any or all such things as may appear to them to be necessary or desirable in order to effect such listing, including, without limitation, the filing of a Registration Statement on Form 8-A to effect the registration of the Trust Preferred Securities under the Securities Exchange Act of 1934, as amended;

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company (in its individual capacity, as General Partner of the Partnership, and as the Sponsor of the Trust), under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions; and

RESOLVED FURTHER, that any and all actions heretofore or hereafter taken by any officer of the Company consistent with the terms of the foregoing resolutions are hereby ratified and confirmed as the act and deed of the Company.

There being no further business to come before the Committee, the meeting was adjourned at 2:40 p.m., C.S.T.

Subsequent to adjournment, Messrs. Lay and Skilling reviewed and approved the bids to be submitted for the hydroelectric power stations in Colombia.

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Secretary

APPROVED:

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Chairman

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MINUTES
MEETING OF THE EXECUTIVE COMMITTEE
OF THE BOARD OF DIRECTORS
ENRON CORP.
JUNE 5, 1997

Minutes of a meeting of the Executive Committee ("Committee") of the Board of Directors of Enron Corp. ("Company"), held pursuant to due notice at 10:00 a.m., C.D.T., on June 5, 1997, at the Enron Building in Houston, Texas.

All of the Committee members were present by telephone conference connection where each could hear the comments of the other meeting participants and join in the discussions, as follows:

John H. Duncan, Chairman
Robert A. Belfer
Joe H. Foy
Kenneth L. Lay
Charles A. LeMaistre
Jeffrey K. Skilling
Herbert S. Winokur, Jr.

Messrs. Andrew S. Fastow, William D. Gathmann, and Rex R. Rogers and Ms. Peggy B. Menchaca, all of the Company, also attended the meeting either in person or by telephone conference connection. Messrs. Guy Eastaugh, Jay L. Fitzgerald, Mark A. Frevert, Dan J. McCarty, John R. Sherriff, and Phil Stokes joined the meeting in progress as noted below.

The Chairman, Mr. Duncan, presided at the meeting, and the Secretary, Ms. Menchaca, recorded the proceedings.

Mr. Duncan called the meeting to order and asked Mr. Lay to present the business of the meeting. Mr. Lay stated that the meeting had been called to consider (i) an ECT Europe project, (ii) the offering and sale of up to $200 million in Adjustable-Rate Capital Trust Securities ("ACTS"), and (iii) an amendment of the stock repurchase authorization. Mr. Lay noted that the meeting participants from London had not yet joined the meeting and requested that the order of the agenda be amended to allow consideration of the other items.

Mr. Duncan amended the order of the agenda and called upon Mr. Gathmann to present the next item. Mr. Gathmann referred the Committee to the

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term sheet included in the meeting materials (a copy of which is filed with the records of the meeting), and he reviewed the terms of the proposed ACTS offering. He noted that it was similar to other trust security offerings previously issued by the Company. Upon motion duly made by Mr. Belfer, seconded by Mr. Winokur, and carried, the following resolutions were adopted:

WHEREAS, the Executive Committee of the Board of Directors of Enron Corp. (the "Company") deems it advisable and in the best interests of the Company to take such actions as shall be required of it in order to enable a Delaware business trust to be created by the Company (the "Trust") to effect the offer and sale of up to $200 million Adjustable-Rate Capital Trust Securities ("Capital Securities"), to be offered and sold to "Qualified Institutional Buyers" pursuant to Rule 144A under the Securities Act of 1933, as amended (the "Securities Act");

NOW, THEREFORE, IT IS RESOLVED that the actions of the officers of the Company in connection with the preparation of the offering memorandum dated June 4, 1997 (the "Offering Memorandum") relating to the offering and sale of the Capital Securities are hereby ratified and approved;

RESOLVED FURTHER, that the actions of the officers of the Company in connection with the formation of the Trust are hereby ratified and approved, and that each of the Chairman of the Board, the Vice Chairman of the Board, the President, the Executive Vice President and Chief of Staff, the Senior Vice President, Finance, the Vice President, Finance and Treasurer, and the Deputy Treasurer, Corporate Finance of the Company is hereby authorized to execute and deliver on behalf of the Company an Amended and Restated Declaration of Trust conforming substantially to the description thereof in the Offering Memorandum with such changes as the officer executing the same shall approve;

RESOLVED FURTHER, that, in connection with the offering of the Capital Securities, each of the Chairman of the Board, the Vice Chairman of the Board, the President, the Executive Vice President and Chief of Staff, and the Senior Vice President, Finance or the Vice President, Finance and Treasurer of the Company is hereby authorized to execute and deliver on behalf of the Company the Guarantees (as defined in the Offering Memorandum), on terms conforming substantially to the descriptions thereof in the Offering

Memorandum, with such changes as the officer executing the same shall approve;

RESOLVED FURTHER, that, in connection with the offering of the Capital Securities, each of the Chairman of the Board, the Vice Chairman of the Board, the President, the Executive Vice President and Chief of Staff, and the Senior Vice President, Finance or the Vice President, Finance and Treasurer of the Company is hereby authorized to execute and deliver on behalf of the Company an Indenture to provide for the issuance of the Debentures (as defined in the Offering Memorandum), on terms conforming substantially to the description thereof in the Offering Memorandum, with such changes as the officer executing the same shall approve, such approval to be conclusively evidenced by such execution; and that any such officer is hereby authorized to execute and deliver the Debentures pursuant to such Indenture in an aggregate principal amount not to exceed $207 million;

RESOLVED FURTHER, that each of the Chairman of the Board, the Vice Chairman of the Board, the President, the Executive Vice President and Chief of Staff, the Senior Vice President, Finance and the Vice President, Finance and Treasurer of the Company is hereby authorized to execute and deliver on behalf of the Company (in its individual capacity and as the Sponsor of the Trust) a Purchase Agreement among the Company, the Trust, Deutsche Morgan Grenfell, and other banks (the "Purchase Agreement"), in connection with the proposed offering of the Capital Securities, on such terms as the officer executing such Purchase Agreement shall deem necessary or appropriate (including any pricing terms therein);

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company (in its individual capacity and as Sponsor of the Trust), under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions; and

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RESOLVED FURTHER, that any and all actions heretofore or hereafter taken by any officer of the Company within the terms of the foregoing resolutions are hereby ratified and confirmed as the act and deed of the Company.

Mr. Gathmann next reviewed the current status of the share repurchase authorization previously granted by the Board and requested authority to increase the existing available capacity under the current authorization from 2.8 million shares to 10 million shares in order to give management the flexibility needed to manage the Company's capital structure. Following discussion, upon motion duly made by Mr. Foy, seconded by Dr. LeMaistre, and carried, the following resolutions were adopted:

WHEREAS, the appropriate officers of the Company as of this date are authorized to make purchases of the Company's Common Stock in the open market ("Open Market Purchases"), and it would be in the best interests of the Company to provide such officers with authority to make additional Open Market Purchases;

NOW, THEREFORE, IT IS RESOLVED, that all authority previously granted by the Board of Directors or the Executive Committee of the Board of Directors with respect to Open Market Purchases be, and it hereby is, superseded and replaced by the authority granted by the following resolutions;

RESOLVED FURTHER, that the appropriate officers of the Company be, and they hereby are, authorized to make Open Market Purchases in accordance with the issuer repurchase "safe-harbor" Rule 10b-18 under the Securities Exchange Act of 1934 of up to an amount of 10,000,000 shares of the Company's Common Stock; *provided that*, such authorized amount shall be:

(a) reduced by (i) the number of shares of the Company's Common Stock from time to time repurchased by the Company and (ii) the number of shares of the Company's Common Stock from time to time subject to outstanding put option agreements to which the Company and any person or entity other than Joint Energy Development Investments Limited Partnership are parties (the "Put Option Agreements"); and

(b) increased to an amount no greater than 5,000,000 at any one time by the number of treasury shares or newly issued Common

Stock issued or sold by the Company and the number of shares of Common Stock sold by the Enron Corp. Flexible Equity Trust from time to time;

RESOLVED FURTHER, that the appropriate officers of the Company are authorized to take all actions that such officers deem necessary, appropriate, or desirable to effectuate the Open Market Purchases, including, without limitation, the following: (i) subject to the limitations described in the immediately preceding resolution, determining the number of shares of the Company's Common Stock to be purchased, (ii) determining the purchase prices at which such Common Stock shall be purchased, and (iii) engaging such investment banking, brokerage, or other firms as such officers shall deem appropriate to effect such Open Market Purchases; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to execute and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, to pay all such expenses, and to do or cause to be done any and all such further things as may in their discretion appear to be necessary, proper, or advisable in order to carry into effect the purposes and intentions of this and the foregoing resolutions.

Mr. Gathmann excused himself from the meeting following his presentation and Messrs. Eastaugh, Fitzgerald, Frevert, McCarty, Sheriff, and Stokes joined the meeting during Mr. Gathmann's presentation by telephone conference connection.

Mr. Duncan called upon Mr. Frevert to present the proposed ECT Europe project, known internally as "Project Cobra." Mr. Frevert referred the Committee to the material related to the project (a copy of which is filed with the records of the meeting), and he described the transaction. He stated that Project Cobra consisted of a 350-megawatt combined cycle gas turbine plant based in central England and owned by Corby Power Limited, a partnership jointly held by Dominion Resources, Inc. ("Dominion") (40%), Electricity Supply Board of Ireland ("ESBI") (20%), and BTR (a registered United Kingdom industrial conglomerate) (40%). He described the plant, which had become fully operational in February, 1994. He noted that Dominion and ESBI had preemption rights but stated that he did not expect that they would exercise them. He described the project economics and noted that East Midlands purchases substantially all of the power from the plant under a 20-year contract. He stated that the Board of Corby Power Limited consisted of five directors, one for each 20% of ownership. He projected $4.4 million of annual earnings and cash flow through the year 2013 and noted that Project Cobra would be a logical addition to ECT Europe's asset and earnings base. He stated that the approval requested by ECT Europe was to submit a bid of up to $56.3 million for the acquisition of BTR's 40% interest in Corby Power Limited, subject to Dominion and ESBI waiving their respective preemption rights. A discussion ensued and Mr. Frevert answered questions from the Committee related to the project. Following discussion, upon motion duly made by Mr. Lay, seconded by Mr. Foy, and carried, management of ECT Europe was authorized to proceed with the submission of a bid of up to $56.3 million for the acquisition of BTR's 40% interest in Corby Power Limited.

Messrs. Eastaugh, Fitzgerald, Frevert, McCarty, Sherriff, and Stokes excused themselves from the meeting following the vote on Project Cobra.

Mr. Lay led a discussion of the week's activities and updated the Committee on (i) the J-Block settlement; (ii) the CATS ruling; (iii) the announcement relative to the project in Italy with ENEL; (iv) the action by the Oregon Public Utility Commission approving the merger with Portland General Corporation; and (v) Project Beta.

There being no further business to come before the Committee, the meeting was adjourned at 10:37 a.m., C.D.T.

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Secretary

APPROVED:

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Chairman

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MINUTES
SPECIAL MEETING OF THE BOARD OF DIRECTORS
ENRON CORP.

SEPTEMBER 27, 1993

Minutes of a special meeting of the Board of Directors of Enron Corp. ("Company"), held pursuant to due notice at 4:00 p.m., C.D.T., on September 27, 1993, in the Boardroom of the Enron Building in Houston, Texas.

The following Directors, constituting a quorum, were present by telephone conference connection where each Director could hear the comments of the other meeting participants and join in the discussions:

Mr. Kenneth L. Lay, Chairman
Mr. Robert A. Belfer
Mr. John H. Duncan
Mr. Joe H. Foy
Dr. Wendy L. Gramm
Dr. Robert K. Jaedicke
Mr. Richard D. Kinder
Dr. Charles A. LeMaistre
Mr. John A. Urquhart
Mr. Herbert S. Winokur, Jr.

Directors William A. Anders, Norman P. Blake, Jr., and Charls E. Walker were absent from the meeting. Messrs. William V. Allison, James V. Derrick, Jr., Stanley C. Horton, Kurt S. Huneke, Edmund P. Segner, III, and Jack I. Tompkins. and Mesdames Nancy G. McNeil and Peggy B. Menchaca also attended the meeting.

The Chairman, Mr. Lay, presided at the meeting, and the Secretary, Ms. Menchaca, recorded the proceedings.

Mr. Lay called the meeting to order and stated that management had several items to present for Board consideration, but the primary reason for the meeting was to hear management's recommendations relating to the issuance of some form of perpetual preferred stock. He directed the attention of the Directors to the agenda and material supporting the items to be discussed, a copy of which is filed with the records of the meeting. He called upon Mr. Kinder to begin the presentation.

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Mr. Kinder, for purposes of clarifying the record, noted that the reference to Series J Preferred Stock in the first item on the agenda for the meeting was in error. He then presented an overview of the perpetual preferred alternatives. He noted that the Company in continuing to grow and expand would continue to be a net user of cash. He stated that the rate of return on the Company's incremental investments had been excellent, but noted that, in order to maintain credit quality, a portion of the growth must be funded with equity. He indicated that reception in the market to perpetual preferred issues appeared to be high, and added that it appeared to be the least expensive alternative to bolster equity. He called upon Mr. Segner for a detailed discussion of the proposed issuance.

Mr. Segner stated that two options were presented in the supporting materials for the meeting: (i) a standard perpetual preferred stock issuance led by Merrill Lynch & Co.; and (ii) a tax-deductible perpetual preferred stock issuance led by Goldman Sachs & Co. He presented the details of both proposals and compared the economic impact of each to the Company. He stated that Arthur Andersen & Co. had indicated that the perpetual preferred stock issuance would not be considered debt in the accounting treatment, and meetings with four rating agencies produced the same indication. He also indicated that Sullivan and Cromwell had issued a letter confirming the tax deductibility of the option proposed by Goldman Sachs & Co., but noted that if future tax law changes negated the deduction, the Company would be in the same tax position as it is today with regard to the deduction of dividends. He responded to questions from the Board, and he was joined in the discussion by Messrs. Lay and Kinder. Mr. Segner stated that the approval sought would be for management flexibility to pursue either of the options presented, to include the issuance in the debt securities shelf registration filing approved by the Board at its August 10, 1993, meeting which filing had not been made as of the date of the meeting; and to appoint a special committee to determine the pricing and other terms of the issuance. Following a thorough discussion, upon motion duly made by Mr. Belfer, seconded by Mr. Winokur, and carried, the following resolutions were adopted:

> RESOLVED, that the Board of Directors hereby deems it advisable and in the best interests of the Company for the Company (or a special purpose company (the "SPC") to be incorporated in the Cayman Islands or the Turks and Caicos, to be 100% directly or indirectly owned by the Company) to issue and sell from time to time up to $250 million of fixed rate perpetual preferred stock (the "Preferred Stock"), at a price and with such terms and conditions to be agreed upon and established by the Preferred Stock Committee referred to below, and to be sold from time to time in public offerings;

RESOLVED, that the Company and/or the SPC enter into one or more underwriting agreements, or other agreements, however designated, together with all necessary agreement wires, confirmation letters, or terms agreements (collectively the "Agreements"), with such underwriting firm or firms or with such institutions or dealers as may, in the judgment of the Chairman of the Board, any Vice Chairman of the Board, the President, any Senior Vice President, or the Vice President and Treasurer of the Company, be necessary to effect the sale of the Preferred Stock; that the Chairman of the Board, any Vice Chairman of the Board, the President, any Executive or Senior Vice President, or the Vice President and Treasurer of the Company be, and each of them hereby is, authorized and directed to execute and deliver the Agreements, for and in the name and on behalf of the Company, in such forms as the officer executing such Agreements shall approve, such approval to be conclusively evidenced by such execution; and that the Company be, and it hereby is, authorized and directed to perform in full all of its obligations under the Agreements;

RESOLVED, in connection with the issuance and sale of the Preferred Stock by the Company or the SPC, that the officers of the Company be, and they hereby are, authorized, empowered, and directed to cause to be prepared, executed, and filed with the Securities and Exchange Commission (the "Commission") (i) a registration statement on Form S-3 or other appropriate form (as so filed, including any exhibits thereto, the "Registration Statement") and (ii) such amendments and post-effective amendments to the Registration Statement or supplements to the Prospectus constituting a part thereof, and to take all such further action, including the filing of final forms of the Prospectus, as may, in the judgment of such officers, be necessary, desirable, or appropriate to secure and thereafter to maintain the effectiveness of the Registration Statement;

RESOLVED, that the Registration Statement may, in the judgment of the officers of the Company, be an "omnibus" registration statement, which may include registration of the sale of the Preferred Stock (and registration of any required Company guarantee of certain SPC Preferred Stock payment obligations, or Company debt obligations to the SPC in connection with the Preferred Stock), or Depository Shares (defined below) representing fractional interests in the Preferred Stock, and registration of the sale

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of debt securities previously authorized for issuance and sale by this Board of Directors on August 10, 1993;

RESOLVED, that the Board of Directors of the Company, in accordance with Section 141 of the General Corporation Law of the State of Delaware and Article IV of the Bylaws of the Company, as amended, does hereby create a special preferred stock committee (the "Preferred Stock Committee") and designate Kenneth L. Lay and Richard D. Kinder as the members of the Preferred Stock Committee, and that the Preferred Stock Committee is hereby authorized and empowered to determine, for and in the name and on behalf of the Company and the SPC, the following terms:

(i) the maximum number of shares to constitute the series of Preferred Stock and the distinctive designation thereof;

(ii) the annual dividend rate, if any, on shares of the series, whether such rate is fixed or variable or both, the date or dates from which dividends will begin to accrue or accumulate and whether dividends will be cumulative;

(iii) whether the shares of the series will be redeemable and, if so, the price at and the terms and conditions on which the shares of the series may be redeemed, including, without limitation, the time during which shares of the series may be redeemed and any accumulated dividends thereon that the holders of shares of the series shall be entitled to receive upon the redemption thereof;

(iv) the liquidation preference, if any, applicable to shares of the series;

(v) whether the shares of the series will be subject to operation of a retirement or sinking fund and, if so, the extent and manner in which any such fund shall be applied to the purchase or redemption of the shares of the series for retirement or for other corporate purposes, and the terms and provisions relating to the operation of such fund;

(vi) the voting rights, if any, on the shares of the series;

(vii) whether fractional interests in shares of the series will be offered in the form of Depository Shares; and

(viii) any other preferences, participating, optional, or other special rights or qualifications, limitations, or restrictions thereof,

and any other term of any Agreement and all such other matters as may be determined by such Preferred Stock Committee consistent with Delaware law, the SPC's Charter and by-laws, the Company's Restated Certificate of Incorporation, the terms of any outstanding series of preferred stock, and these resolutions, such Preferred Stock Committee's approval of such terms and conditions to be conclusively determined by their inclusion in the executed copies of any Agreements; and that the Preferred Stock Committee is hereby authorized to take any and all action and to do or cause to be done any or all things which may appear to the Preferred Stock Committee to be necessary or advisable in order for the Company, or to cause the SPC, to offer, issue, and sell the Preferred Stock, to the full extent and with the same effect as the Board of Directors of the Company could take such action or do or cause such things to be done; and that a majority of the members of the Preferred Stock Committee shall constitute a quorum for the transaction of business; and that the Preferred Stock Committee shall keep a written record of its meetings, shall present such record to the meetings of the Preferred Stock Committee, and shall file a copy of such record in the corporate minutes of the Company;

RESOLVED, that in the event Preferred Stock is issued by the SPC, it may be in the best interests of the Company, and the Company is hereby authorized, to guarantee, on such terms as the Preferred Stock Committee deems appropriate, the liquidation value of the Preferred Stock to be issued by the SPC, as well as dividends on the Preferred Stock, if and when declared;

RESOLVED, that the Company is hereby authorized to elect to offer fractional interests in shares of the Preferred Stock, rather than full shares, in the form of Depository Shares evidenced by Depository Receipts; that the Preferred Stock Committee is hereby authorized to determine the fractional interest of a share of Preferred Stock represented by each Depository Share, and any other terms of the Depository Shares;

RESOLVED, that the Company is hereby authorized to deposit the Preferred Stock represented by the Depository Shares

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under a deposit agreement ("Deposit Agreement") to be entered into between the Company and a bank or trust company having its principal office in the United States and having a combined capital and surplus of at least $50,000,000 (the "Depository"); that the Chairman of the Board, any Vice Chairman of the Board, the President or any Vice President of the Company be, and each of them hereby is, authorized and directed to execute, acknowledge, and deliver the Deposit Agreement, for and in the name and on behalf of the Company, in such form as the officer executing such Deposit Agreement shall approve, such approval to be conclusively evidenced by such execution;

RESOLVED, that the Chairman of the Board, the President, or any Vice President and the Corporate Secretary, any Deputy Corporate Secretary, or any Assistant Secretary of the Company be, and each of them hereby is, authorized, empowered, and directed, for and in the name and on behalf of the Company, to take any and all action which they may deem necessary or advisable in order for the Company or the SPC to obtain a permit, to register, or to qualify part or all of the Preferred Stock or Depository Shares for issuance and sale or to request an exemption from registration of part or all of the Preferred Stock or Depository Shares or to register or obtain a license for the Company or the SPC as a dealer or broker under the securities laws of such of the states of the United States of America and of such foreign jurisdictions as such officers may deem advisable, and in connection with such registrations, permits, licenses, qualifications, and exemptions, to execute, acknowledge, verify, deliver, file, and publish all such applications, reports, resolutions, irrevocable consents to service of process, powers of attorney, and other papers and instruments as may be required under such laws, and to take any and all further action which they may deem necessary or advisable in order to maintain such registration in effect as long as they may deem it to be in the best interests of the Company;

RESOLVED, that the Company or the SPC make application to the New York Stock Exchange, Inc. and one or more other securities exchanges as the officer acting shall deem necessary or appropriate for the listing thereon of the Preferred Stock or Depository Shares; that the Chairman of the Board, the President, or any Vice President of the Company be, and each of them hereby is, authorized, empowered, and directed to execute and deliver, for and in the name and on behalf of the Company, to the New York Stock Exchange, Inc. and all other securities exchanges on which the Preferred Stock or Depository Shares of the Company are to be listed, such agreements in such form as may be necessary to effect the aforesaid listing; and that the officers of the Company be, and they hereby are, authorized, empowered, and directed to execute and deliver any applications, documents, or agreements, to appear, if requested, before officials of any such exchanges, and to take any and all such actions, to appoint any banking institution as an agent of the Company or the SPC for any purpose, and to do or cause to be done any or all such things as may appear to them to be necessary or desirable in order to effect such listing, specifically including registration of the Preferred Stock or Depository Shares under Section 12 of the Securities Exchange Act of 1934, as amended;

RESOLVED, that the Preferred Stock Committee is hereby authorized to determine the form of stock certificate representing the Preferred Stock, and the form of certificate representing a Depository Share, with such changes thereto, consistent with these resolutions and any applicable resolutions of the Preferred Stock Committee, as the officers executing the same shall approve, such execution to be conclusive evidence of the approval of such officers and this Board of Directors or such Preferred Stock Committee;

RESOLVED, that the signature of the Chairman of the Board, any Vice Chairman of the Board, the President, or any Vice President of the Company or the SPC, as appropriate, the corporate seal of the Company, and the signature of the Corporate Secretary, any Deputy Corporate Secretary, or any Assistant Secretary of the Company or the SPC, as appropriate, on any or all of the certificates of Preferred Stock or Depository Shares may be facsimile, and that the Company hereby adopts and approves any such facsimile signatures and seal;

RESOLVED, that the facsimile signatures which appear upon any of the certificates of Preferred Stock or Depository Shares shall be valid regardless of whether such officer ceases to hold such office prior to the issuance of the Preferred Stock or Depository Shares; and

RESOLVED, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Mr. Kinder reviewed the Northern Border Master Limited Partnership ("MLP"), which had priced the previous week. He requested ratification and approval of the various transactions and agreements contemplated by the MLP. Upon motion duly made by Mr. Foy, seconded by Mr. Belfer, and carried, the following resolutions were adopted:

RESOLVED, that the transactions contemplated by (i) the registration statement of Northern Border Partners, L.P. (the "Partnership") filed with the Securities and Exchange Commission (the "Commission") on July 16, 1993 and Amendment Nos. 1 and 2 thereto filed with the Commission on August 25, 1993 and September 22, 1993, including, without limitation, the forms of preliminary prospectus contained therein (the "Registration Statement"), (ii) the form of Conveyance, Contribution and Assumption Agreement (the "Conveyance") among Northern Plains Natural Gas Company ("Northern Plains"), Pan Border Gas Company ("Pan Border"), Northwest Border Pipeline Company ("Northwest Border"), the Partnership, and Northern Border Intermediate Limited Partnership (the "ILP"), (iii) the form of Administrative Services Agreement among NBP Services Corporation, the Partnership, and the ILP, (iv) the form of Credit Agreement among the ILP, as Borrower, and Northern Plains, Pan Border, and Northwest Border, as Lenders, and (v) the form of Amended and Restated Partnership Agreement of the Partnership and the form of Amended and Restated Partnership Agreement of the ILP, be, and the same hereby are, authorized and approved; and (x) the transfer by Northern Plains of substantially all of its assets to the ILP pursuant to the Conveyance and (y) the sale by Northern Plains pursuant to the Registration Statement of up to 9,890,000 Common Units representing limited partner interests in the Partnership be, and the same hereby are, authorized and approved;

RESOLVED, that the execution on behalf of the Company of the Underwriting Agreement dated September 23, 1993, among the Company, the Partnership, the ILP, Northern Plains, Pan Border, Panhandle Eastern Corporation, and the Representatives of the Underwriters, relating to the sale of Common Units by Northern Plains and Pan Border pursuant to the Registration Statement, be, and it hereby is, ratified and approved; and that the Company be, and it hereby is, authorized and directed to perform in full all of its obligations under the Underwriting Agreement;

RESOLVED, that, on or prior to the closing of the offering pursuant to the Registration Statement, the Company is hereby authorized to make a capital contribution to Northern Plains in the form of a demand note in the amount contemplated by the Registration Statement; and the Chairman of the Board, the President or any Vice President of the Company be, and each hereby is, authorized to execute and deliver a demand promissory note in such form and in such amount as the officer executing the same shall approve, such approval to be conclusively evidenced by such execution; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Mr. Horton stated that Florida Gas Transmission Company ("FGT") had received the order from the Federal Energy Regulatory Commission approving its Phase III Expansion project. He indicated that during the preceding week, the boards of both Sonat, Inc., owner of one-half interest in Citrus Corp., the parent of FGT, and Citrus Corp. (at a meeting held earlier in the day) had each approved the project. He called upon Mr. Allison to present the details of the order and the project.

Mr. Allison discussed the economics of the project in each of the next five years and probable financing for the project. He indicated that the project would begin in February, 1994 and would add 860 miles of pipe and 1.45 billion cubic feet of gas to the Florida market. He estimated completion of construction in 11 months at a cost of approximately $760 million. He noted that the project would require an agreement by the Company, as owner of one-half interest in Citrus Corp. and FGT, to make a capital contribution of between $130-$150 million. He answered questions from the Board, and a full discussion ensued. Following the discussion, upon motion duly made by Mr. Foy, seconded by Mr. Winokur, and carried, the following resolutions were approved:

> RESOLVED, that the Company's jointly-owned indirect subsidiary, Florida Gas Transmission Company ("FGT"), its parent, Citrus Corp., or any affiliate thereof, be, and hereby are, authorized to accept the Certificate of Public Convenience and Necessity issued by the Federal Energy Regulatory Commission on September 15, 1993, and to proceed with the pipeline expansion project known as the "Phase III Expansion;"
>
> RESOLVED FURTHER, that it being in the best interest of the joint owners, Sonat, Inc. and the Company, to each make a contribution of capital and to provide guarantees of indebtedness of Citrus Corp. and FGT to assist in the funding of the Phase III Expansion, the Company's equity contribution of up to seventeen and one-half percent (17.5%) of such capital requirements (approximately $130 to $150 million), is hereby approved;
>
> RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, FGT, or Citrus Corp. related to or in connection with the transactions contemplated by the Phase III Expansion project, including, without limitation, the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and
>
> RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Mr. Huneke presented the financial matters. He discussed the seasonal increase in the trade receivable purchase and sale agreement with Corporate Asset Funding Company, Inc., CIESCO L.P. and Asset Securitization Cooperative Corporation, and reviewed the terms of the agreement. Upon motion duly made by Mr. Duncan, seconded by Dr. Gramm, and carried, the following resolutions were adopted:

RESOLVED, that the Chairman of the Board, the Vice Chairman of the Board, the President, or any Vice President of the Company is hereby authorized (any one of them acting alone) to negotiate, execute, and deliver, for and in the name and on behalf of the Company, Amendments (the "Amendments") to the following Agreements, as appropriate:

(a) The Trade Receivables Purchase and Sale Agreement dated as of March 9, 1990, as amended, among the Company, Corporate Asset Funding Company, Inc., CIESCO L.P., Asset Securitization Cooperative Corporation, Citibank, N.A., Canadian Imperial Bank of Commerce, and Citicorp North America Inc. ("CNA"), individually and as Agent (the "Investor Agreement"), and

(b) the Trade Receivables Purchase and Sale Agreement dated as of March 9, 1990, as amended, among the Company, the Banks named therein, and CNA, individually and as Agent (such agreement together with the Investor Agreement being the "Agreements");

said Amendments providing for, among other things, the following:

(1) an increase in the Purchase Limit under and as defined in the Investor Agreement from $500,000,000 to $800,000,000, from September 30, 1993, through April 15, 1994;

(2) the payment of certain additional fees in connection with such Purchase Limit increase;

(3) the addition to Schedule I to each of the Agreements of any or all of Louisiana Gas Marketing Company, Enron Access Corporation, Transwestern Pipeline Company, and Enron Clean Fuels Company (a division of Enron Gas Liquids, Inc.), as new "Selling Subsidiaries" under the Agreements, and the

addition of the "Receivables" owed from time to time to each such new Selling Subsidiary by "Designated Obligors" (in each case as defined in the Agreements) to the "Receivables Pool" under the Agreements; and

(4) purchase agreements ("Receivables Purchase Agreements") whereby the Company shall purchase from such new Selling Subsidiaries from time to time "Receivables" (as defined in the Agreements) existing on the date of such Receivables Purchase Agreements and thereafter arising from time to time, for amounts equal to the fair market value of such Receivables computed by subtracting from the face amounts of such Receivables a discount that reflects (among other things) the cost to the Company of owning such Receivables (including, without limitation, the Company's cost of funding its purchase of such Receivables) and the estimated costs (taking into account collection risks) of collections of such Receivables;

but with such changes, amendments, and modifications and in such form as the officer executing such Amendments shall approve, such approval to be conclusively evidenced by his or her execution of such Amendments;

RESOLVED FURTHER, that the Company is authorized and directed to observe and perform in full all of the obligations, conditions, covenants, and other terms set forth in or contemplated by the Amendments and the Agreements as amended thereby;

RESOLVED FURTHER, that the Company is authorized and directed to observe and perform in full all of the obligations, conditions, covenants, and other terms set forth in or contemplated by the Receivables Purchase Agreements;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, related to or in connection with the transactions contemplated by these resolutions, including without limitation the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered and directed (any one of them acting alone) to take all such further action, to execute and deliver all such further agreements, certificates, instruments, and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise as such officer of the Company may deem (as evidenced by such execution and delivery) necessary, appropriate, or advisable in order to effectuate or carry out the purposes and intentions of this and the foregoing resolutions and to observe and perform the obligations, conditions, covenants, and other terms set forth in or contemplated by the Amendments and the Agreements as amended thereby and the Receivables Purchase Agreements.

Mr. Huneke reviewed a proposed receivable sales agreement with Citibank, N.A. or Citicorp North America, Inc. from Enron Power Philippines Corp., a wholly-owned indirect subsidiary of the Company, in connection with the Batangas power project of Batangas Power Corp., a joint venture company owned 50% by Enron Power Philippines Corp. and 50% by New Saga Power Corp. Upon motion duly made by Mr. Duncan, seconded by Dr. Gramm, and carried, the following resolutions were approved:

WHEREAS, Enron Power Philippines Corp., a corporation organized and existing under the laws of the Republic of the Philippines ("EPPC"), is entering into a purchase and repurchase agreement (the "Agreement") with Citibank, N.A. or any of its affiliates ("Citibank"), whereby EPPC will sell to Citibank receivables (the "Receivables") arising from advances made from EPPC to Batangas Power Corp. in the aggregate amount of up to $103,064,727 bearing interest at a rate of 9% per annum;

WHEREAS, EPPC is a wholly-owned subsidiary of the Company;

WHEREAS, it is a condition precedent to the sale of the Receivables to Citibank that the Company provide to Citibank a guaranty (the "Guaranty") of EPPC's obligations under the Agreement, which obligations include, but are not limited to, the obligation by EPPC to repurchase from Citibank the Receivables on or before December 15, 1993;

WHEREAS, the undertaking of the obligations set forth in the immediately preceding paragraphs by the Company will benefit, directly or indirectly, the Company;

NOW, THEREFORE, BE IT RESOLVED, that the Company be, and it hereby is, authorized to provide the Guaranty;

RESOLVED FURTHER, that the Chairman of the Board, the Vice Chairman of the Board, the President, any Vice President, the Treasurer, or any Assistant Treasurer of the Company be, and each of them hereby (acting alone) is, authorized in the name and on behalf of the Company, under its corporate seal or otherwise, to negotiate, execute, deliver, amend, perform, and consummate the Guaranty and such other agreements, instruments, or documents as such officer may deem necessary or desirable to carry out the purpose and intent of the foregoing resolutions, in such forms as shall be approved by the officer executing the same, such approval to be conclusively evidenced by the execution thereof by such officer;

RESOLVED FURTHER, that each such officer be, and each such officer hereby is, authorized in the name and on behalf of the Company to take or cause to be taken such action as such officer may deem necessary or desirable in connection with the performance by the Company of its obligations under any agreement, document, or instrument related to these transactions to which the Company is a party;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, related to or in connection with the transactions contemplated by these resolutions, including without limitation the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Mr. Huneke discussed a corporate guaranty of the obligations of its indirect subsidiary, Enron Gas Marketing, Inc., under a Master Firm Purchase/Sale Agreement with Equitrans, Inc. Upon motion duly made by Mr. Duncan, seconded by Dr. Gramm, and carried, the following resolutions were approved:

WHEREAS, Enron Gas Marketing, Inc., a Delaware corporation ("EGM"), is entering into a Master Firm Purchase/Sale Agreement (the "Agreement") with Equitrans, Inc., a Delaware corporation ("Equitrans");

WHEREAS, EGM is a wholly-owned subsidiary of the Company;

WHEREAS, it is a condition precedent to the effectiveness of the Agreement that the Company provide to Equitrans a guaranty (the "Guaranty") of the performance of EGM's obligations under the Agreement; and

WHEREAS, the undertaking of the obligations set forth in the immediately preceding paragraphs by the Company will benefit, directly or indirectly, the Company;

NOW, THEREFORE, BE IT RESOLVED, that the Company be, and it hereby is, authorized to provide the Guaranty;

RESOLVED FURTHER, that the Chairman of the Board, the Vice Chairman of the Board, the President, any Vice President, the Treasurer, or any Assistant Treasurer of the Company be, and each of them hereby is, authorized in the name and on behalf of the Company, under its corporate seal or otherwise, to negotiate, execute, deliver, amend, perform, and consummate such agreements, instruments, or documents as such officer may deem necessary or desirable to carry out the purpose and intent of the foregoing resolutions, in such forms as shall be approved by the officer executing the same, such approval to be conclusively evidenced by the execution thereof by such officer;

RESOLVED FURTHER, that each such officer be, and each such officer hereby is, authorized in the name and on behalf of the

Company to take or cause to be taken such action as such officer may deem necessary or desirable in connection with the performance by the Company of its obligations under any agreement, document, or instrument related to these transactions to which the Company is a party;

RESOLVED FURTHER, that all actions heretofore taken by any officer of the Company, related to or in connection with the transactions contemplated by these resolutions, including without limitation the execution and delivery of any instruments or other documents as any such officer shall have deemed necessary, proper, or advisable, are hereby adopted, ratified, confirmed, and approved in all respects; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Mr. Lay informed the Board that in connection with the Government's change in corporate tax rates, under generally accepted accounting principles, the Company would be required to record the change in tax rates as an increased or deferred tax expense in the third quarter. He estimated that the economic impact to the Company would be $50 million in the third quarter.

There being no further business to come before the Board, the meeting was adjourned at 4:35 p.m., C.D.T.

Peggy B. Menchaca

Secretary

APPROVED:

Kenneth L. Lay

Chairman

MINUTES
MEETING OF THE FINANCE COMMITTEE
OF THE BOARD OF DIRECTORS
ENRON CORP.
OCTOBER 12, 1993

Minutes of a meeting of the Finance Committee ("Committee") of the Board of Directors of Enron Corp. ("Company"), held pursuant to due notice at 3:00 p.m., E.D.T., on October 12, 1993, at the Willard InterContinental Hotel in Washington, D.C.

The following Committee members were present, constituting a quorum:

Mr. Herbert S. Winokur, Jr., Chairman
Mr. William A. Anders
Mr. Norman P. Blake, Jr.
Mr. John A. Urquhart

Committee member Robert K. Jaedicke joined the meeting in progress, as noted hereinbelow. Directors Kenneth L. Lay, and Richard D. Kinder, Messrs. Rodney L. Gray, Kurt S. Huneke, Edmund P. Segner, III, and Jack I. Tompkins, and Mesdames Nancy G. McNeil and Peggy B. Menchaca also attended the meeting.

The Chairman, Mr. Winokur, presided at the meeting, and the Secretary, Ms. Menchaca, recorded the proceedings.

Mr. Winokur noted that drafts of minutes of a meeting of the Committee held on May 3, 1993, had been distributed to members of the Committee and called for corrections or additions. There being none, upon motion duly made by Mr. Anders, seconded by Mr. Urquhart, and carried, the minutes of the meeting of the Committee held on May 3, 1993, were approved as distributed.

Mr. Segner distributed and discussed material related to the dividend to be paid in the fourth quarter, a copy of which is filed with the records of the meeting. He reviewed a comparison of dividends paid by classes of companies, such as the pipeline industry, S&P 500, producers, oil service, international oil, domestic oil, refiners, and distributors. He recommended that the Company's dividend be increased from \$.70 annually to \$.75 annually, resulting in a quarterly rate of \$.1875. He noted that the percent increase would amount to 7.1%. Mr. Kinder stated that the increase would decrease cash flow by approximately \$12 million.

Upon motion duly made by Mr. Urquhart, seconded by Mr. Anders, and carried, the increase in the dividend policy recommended by management was approved for recommendation to the Board of Directors.

Mr. Segner distributed and referred the Committee to a Debt Rating Study prepared by Merrill Lynch & Co. ("Merrill Lynch") and asked the Committee members to substitute it for the copy sent with each member's Committee materials. A copy of the substituted Debt Rating Study is filed with the records of the meeting. Mr. Segner reviewed the Debt Rating Study on a page-by-page basis. He also distributed and discussed an Enron Corp. summary of issues relating to the Debt Rating Study, a copy of which is filed with the records of the meeting. A discussion ensued related to the importance of achieving an "A" debt rating for the Company, particularly in its international and gas services businesses. Mr. Winokur observed that no action was required of the Committee but noted the Committee's consensus with the direction taken by the management of the Company with regard to seeking an "A" debt rating.

Mr. Huneke presented an update on the perpetual preferred stock issue and distributed material related thereto, a copy of which is filed with the records of the meeting. He noted that Texaco, Inc. had filed a registration statement with the Securities and Exchange Commission ("SEC") for a similar offering and would make its offering to the market just prior to that of the Company. He indicated that if there were no SEC review of the Company's registration statement, it could "go effective" during the first week of November if not earlier. He led a discussion related to the filing of an "omnibus" type shelf registration, from which issues of debt, preferred, or common securities could be made. He indicated that determination of the question of whether or not the preferred stock offering would be tax deductible was key to management's decision to proceed.

Mr. Segner reminded the Committee that the Board of Directors had approved a debt securities shelf registration at its meeting on August 10, 1993, and he proposed that the resolutions adopted at that time be restated to provide management the flexibility to proceed with the filing of an omnibus type registration statement with the SEC, from which issues of debt, preferred securities, or common securities could be made. Following discussion, the consensus of the Committee was to recommend to the Board of Directors of the Company the restatement of resolutions adopted at the Board's August 10, 1993 meeting to provide for offerings of up to $575 million if the structure of the perpetual preferred stock offerings were determined to be tax deductible and if the rating agencies would treat the issue as equity for purposes of debt rating, and offerings of up to $350 million if the structure of the offerings were determined not to be tax deductible.

Mr. Segner next presented a proposal related to the creation and funding of a "Flexitrust" program. A copy of Mr. Segner's report is filed with the records of the meeting. He stated that with regard to the Company's firm commitment to issue equity in the future, the Flexitrust would offer a vehicle through which to issue the equity and not incur a penalty in the equity market for having done so. He indicated that using a Flexitrust had advantages over other equity products in that it would allow the Company to avoid immediate dilution to earnings per share; avoid payment of dividends on newly-issued shares; and retain future appreciation on newly-issued shares. He and Mr. Huneke discussed the transaction structure and operation and described the benefit and compensation plans which would be covered. Mr. Segner recommended that a five-year $262.5 million Flexitrust program with a firm commitment to issue a prescribed amount of stock every two years be approved for recommendation to the Board. Following discussion, upon motion by Mr. Blake, seconded by Mr. Urquhart, and carried, the Flexitrust program was approved for recommendation to the Board.

Mr. Huneke presented proposed changes to the Company's Investment Policy, including expanded investment alternatives, replacing the approved institutions list with defined credit criteria, increasing the maximum investment maturity to one year, revising the investment limits to $50 million for AAA issuers (but remaining at current level of $25 million for AA and A issuers), and requiring custody for commercial paper only if the term of the investment were greater than 31 days. He noted that the revised policy would apply to all Company-owned affiliates unless exceptions were made by the Board. He stated that the amended policy would allow management more flexibility to optimize rates. A copy of Mr. Huneke's report is filed with the records of the meeting. Mr. Winokur called for questions or dissents to the proposed amended Investment Policy as presented and discussed. There being none, he declared the policy approved for recommendation to the Board. Mr. Winokur suggested that management report back to the Committee on an annual basis on how it had performed the previous year under the Investment Policy.

Mr. Tompkins presented the Capital Expenditure Approval Policy and Procedure indicating approval levels and procedures for making capital expenditures. He noted that there was no change in the approval levels. Mr. Winokur called for questions or dissents to the proposed policy and levels of approval for capital expenditures. There being none, Mr. Winokur declared the item approved for recommendation to the Board.

Mr. Huneke reported on the performance of the Company's Retirement Plan, indicating rates of return from December, 1986, to date on a prorata basis as between domestic equities, international equities, and fixed income funds.

Mr. Segner next distributed material related to the status of holders of the Company's $10.50 Cumulative Second Preferred Convertible Stock (the "Series J Stock"). He indicated that management was considering an amendment to be submitted to the Board and, if approved, to the shareholders of the Company at its Annual Shareholders Meeting in May, 1994, which would amend the dividend portion of the Certificate of Designation to allow Series J Stock holders to receive the higher of the original dividend ($10.50) or the equivalent dividend that would be paid if the Series J Stock were converted to the Company's common stock at the current conversion rate. Mr. Segner indicated that the item was informational only, and no action was requested at the instant meeting.

Mr. Segner next distributed and discussed a draft letter which would be sent to all holders of Series J Stock informing them of management's intent with regard to the proposed amendment to the Certificate of Designation in order that each holder would be fully advised before making a decision with regard to conversion of said Series J Stock. He also distributed a copy of an opinion from Lehman Brothers reflecting that the proposed amendment would not have a material adverse effect on the Company (or the Company's common stockholders). Draft copies of the letter to holders of Series J Stock and the Lehman Brothers opinion are filed with the records of the meeting. There were no dissenting comments from the Committee relative to the mailing of the letter to the holders of Series J Stock, and Mr. Winokur declared the matter approved for recommendation to the Board.

Mr. Winokur informed the Committee that the Company was now considering selling at least half of EOTT Energy Corp. through a master limited partnership structure, as opposed to spinning it off to the Company's common shareholders. He noted the successful financial turn-around of the Company under its new management.

Mr. Huneke reviewed the guaranties proposed for Board approval, including (i) a guaranty required as security for transactions by the Company's indirect subsidiaries, EOTT Energy Corp. and Enron Products Marketing Company, with Exxon Corporation for the sale or exchange of petroleum products; and (ii) a guaranty of obligations of the Company's indirect subsidiary, Enron Industrial Natural Gas Company, under a Gas Purchase Agreement with Exxon Company U.S.A. He also discussed an amendment increasing the Cactus III funding vehicle to $45 million.

In addition, Mr. Huneke reviewed four guaranties which were requested after the Board and Committee material had been prepared: (i) a guaranty of the obligations of the Company's indirect subsidiary, Enron Power Services, Inc., under a Gas Sales Agreement with Brooklyn Navy Yard Cogeneration Partners; (ii) a guaranty of the obligations of the Company's indirect subsidiary, Enron Power Services, Inc., under a Gas Sales Agreement with Auburdale Power Partners, L.P.; (iii) a guaranty of the obligations of the Company's jointly-owned subsidiary, Citrus Marketing, Inc., under a Gas Sales Agreement with Auburdale Power Partners, L.P., subject to approval by the Board of Directors of Sonat, Inc., joint owner of Citrus Marketing, Inc.; and (iv) a guaranty required by the Company's partially owned subsidiary, Subic Power Corp., in order to obtain financing of approximately $100 million for the development, construction, and startup of the Subic Bay project in the Philippines.

Mr. Winokur summarized the recommendations for approval of guaranties, and he suggested to management that in making future recommendations of this type it correlate the guarantee sought to the Company's Investment Policy, as well as the Foreign Exchange Policy, if appropriate, and make that representation to the Committee.

Mr. Tompkins next updated the Committee on the Electronic Data Systems ("EDS") registration rights granted by the Company's Board in a stock option effective January 1, 1993. He stated that EDS had announced that it intended to exercise the option and sell the shares immediately upon exercise. He stated that EDS had agreed that 90 percent of the funds received would be credited to the Company to lower the EDS contract costs and that any exercise would be contingent on successful resolution of all accounting and legal issues. He noted that the option was a one year option, and, if approved by the Company's Board, another option could be granted to EDS in January, 1994.

There being no further matters to be brought before the Committee, the meeting was adjourned at 4:30 p.m., E.D.T.

Peggy B. Menchaca

Secretary

APPROVED:

Chairman

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MINUTES
MEETING OF THE BOARD OF DIRECTORS
ENRON CORP.
OCTOBER 13, 1993

Minutes of a meeting of the Board of Directors of Enron Corp. ("Company"), held pursuant to due notice at 8:30 a.m., E.D.T., on October 13, 1993, at the Willard InterContinental Hotel in Washington, DC.

All of the Directors were present, constituting a quorum:

Mr. Kenneth L. Lay, Chairman
Mr. William A. Anders
Mr. Robert A. Belfer
Mr. Norman P. Blake, Jr.
Mr. John H. Duncan
Mr. Joe H. Foy
Dr. Wendy L. Gramm
Dr. Robert K. Jaedicke
Mr. Richard D. Kinder
Dr. Charles A LeMaistre
Mr. John A. Urquhart
Dr. Charls E. Walker
Mr. Herbert S. Winokur, Jr.

Messrs. Ronald J. Burns, James V. Derrick, Jr., Rodney L. Gray, Forrest E. Hoglund, Stanley C. Horton, Kurt S. Huneke, Edmund P. Segner, III, Jack I. Tompkins, and Thomas E. White, and Mesdames Rebecca C. Mark, Nancy G. McNeil, and Peggy B. Menchaca also attended the meeting.

The Chairman, Mr. Lay, presided at the meeting, and the Secretary, Ms. Menchaca, recorded the proceedings.

Mr. Lay called the meeting to order and noted that copies of minutes of meetings of the Board held on August 10, 1993, and September 27, 1993, had been distributed to the members of the Board. He called for additions, corrections, or comments; and there being none, upon motion duly made by Mr. Anders, seconded by Mr. Duncan, and carried, the minutes were approved as distributed.

Mr. Lay called on Mr. Winokur for a report on the meeting of the Finance Committee held the previous day. Mr. Winokur stated that the Committee had heard a report on a Debt Rating Study prepared by Merrill Lynch relative to the Company's efforts in achieving an "A" debt rating. He indicated that the "A" rating was particularly important to the international and gas services operations, and he noted the Committee's approval of the direction taken by management.

Mr. Winokur stated that the Committee had heard an update on the perpetual preferred stock issue. In that regard, he noted that the Committee had approved for recommendation to the Board a restatement of the shelf registration resolutions adopted by the Board at its September meeting to provide for an omnibus type shelf registration which would allow management flexibility with regard to this and future perpetual preferred stock offerings and debt securities offerings. He noted that the maximum aggregate amount of the perpetual preferred stock that could be offered would be $575 million, if the structure of the perpetual preferred offerings were determined to be tax deductible and if the rating agencies would treat the issue as equity for purposes of debt rating, and an additional maximum aggregate amount of $350 million if the structure of the perpetual preferred stock offerings were determined not to be tax deductible. He moved approval of the restatement. Mr. Winokur's motion was seconded by Mr. Blake, carried, and the following resolutions were approved:

> WHEREAS, on August 10, 1993, this Board of Directors authorized (the "Previous Debt Securities Authorization") the issuance and sale of up to $600,000,000 aggregate principal amount of the Company's unsecured debentures, notes, or other debt obligations (the "Debt Securities");
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> WHEREAS, on September 27, 1993, this Board of Directors authorized (the "Previous Preferred Stock Authorization") the issuance and sale from time to time of up to $250,000,000 of fixed rate perpetual preferred stock (the "Preferred Stock") by the Company or a special purpose company (the "SPC") to be incorporated in the Cayman Islands or the Turks and Caicos Islands, at a price and with such terms and conditions to be agreed upon and established by the Preferred Stock Committee created by this Board at such meeting;
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> WHEREAS, this Board of Directors desires to authorize the issuance and sale of additional amounts of Preferred Stock by the Company or an SPC, such that: (i) up to $575,000,000 of Preferred Stock may be issued and sold, as hereinafter provided, provided that the issuer is an SPC organized in the Cayman Islands or the Turks and Caicos Islands, or another subsidiary of the Company that is

treated as a partnership for U.S. federal income tax purposes; and (ii) up to an additional $350.000,000 of Preferred Stock may be issued and sold, as hereinafter provided, if the issuer is not an SPC organized in the Cayman Islands or the Turks and Caicos Islands, or another subsidiary of the Company that is treated as a partnership for U.S. federal income tax purposes; and this Board desires to provide for the issuance and sale of the Debt Securities and the Preferred Stock by restating and, to the extent the following resolutions are inconsistent with the Previous Debt Securities Authorization and the Previous Preferred Stock Authorization, amending such previous authorizations.

RESOLVED, that the Board of Directors hereby deems it advisable and in the best interests of the Company for the Company (or one or more special purpose companies (the "SPC") to be incorporated in the Cayman Islands or the Turks and Caicos Islands, to be 100% directly or indirectly owned by the Company) to issue and sell from time to time (i) up to $575 million of fixed rate perpetual preferred stock if the issuer is an SPC organized in the Cayman Islands or the Turks and Caicos Islands, or another subsidiary of the Company that is treated as a partnership for U.S. federal income tax purposes, and (ii) up to an additional $350 million of fixed rate perpetual preferred stock if the issuer is the Company and not an SPC organized in the Cayman Islands or the Turks and Caicos Islands, or another subsidiary of the Company that is treated as a partnership for U.S. federal income tax purposes (the preferred stock referred to in (i) and (ii) above to be referred to herein as the "Preferred Stock"), at prices and with such terms and conditions to be agreed upon and established by the Preferred Stock Committee referred to below, and to be sold from time to time in public offerings;

RESOLVED, that the Company and/or the SPC enter into one or more underwriting agreements, or other agreements, however designated, together with all necessary agreement wires, confirmation letters, or terms agreements (collectively the "Agreements"), with such underwriting firm or firms or with such institutions or dealers as may, in the judgment of the Chairman of the Board, any Vice Chairman of the Board, the President, any Executive or Senior Vice President, or the Vice President and Treasurer of the Company, be necessary to effect the sale of the Preferred Stock; that the Chairman of the Board, any Vice Chairman of the Board, the President, any Executive or Senior Vice President, or the Vice President and Treasurer of the Company be, and each of them hereby is, authorized and directed to execute and deliver the Agreements, for and in the name and on behalf of the Company or the SPC, in such forms as the officer executing such Agreements shall approve, such approval to be conclusively evidenced by such execution; and that the Company be, and it hereby is, authorized and directed to perform in full all of its obligations under the Agreements;

RESOLVED, in connection with the issuance and sale of the Preferred Stock by the Company or the SPC, that the officers of the Company be, and they hereby are, authorized, empowered, and directed to cause to be prepared, executed, and filed with the Securities and Exchange Commission (the "Commission") (i) a registration statement on Form S-3 or other appropriate form (as so filed, including any exhibits thereto, the "Registration Statement") and (ii) such amendments and post-effective amendments to the Registration Statement or supplements to the Prospectus constituting a part thereof, and to take all such further action, including the filing of final forms of the Prospectus, as may, in the judgment of such officers, be necessary, desirable, or appropriate to secure and thereafter to maintain the effectiveness of the Registration Statement;

RESOLVED, that the Registration Statement may, in the judgment of the officers of the Company, be an "omnibus" registration statement, which may include registration of the sale of (i) the Preferred Stock (and registration of any required Company guarantee of certain SPC Preferred Stock payment obligations, or Company debt obligations to the SPC in connection with the Preferred Stock), and (ii) Depository Shares (defined below) representing fractional interests in the Preferred Stock, and (iii) registration of the sale of Debt Securities previously authorized for issuance and sale by this Board of Directors on August 10, 1993;

RESOLVED, that the Board of Directors of the Company, in accordance with Section 141 of the General Corporation Law of the State of Delaware and Article IV of the Bylaws of the Company, as amended, does hereby create a special preferred stock committee (the "Preferred Stock Committee") and designate Kenneth L. Lay and Richard D. Kinder as the members of the Preferred Stock Committee, and that the Preferred Stock Committee is hereby authorized and empowered to determine, for and in the name and on behalf of the Company and the SPC, the following terms:

(i) the maximum number of shares to constitute the series of Preferred Stock and the distinctive designation thereof;

(ii) the annual dividend rate, if any, on shares of the series, whether such rate is fixed or variable or both, the date or dates from which dividends will begin to accrue or accumulate, and whether dividends will be cumulative;

(iii) whether the shares of the series will be redeemable and, if so, the price at and the terms and conditions on which the shares of the series may be redeemed, including, without limitation, the time during which shares of the series may be redeemed and any accumulated dividends thereon that the holders of shares of the series shall be entitled to receive upon the redemption thereof;

(iv) the liquidation preference, if any, applicable to shares of the series;

(v) whether the shares of the series will be subject to operation of a retirement or sinking fund and, if so, the extent and manner in which any such fund shall be applied to the purchase or redemption of the shares of the series for retirement or for other corporate purposes, and the terms and provisions relating to the operation of such fund;

(vi) the voting rights, if any, on the shares of the series;

(vii) whether fractional interests in shares of the series will be offered in the form of Depository Shares; and

(viii) any other preferences, participating, optional, or other special rights or qualifications, limitations, or restrictions thereof, and any other term of any Agreement and all such other matters as may be determined by such Preferred Stock Committee consistent with Delaware law, the SPC's Charter and by-laws, the Company's Restated Certificate of Incorporation, the terms of any outstanding series of preferred stock, and these resolutions, such Preferred Stock Committee's approval of such terms and conditions to be conclusively determined by their inclusion in the executed copies of any Agreements;

and that the Preferred Stock Committee is hereby authorized to take any and all action and to do or cause to be done any or all things which may appear to the Preferred Stock Committee to be necessary or advisable in order for the Company, or to cause the SPC, to offer, issue, and sell the Preferred Stock, to the full extent and with the same effect as the Board of Directors of the Company could take such action or do or cause such things to be done; and that a majority of the members of the Preferred Stock Committee shall constitute a quorum for the transaction of business; and that the Preferred Stock Committee shall keep a written record of its meetings, shall present such record to the meetings of the Preferred Stock Committee, and shall file a copy of such record in the corporate minutes of the Company;

RESOLVED, that in the event Preferred Stock is issued by the SPC, it may be in the best interests of the Company, and the Company is hereby authorized, to guarantee, on such terms as the Preferred Stock Committee deems appropriate, the liquidation value of the Preferred Stock to be issued by the SPC, as well as dividends on the Preferred Stock, if and when declared, and to enter into any loan agreement or other agreements as may be determined by the Preferred Stock Committee to be necessary or advisable in order to cause the SPC to offer, issue, and sell the Preferred Stock;

RESOLVED, that the Company is hereby authorized to elect to offer fractional interests in shares of the Preferred Stock, rather than full shares, in the form of Depository Shares evidenced by Depository Receipts; and that the Preferred Stock Committee is hereby authorized to determine the fractional interest of a share of Preferred Stock represented by each Depository Share and any other terms of the Depository Shares;

RESOLVED, that the Company is hereby authorized to deposit the Preferred Stock represented by the Depository Shares under a deposit agreement ("Deposit Agreement") to be entered into between the Company and a bank or trust company having its principal office in the United States and having a combined capital and surplus of at least $50,000,000 (the "Depository"); that the Chairman of the Board, any Vice Chairman of the Board, the

President or any Vice President of the Company be, and each of them hereby is, authorized and directed to execute, acknowledge, and deliver the Deposit Agreement for and in the name and on behalf of the Company, in such form as the officer executing such Deposit Agreement shall approve, such approval to be conclusively evidenced by such execution;

RESOLVED, that the Chairman of the Board, the President, or any Vice President and the Corporate Secretary, any Deputy Corporate Secretary, or any Assistant Secretary of the Company be, and each of them hereby is, authorized, empowered, and directed, for and in the name and on behalf of the Company, to take any and all action which they may deem necessary or advisable in order for the Company or the SPC to obtain a permit, to register, or to qualify part or all of the Preferred Stock or Depository Shares for issuance and sale or to request an exemption from registration of part or all of the Preferred Stock or Depository Shares or to register or obtain a license for the Company or the SPC as a dealer or broker under the securities laws of such of the states of the United States of America and of such foreign jurisdictions as such officers may deem advisable, and in connection with such registrations, permits, licenses, qualifications, and exemptions, to execute, acknowledge, verify, deliver, file, and publish all such applications, reports, resolutions, irrevocable consents to service of process, powers of attorney, and other papers and instruments as may be required under such laws, and to take any and all further action which they may deem necessary or advisable in order to maintain such registration in effect as long as they may deem it to be in the best interests of the Company;

RESOLVED, that the Company or the SPC make application to the New York Stock Exchange, Inc. and one or more other securities exchanges as the officer acting shall deem necessary or appropriate for the listing thereon of the Preferred Stock or Depository Shares; that the Chairman of the Board, the President, or any Vice President of the Company be, and each of them hereby is, authorized, empowered, and directed to execute and deliver, for and in the name and on behalf of the Company or the SPC, to the New York Stock Exchange, Inc. and all other securities exchanges on which the Preferred Stock or Depository Shares of the Company or the SPC are to be listed, such agreements in such form as may be necessary to effect the aforesaid listing; and that the officers of the

Company be, and they hereby are, authorized, empowered, and directed to execute and deliver any applications, documents, or agreements, to appear, if requested, before officials of any such exchanges, and to take any and all such actions, to appoint any banking institution as an agent of the Company or the SPC for any purpose, and to do or cause to be done any or all such things as may appear to them to be necessary or desirable in order to effect such listing, specifically including registration of the Preferred Stock or Depository Shares under Section 12 of the Securities Exchange Act of 1934, as amended;

RESOLVED, that the Preferred Stock Committee is hereby authorized to determine the form of stock certificate representing the Preferred Stock, and the form of certificate representing a Depository Share, with such changes thereto, consistent with these resolutions and any applicable resolutions of the Preferred Stock Committee, as the officers executing the same shall approve, such execution to be conclusive evidence of the approval of such officers and this Board of Directors or such Preferred Stock Committee;

RESOLVED, that the signature of the Chairman of the Board, any Vice Chairman of the Board, the President, or any Vice President of the Company or the SPC, as appropriate, the corporate seal of the Company or the SPC, and the signature of the Corporate Secretary, any Deputy Corporate Secretary, or any Assistant Secretary of the Company or the SPC, as appropriate, on any or all of the certificates of Preferred Stock or Depository Shares may be facsimile, and that the Company hereby adopts and approves any such facsimile signatures and seal;

RESOLVED, that the facsimile signatures which appear upon any of the certificates of Preferred Stock or Depository Shares shall be valid regardless of whether such officer ceases to hold such office prior to the issuance of the Preferred Stock or Depository Shares; and

RESOLVED, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company or the SPC, under the Company's or the SPC's corporate seal or otherwise, as appropriate, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Mr. Winokur stated that the Committee had heard a presentation on the proposed creation of a "Flexitrust" Program and approved it for recommendation to the Board. He explained that "Flexitrust" referred to a flexible employee benefit trust which would be created for the purpose of funding certain employee benefits. Upon motion duly made by Mr. Winokur, seconded by Mr. Blake, and carried, the following resolutions were adopted:

RESOLVED, that the Board of Directors hereby approves the creation of a flexible employee benefit trust (the "Flexitrust") for the purpose of funding certain employee benefits;

RESOLVED FURTHER, that the Chairman of the Board, any Vice Chairman of the Board, the President, any Executive Vice President, any Senior Vice President, or the Treasurer of the Company be, and each of them hereby is, authorized and empowered for and on behalf of the Company to negotiate such terms and conditions for the Flexitrust as any of said officers may deem best, and to execute, deliver, and perform for and on behalf of the Company such trust agreements, agreements to pay trustee fees, and such other instruments or written obligations (collectively, the "Agreements") of the Company as may be desired or required in connection with the Flexitrust and containing such terms and conditions as may be acceptable or agreeable to any of said officers, such acceptance and agreement to be conclusively evidenced by any of said officers' execution and delivery thereof; and that the Company be, and it hereby is, authorized and directed to perform in full all of its obligations under the Agreements;

RESOLVED FURTHER, that the Company is hereby authorized to sell to the Flexitrust, for good and valid consideration, up to 7.5 million shares of Common Stock, par value $.10 per share (such shares may be newly issued shares or treasury shares, or any combination thereof), at such prices and with such terms and conditions to be agreed upon and established by the Special Committee referred to below;

(713) 758-2192

November 4, 1993

Enron Corp.
1400 Smith Street
Houston, Texas 77002

Gentlemen:

You have requested our opinion concerning certain federal income tax consequences relative to the loans (the "Loans") to be made by Enron Capital LLC (the "Company") to Enron Corp. ("Enron") pursuant to that certain Loan Agreement to be entered into between the Company and Enron, as hereinafter described.

Based upon the facts, representations, assumptions, law and analysis all as set forth below, in our opinion for federal income tax purposes (i) the Company will be treated as a partnership, (ii) the Loans should be classified as indebtedness, and (iii) as such no tax will be required to be deducted and withheld by Enron pursuant to section 1441 of the Internal Revenue Code of 1986 (the "Code") from the interest payable to the Company in respect of the Loans.

FACTS

The Company is a limited life company organized under the laws of the Turks and Caicos Islands, and exists solely for the purpose of issuing its shares and lending the net proceeds thereof to Enron. The Company's current capitalization consists of 5,000 shares of $1 par value common stock (the "Common Shares"), of which 4,998 are issued and outstanding and owned by Enron. Prior to making the Loans to Enron, the Company's authorized capital will be increased by an additional class of 8,000,000 shares of $1 par value preferred stock (the "Preferred Shares"). Dividends on the Preferred Shares will (i) be cumulative, (ii) accrue from the date of original issue and (iii) be payable monthly in United States dollars at a rate on each Preferred Share of

8% of its stated liquidation preference of $25. Pursuant to an Underwriting Agreement,1 the Company will sell the Preferred Shares to several Underwriters for ultimate sale to the public.

After the sale of the Preferred Shares and pursuant to the terms of the Loan Agreement, the Company will loan to Enron an aggregate principal amount equal to the aggregate Liquidation Preference of the Preferred Shares issued and sold by the Company (approximately $200,000,000) plus the aggregate Common Share Payments (approximately $53,165,000). Enron is expected to use the proceeds of the Loans for general corporate purposes including the repayment of indebtedness. The Loan Agreement provides for fixed interest at an annual rate of 8%, with interest payable on the last day of each calendar month of each year commencing November 30, 1993, provided that Enron has the right to extend the interest payment period up to a maximum of 18 months so long as Enron is not in default in its payment of interest on the Loans. The entire principal amount of the Loans becomes due and payable, together with any accrued and unpaid interest thereon, on the earliest of (i) November 30, 2043, (ii) the date upon which Enron is dissolved or liquidated or (iii) the date upon which the Company is dissolved or liquidated.

The proceeds from any repayment of principal on the Loans will be applied to redeem the Preferred Shares at the Redemption Price, subject to the provision that any such amounts may be reloaned to Enron and not used for such redemption if, at the time of each such loan and as determined in the judgment of Enron, as Manager, and its financial advisor, (a) Enron is not in bankruptcy, (b) Enron is not in default on any Loan pertaining to the Preferred Shares, (c) Enron has made timely payments on the repaid Loan for the immediately preceding 18 months, (d) the Company is not in arrears on payments of dividends on the Preferred Shares, (e) Enron is expected to be able to make timely payment of principal and interest on such loan, (f) such loan is being made on terms, and under circumstances, that are consistent with those which a lender would require for a loan to an unrelated party, (g) such loan is being made at a rate sufficient to provide payments equal to or greater than the amount of dividends that accrue on the Preferred Shares, (h) the senior unsecured long-term debt of Enron is rated BBB- or better by Standard & Poor's Corporation or Baa3 or better by Moody's Investors Service, Inc. or the equivalent by any other nationally recognized statistical rating organization, (i) such loan is being made for a term that is consistent with market circumstances and Enron's financial condition and (j) the final maturity of such loan is not later than the 100th anniversary of the issuance of the Preferred Shares.

The Loan Agreement contains a mandatory prepayment provision whereby, if the Company redeems Preferred Shares, the Loans become due and payable in a principal amount equal to the aggregate stated liquidation preference of the Preferred Shares so redeemed plus all accrued interest. Optional prepayment provisions in the Loan Agreement give Enron the right to prepay the Loans without premium or penalty (i) in whole or in part, together with all accrued and unpaid interest and Additional Interest on the portion being prepaid at any time following November 30, 1998, and (ii) in whole (or in part, provided such partial prepayment would not result in a delisting of the Preferred Shares) together with all accrued and unpaid interest and Additional Interest, at any time after Enron is or would be required to pay Additional Interest. However, Enron does not have the right to prepay the Loans based on (a) a technical obligation to pay Additional Interest because of a withholding obligation to the extent Enron would not incur any penalties, interest or tax under the Code or other applicable law if Enron did not withhold, or (b) a *de minimis* obligation to pay Additional Interest. For purposes of the foregoing, in the event that Enron is advised by independent legal counsel that more than an insubstantial risk exists that Enron will incur penalties, interest or tax under the Code or other applicable law if it does not withhold, Enron shall have the right to repay the Loans unless the obligation to pay Additional Interest if Enron does so withhold is a *de minimis* obligation.

The Loan Agreement provides that each of the Loans is subordinate and junior in right of payment to all Senior Indebtedness, which is defined as the principal, premium, if any, and interest on (i) all indebtedness of Enron, whether outstanding on the date of the Loan Agreement or thereafter created, incurred or assumed, which is for money borrowed or evidenced by a note or similar instrument given in connection with the acquisition of any business, properties or assets, (ii) any indebtedness of others of the kind described in the preceding clause for which Enron is responsible or liable as guarantor or otherwise, (iii) any indebtedness secured by a lien upon property owned by Enron and upon which indebtedness Enron customarily pays interest, even though Enron has not assumed or become liable for the payment of such indebtedness and (iv) amendments, renewals, extensions and refundings of any such indebtedness, unless in any instrument or instruments evidencing or securing such indebtedness or pursuant to which the same is outstanding, or in any such amendment, renewal, extension or refunding, it is expressly provided that such indebtedness is not superior in right of payment to the Loans. In the event that Enron defaults in the payment of any principal, premium or interest on any Senior Indebtedness or an Event of Default has occurred with respect to any Senior Indebtedness and written notice describing such Event of Default and requesting commencement of payment blockage on the Loans is given to Enron by the holders of Senior Indebtedness, the Loan Agreement prohibits Enron from making any direct or indirect payment with respect to the Loans until the default on the Senior Indebtedness has been cured or waived or ceases to exist. In the event of any insolvency, bankruptcy or other similar proceeding relating to Enron, all Senior Indebtedness must be paid in full before any payment or distribution on the Loans may be made.

The Loan Agreement provides for various Events of Default pursuant to which the Company has the right to declare all amounts payable under the Loan Agreement to be immediately due and payable and to enforce its other rights as a defaulted creditor with respect to the Loans. The Operative Documents further provide that (i) if the Company fails to pay dividends in full on the Preferred Shares for 18 consecutive monthly dividend periods (assuming that Enron has not exercised its right to extend the interest payment period), (ii) an Event of Default occurs and is continuing or (iii) Enron breaches any of its obligations under the Guarantee (described below), then the holders of a majority in liquidation preference of the outstanding Preferred Shares may appoint a trustee to enforce the Company's creditor rights under the Loan Agreement, enforce the obligations of Enron under the Guarantee and the Expense Agreement, and declare and pay dividends on the Preferred Shares.

As part of these transactions, Enron will execute and deliver a guarantee (the "Guarantee") for the benefit of the holders of the Preferred Shares, which Guarantee will constitute a guarantee of payment and not of collection and will rank (i) subordinate to all liabilities of Enron, (ii) *pari passu* with the most senior preferred or preference stock now or hereafter issued by Enron and with any Enron guarantee now or hereafter entered into by Enron by respect of any preferred or preference stock of any Enron affiliate, and (iii) senior to Enron's common stock. Under the Guarantee, Enron is unconditionally obligated to pay the Guarantee Payments (except to the extent paid by the Company) in full to the holders of the Preferred Shares regardless of any defense, right of set off or counterclaim which the Company may have or assert. The following payments (to the extent not paid by the Company) constitute Guarantee Payments: (i) any accumulated and unpaid dividends declared on the Preferred Shares out of funds legally available therefor, (ii) the Redemption Price payable out of funds legally available therefor with respect to Preferred Shares called for redemption by the Company, (iii) upon a liquidation of the Company, the lesser of (a) the Liquidation Distribution and (b) the amount of assets of the Company available for distribution to Preferred Shareholders in liquidation of the Company, and (iv) any Additional Amounts payable by the Company in respect of the Preferred Shares.

As part of the Loan Agreement, Enron will covenant that, so long as any Preferred Shares remain outstanding, neither it nor any majority-owned subsidiary will declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment with respect to, any of its capital stock, or make any guarantee payments with respect to the foregoing (other than (i) payments under the Guarantee, (ii) dividends or guarantee payments to Enron, or (iii) dividends on common stock paid by Enron Oil & Gas Company) if at such time Enron is in default with respect to its payment or other obligations under the Guarantee or the Expense Agreement or there has occurred any event that, with the giving of notice or the lapse of time or both, would constitute an Event of Default under the Loan Agreement. Enron will also covenant that so long as any Preferred Shares remain outstanding (i) it will maintain direct or indirect 100% ownership of the Common Shares and any other shares of the Company other than the Preferred Shares, (ii) it will cause at least 21% of the total value of the Company and at least 21% of all interests in the capital, income, gain, loss, deduction and credit of the Company to be represented by Common Shares, (iii) it will not voluntarily dissolve, wind-up or liquidate the Company, (iv) it will remain the Manager of the Company and timely perform all of its duties as Manager of the Company (provided that any permitted successor of Enron under the Loan Agreement may succeed to Enron's duties as Manager), and (v) it will use reasonable efforts to cause the Company to remain a limited life company and otherwise continue to be treated as a partnership for United

States federal income tax purposes.

The Articles of Association of the Company (referred to therein and herein as "Regulations") provide, in Regulation 15, that a Common Shareholder ceases to be a Member of the Company if such Common Shareholder attempts to make a transfer of his share in breach of the provisions of the Regulations. Regulation 16 provides that the transfer of any Common Shares in the Company is prohibited absolutely. Regulation 34 provides that the Manager (which is defined in the Regulations to mean Enron, any permitted successor to Enron, or any other holder of the Common Shares) will cause at least 21 percent of the total value of the Company and at least 21 percent of all interests in the capital, income, gain, loss, deduction and credit of the Company to be represented by Common Shares.

Regulation 52 provides that the Company shall be in dissolution automatically and without requirement of any other act upon the bankruptcy, resignation, withdrawal, expulsion, termination, cessation or dissolution under U.S. law of the holder of a majority of the Common Shares. Regulation 56 provides that when the Company is in dissolution, the Manager shall serve as liquidator unless and until the majority of the former Common Shareholders who were Members immediately preceding the commencement of dissolution and winding up by majority vote appoint a liquidator to replace the Manager.

REPRESENTATIONS AND ASSUMPTIONS

In connection with your request that we furnish this opinion you have made and we have relied upon the following representations, and our opinion is conditioned upon the initial and continuing accuracy of these representations and upon the assumptions set forth below:

1. At the time the Loans are made, (a) Enron is expected to be able to make timely payment of all principal and interest on the Loans, (b) the Loans are being made on terms, and under circumstances, that are consistent with those which a lender would require with respect to a loan of similar tenor and subordination to an unrelated party, and (c) the Loans are being made for a term that is consistent with market circumstances and Enron's financial condition.

2. The Company will enforce its creditor rights against Enron as specified in the Operative Documents in the case of an Event of Default or any other event giving rise to such rights under the Operative Documents.

3. Enron expects to continue its corporate existence and substantial business operations at least for the term of the Loans.

4. At the time the Loans are made, Enron could have borrowed the amount

of the Loans on similar terms from unrelated independent lenders.

5. The Company has been organized and at all times will be operated in conformance with the provisions of the Regulations, all of which provisions are effective under applicable law to establish the rights and obligations of the holders of the Common Shares and the holders of the Preferred Shares among themselves and with the public at large.

6. At all times during the existence of the Company, the Common Shares will represent at least 21 percent of all interests in the capital, income, gain, loss, deduction and credit of the Company.

7. None of the Loans will be secured by an interest in real property.

8. At least 90 percent of the gross income of the Company for each taxable year will consist of interest on the Loans.

9. At no time will the Company be engaged in the conduct of a financial or insurance business.

10. Each of the Loans will be registered with Enron as to both principal and interest, and the transfer of each Loan may be effected only by surrender of the note evidencing such Loan and either the reissuance by Enron of the note to the new holder or the issuance by Enron of a new note to the new holder evidencing such Loan.

11. The Company will file timely and periodically with Enron a duly completed and executed Internal Revenue Service Form W-8 stating that the Company is the beneficial owner of the Loans and that it is not a United States person.

12. Enron will comply with its covenants in the Loan Agreement.

We have assumed that the holders of the Preferred Shares at no time will own (directly or through application of the attribution rules of section 318(a) as modified by section 871(h)(3)(C) of the Code) stock of Enron representing 10 percent or more of the total combined voting power of all classes of stock entitled to vote, and that the holders of the Preferred Shares will file such forms appropriate to, or will otherwise, establish their exemption from U.S. withholding tax with respect to distributions on the Preferred Shares.

LAW AND ANALYSIS

The Loans

Neither the Code nor the Treasury Regulations promulgated thereunder specifically defines the characteristics which an interest must possess in order to be characterized for federal income tax purposes as indebtedness. Section 385, added to the Code in 1969, authorizes the Internal Revenue Service (the "Service") to prescribe regulations as necessary to determine whether an interest in a corporation is to be treated as debt or equity. Section 385(b) lists as factors to be addressed in those regulations: (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for adequate consideration in money or money's worth, and to pay a fixed rate of interest, (2) whether there is subordination to or preference over any other indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

In the context of loans from a subsidiary to its parent corporation, the principal tax issue is whether the stockholder withdrawal is classified as a loan or as a constructive dividend. While the Supreme Court has not addressed the issue of characterization in the context of a subsidiary-to-parent loan, the Court has addressed the characterization of an instrument in the converse situation of advances by shareholders to their corporations. In *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946), the Supreme Court concluded that the characterization of an instrument as debt or equity for federal tax purposes depends on a facts and circumstances analysis in which, generally, no single factor is controlling. While this facts and circumstances analysis has resulted in outcomes which are frequently confusing and difficult to reconcile, a recent Tax Court decision enumerated many of the factors which courts have identified and used as aids in determining whether an instrument constitutes debt or equity (including a constructive dividend): (i) the name given the instrument evidencing the indebtedness, (ii) the presence or absence of a fixed maturity date, (iii) the source of payments, (iv) the right to enforce payments, (v) participation in management as a result of the advances, (vi) subordination to other creditors, (vi) intent of the parties to create debt, (viii) whether the purported creditors are also stockholders, (ix) the debt to equity ratio, (x) the ability of the debtor to otherwise obtain credit from outside sources, (xi) the use to which the advances will be put, (xii) the failure of the debtor to repay and (xiii) the risk involved in making the advances. *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980).

The Loan Agreement and Loans will have the form of a debt instrument and provide for (i) a market interest rate, (ii) a fixed date for maturity, (iii) the enforcement of the terms under certain conditions such as events of default and (iv) no participation in management of Enron as a result of the advances. These provisions evidence the clear intent of the parties to create indebtedness on the part of Enron to the Company. The fact that the maturity date of the Loans does not occur for 50 years (and that interest may be payable only every 18 months) is but one factor to be weighed in the debt determination. As the Tax Court noted in *Monon Railroad v. Commissioner*, 55 T.C. 345, 359 (1970), "[a]lthough 50 years might under some circumstances be considered as a long time for the principal of a debt to be outstanding, [the court] must take into consideration the substantial nature of the [taxpayer's] business and the fact that it had been in corporate existence . . . [for] 61 years prior to the issuance of the debentures." The *Monon* court emphasized that the instruments at issue contained a definite maturity date without reservation or condition and concluded that, based on the facts and circumstances, a 50-year term was not unreasonable. *Id. See also Ruspyn Corp. v. Commissioner*, 18 T.C. 769 (1952) (debentures with 89-year term due 4 years after expiration of lease covering corporation's principal asset constituted debt); *Mayerson v. Commissioner*, 47 T.C. 340, 352 (1966) (purported mortgage with 99-year term held valid debt obligation as "definite contractual obligation was created which would have to be fulfilled by or before a definite date in the future"). In *Swoby Corp. v. Commissioner*, 9 T.C. 887 (1947), however, the Tax Court held that an "income debenture" with a 99-year maturity date issued by a new corporation whose principal asset was a building which had an anticipated life of less than 33 years represented equity. The Loans can be distinguished from the situation in *Swoby Corp.* because Enron (including its predecessors) has been in business for many years and is expected to continue its corporate existence and substantial business operations at least for the term of the Loans.

The absence of realistic creditor safeguards is indicative of an equity contribution rather than a loan. The Tax Court has stated that "[t]he right to enforce the payment of interest is one of the requisites of a genuine indebtedness." *Gokey Properties, Inc. v. Commissioner*, 34 T.C. 829, 835 (1960). The Loan Agreement provides protection for the Company pursuant to the enforcement provisions available in case of a continuing Event of Default. Moreover, neither the Operative Documents nor applicable law restricts payment on the Loans to the corporate earnings of Enron or otherwise makes Loan payments contingent on the success of Enron. *See* Rev. Rul. 73-122, 1973-1 C.B. 66 (payments not dependent on earnings or at discretion of the organization favors debt characterization); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (when repayment is possible only out of corporate earnings transaction reflects equity contribution). These characteristics are reflective of indebtedness rather than an equity interest.

Subordination of a debt to claims of general creditors is an important indication that the debt is really equity. *Harlan v. United States*, 409 F.2d 907 (5th Cir. 1969). However, subordination *per se* is not a fatal impediment to establishing a bona fide indebtedness. The bonds in *John Kelley Co. v. Commissioner, supra*, were subordinated; however, the Supreme Court, after weighing all the facts, held that such bonds constituted valid debt. Generally, if the holders of the instruments in question have rights which take precedence over those of shareholders and there is substantial equity in the corporation, these circumstances suggest that the instruments are in fact debt even though the creditors' claims are subordinated to those of general business creditors. *Monon Railroad*, 55 T.C. at 360. In Rev. Rul. 68-54, 1968-1 C.B. 69, the Service noted that the subordination of registered debentures raised questions as to the true nature of the debentures, yet concluded that the instruments qualified as valid indebtedness on the basis of other factors, including the fact that the claims of the debenture holders had priority over the claims of all equity holders. *See also* Rev. Rul

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73-122, *supra* (concluding that the presence of other factors, including the priority of all equity interests over the debentures, outweighed the subordination of the debentures at issue).

While the Fifth Circuit, in one case, appeared to place greater emphasis on the effects of subordination than the Tax Court, later cases have clarified that the Fifth Circuit now employs a facts and circumstances analysis in which no one factor is determinative. In *Tomlinson v. 1661 Corp.*, 377 F.2d 291 (5th Cir. 1967), the court stated that the fact that an instrument is subordinated to all other indebtedness of the corporation, whether already incurred or to be incurred in the future with no limitation on the amount of such indebtedness, would "weigh heavily" toward an equity participation and against the existence of a bona fide debtor-creditor relationship. *Id.* at 298, discussing *United States v. Snyder Bros. Co.*, 367 F.2d 980 (5th Cir. 1966). In subsequent cases, however, the Fifth Circuit recognized that the subordination of an obligation to the claims of other creditors does not necessarily indicate that the purported debt is in reality an equity contribution, particularly where the advance is given a superior status to that of other equity contributions. *Estate of Mixon v. United States,* 464 F.2d 394, 406 (5th Cir. 1972). Like the Tax Court, the Fifth Circuit views the subordination of an instrument to other creditors, but not equity holders, as merely a factor to be considered in the facts and circumstances analysis of characterizing an instrument.

In *Rose v. Commissioner,* 435 F.2d 149 (5th Cir. 1970), the Fifth Circuit addressed the risks assumed by the lender in making advances to the borrower, and concluded that "[t]he ultimate question presented here is whether the investment, analyzed in terms of economic reality, constitutes risk capital subject to the fortunes of the venture, or whether it represents a strict debtor-creditor relationship." The Loans will be made generally on terms similar to those on which Enron could have borrowed similar amounts from independent lenders, and do not entitle the Company to share in any of the potential appreciation in the value of Enron other than to the extent of repayment of principal and interest on the Loans. The fact that the Underwriters, representing the global securities markets, will purchase the newly issued Preferred Shares which depend on the loans for their value is indicative of Enron's sound financial condition. Therefore, the risks assumed by the Company comport with a characterization of the Loans as indebtedness.

The Revenue Reconciliation Act of 1993 added section 7701(l) to the Code effective August 10, 1993, which states as follows:

> *Regulations Relating to Conduit Arrangements.* -- The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title.

The legislative history accompanying this provision indicates that it would be within the proper scope of the provision to issue regulations dealing with multiple-party transactions involving debt guarantees or equity investments. To date, no regulations have been proposed under section 7701(l), and accordingly we are unable to express an opinion on the effect of new section 7701(l) on the characterization of the Loans for federal income tax purposes. We do note, however, that the existing authorities cited in that legislative history dealt with situations in which an intermediary party was disregarded as a conduit for federal income tax purposes. In each case, a purported payment to the intermediary was treated as in substance a payment directly by the first party to the third party; in no case was the character of the first party's payment as interest questioned. Indeed, in Technical Advice Memorandum 9133004, a payment of interest by the first party to an intermediary party and a related payment of dividends by the intermediary party to a third party was treated as a payment of *interest* directly by the first party to the third party.

Based on the facts, representations, assumptions, law and analysis set forth above, in our opinion the Loans should be classified as indebtedness for federal income tax purposes.

Classification of the Company

Section 7701(a)(2) of the Code provides that the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust or estate or a corporation.

Section 301.7701-1(b) of the Treasury Regulations states that the Code prescribes certain categories or classes into which various organizations fall for purposes of taxation. These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts. The tests, or standards, which are to be applied in determining the classification of an organization are set forth in sections 301.7701-2 through 301.7701-4 of the Treasury Regulations.

Section 301.7701-2(a)(2) of the Treasury Regulations provides that the determination of whether an organization is to be treated as a partnership or as an association taxable as a corporation depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability. Section 301.7701-2(a)(3) of the Treasury Regulations provides that an unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics.

Section 301.7701-2(b)(1) of the Treasury Regulations provides that if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist.

Section 301.7701-2(e)(1) of the Treasury Regulations provides that an organization has the corporate characteristic of free transferability of interests if each of the members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization. Thus, the characteristic of free transferability of interests does not exist in a case in which each member can, without the consent of other members, assign only his right to share in profits but cannot so assign his right to participate in the management of the organization.

An entity organized under foreign law is treated as an unincorporated organization and thus is classified for federal tax purposes on the basis of the characteristics set forth in the Treasury Regulations under section 7701 of the Code. Rev. Rul. 88-8, 1988-1 C.B. 403. However, it is the local law of the foreign jurisdiction that must be applied in determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets. Rev. Rul. 73-254, 1973-1 C.B. 613.

In Rev. Rul. 93-4, 1993-3 I.R.B. 5, the Service ruled that where the organic documents of a foreign entity require dissolution upon the bankruptcy of an interest holder, without further action, the entity lacks the corporate characteristic of continuity of life (regardless of the identity of the interest holders and their relationship to each other).

In Rev. Proc. 92-33, 1992-1 C.B. 782, the Service provided a "numerical interpretation" of the phrase "substantially all" as it appears in section 301.7701-2(e)(1) of the Treasury Regulations for purposes of ruling whether an organization has the corporate characteristic of free transferability of interests. The Service stated that generally it will rule that a partnership lacks free transferability of interests if, throughout the life of the partnership, the partnership agreement expressly restricts the transferability of partnership interests representing more than 20 percent of all interests in partnership capital, income, gain, loss, deduction and credit.

Under section 7701(i) of the Code, any entity (including a partnership) that constitutes a "taxable mortgage pool" will be taxable as a separate corporation which may not be treated as a member of a consolidated group of corporations for purposes of section 1501 of the Code. To be classified as a taxable mortgage pool, (i) substantially all of the assets of such entity must consist of "debt obligations (or interests therein)", and (ii) more than 50 percent of such debt obligations must consist of "real estate mortgages (or interests therein)".

Under section 7704 of the Code, a publicly traded partnership is generally treated as a corporation. However, section 7704(c) provides that the treatment of a publicly traded partnership as a corporation shall not apply to any publicly traded partnership for any taxable year if 90 percent or more of the gross income of such partnership for such taxable year consists of "qualifying income", which section 7704(d) of the Code defines to include interest (other than interest derived in the conduct of a financial or insurance business or interest the determination of the amount of which depends in whole or in part on the income or profits of any person) and dividends.

Under the Regulations and as represented above, the Common Shares of the Company at all times will represent at least 21 percent of the total value of the Company and at least 21 percent of all interests in the capital, income, gain, loss, deduction and credit of the Company. The transfer of any Common Shares in the Company is prohibited absolutely, and if a Common Shareholder attempts to make a transfer of its shares in breach of the Regulations, the Common Shareholder ceases to be a Member of the Company. Accordingly, we conclude that the Company does not possess the corporate characteristic of free transferability of interests.

The Regulations provide that the Company shall be in dissolution automatically and without the requirement of any other act upon the bankruptcy, resignation, withdrawal, expulsion, termination, cessation, or dissolution of the holder of a majority of the Common Shares. Accordingly, we conclude that the Company lacks the corporate characteristic of continuity of life.

Because none of the Loans will be secured by an interest in real property, we conclude that the Company will not constitute a taxable mortgage pool under section 7701(i) of the Code. Because at least 90 percent of the gross income of the Company for each taxable year will consist of interest on the Loans, we also conclude that the Company will not be treated as a corporation pursuant to section 7704 of the Code.

Because we have concluded that the Company will not possess the corporate characteristics of continuity of life and free transferability of interests, we conclude that the Company will not have more corporate characteristics than noncorporate characteristics. We have also concluded that the Company will not constitute a taxable mortgage pool, or be treated as a corporation under section 7704 of the Code. Accordingly, in our opinion the Company will be treated as a partnership rather than as an association taxable as a corporation for federal income tax purposes.

Withholding Tax Under Section 1441

Section 1441 of the Code provides generally that all persons paying interest from sources within the United States to any nonresident alien individual or any foreign partnership shall withhold a tax equal to 30 percent thereof. Section 1441(c)(9) of the Code provides that no tax shall be required to be deducted and withheld from portfolio interest (within the meaning of section 871(h) of the Code) unless the person required to deduct and withhold tax from such interest knows, or has reason to know, that such interest is not portfolio interest by reason of section 871(h)(3) of the Code.

Section 871(h)(2)(B) of the Code defines the term "portfolio interest" to include any interest (including original issue discount) which is paid on an obligation which is in registered form and with respect to which the United States person who would otherwise be required to deduct and withhold tax from such interest under section 1441 receives a statement (which meets the requirements of section 871(h)(5)) that the beneficial owner of the obligation is not a United States person.

Section 871(h)(7) of the Code provides that the term "registered form" has the same meaning given such term by section 163(f) of the Code. The Treasury Regulations under section 163(f) provide that an obligation is in registered form if the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and the transfer of the obligation may be effected only by the surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder.

Section 871(h)(5) of the Code provides that the statement with respect to an obligation must be made by the beneficial owner of such obligation, or a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business, provided the Secretary of the Treasury has not published a determination that any statement from such person (or any class including such person) does not meet the requirements of section 871(h)(5) of the Code at least one month before the payment of interest on the obligation.

Treasury Regulation § 35a.9999-5(b)A-9 provides that interest on a registered obligation may be treated as portfolio interest by a United States person otherwise required to deduct and withhold tax under section 1441 of the Code if that person receives a statement that (i) is signed by the beneficial owner under penalties of perjury, (ii) certifies that such owner is not a United States person, or in the case of an individual that he is neither a citizen nor a resident of the United States, and (iii) provides the name and address of the beneficial owner. This statement may be made, at the option of the person otherwise required to withhold, on a Form W-8 or a substitute form that is substantially similar to Form W-8 and must be prepared, renewed and retained in accordance with the procedures prescribed at Treasury Regulation § 1.6049-5(b)(2)(iv). Treasury Regulation § 35a.9999-5(d) provides that an information return on Form 1042S, accompanied by the statement or Form W-8, is required to be filed with the Internal Revenue Service for the calendar year in which the interest payment is made.

Section 871(h)(3) of the Code provides that "portfolio interest" shall not include any interest which is received by a 10-percent shareholder. A "10-percent shareholder" means, in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. For this purpose, the attribution rules of section 318(a) of the Code, as modified by section 871(h)(3)(C) of the Code, apply.

The Loans are issued by a corporation (Enron) to a partnership (the Company) which does not directly own any of the voting stock of Enron. We have assumed that the holders of the Preferred Shares at no time will own (directly or through application of the attribution rules of section 318(a) as modified by section 871(h)(3)(C) of the Code) 10 percent or more of the voting stock of Enron. Further, it has been represented that each of the Loans will be registered as to both principal and interest and that the Company will file timely and periodically with Enron a duly completed and executed Form W-8 stating that the Company is the beneficial owner of the Loans and that it is not a United States person. Therefore, we conclude that interest paid on the Loans will qualify as portfolio interest within the meaning of section 1441(c)(9) of the Code. Accordingly, in our opinion Enron will not be required to deduct and withhold tax pursuant to section 1441 of the Code with respect to interest on the Loans paid to the Company.

We express no opinion as to the tax treatment of any of the transactions contemplated by the Operative Documents which is not specifically addressed in the foregoing opinion. Our opinion is based upon the existing provisions of the Code, regulations (and administrative pronouncements) promulgated or proposed thereunder, and interpretations thereof by the Internal Revenue Service and the courts, all as of the date hereof, all of which are subject to change with prospective or retroactive effect, and our opinion could be adversely affected or rendered obsolete by any such change. This opinion is given to you by us solely for your use and is not to be quoted or otherwise referred to or furnished to any governmental agency (other than the Internal Revenue Service in connection with an examination of Enron or the Company) or to other persons without our prior written consent.

Very truly yours,

VINSON & ELKINS L.L.P.

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December 17, 1993

PRIVILEGED ATTORNEY-CLIENT COMMUNICATION

Mr. Robert J. Hermann
Vice President - Tax
Enron Corp.
P. O. Box 1188
Houston, Texas 77251

Re: Enron Capital LLC

Dear Mr. Hermann:

In our opinion letter addressed to Enron Corp. dated November 4, 1993 (the "Tax Opinion"),[1] we concluded that the Loans from the Company to Enron should be classified as indebtedness for federal income tax purposes and that, accordingly, no tax would be required to be deducted and withheld by Enron pursuant to section 1441 of the Code from the interest payable to the Company in respect of the Loans.

You asked us to analyze the applicability of interest, penalties and other additions to tax arising from Enron's failure to so withhold in the event the Service recharacterized the Loans as an equity interest in Enron and treated such payments of interest as the payment of dividends from Enron either to the Company or to the holders of the Preferred Shares.

Based on the discussion below, we believe that (i) Enron should not be liable for penalties or additions to tax by reason of any failure to withhold in respect of a payment on the Loans, (ii) Enron would be liable for interest on any tax that should have been withheld during any calendar year, but such interest should not start to accrue until March 15 of the following year and should cease to accrue upon payment of the tax against which such withholding tax may be credited by the holders of the Preferred Shares (which may be as early as April 15 of such following year), and (iii) Enron would be liable for any

[1] Capitalized terms used but not defined herein have the meanings ascribed to them in the Tax Opinion.

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tax that should have been withheld to the extent such tax is not paid by the holders of the Preferred Shares.

DISCUSSION

Section 1441(a) of the Code[2] provides generally that all persons having the control, receipt, custody, disposal or payment of any interest, dividends, or other fixed or determinable annual or periodical income (to the extent that any of such items constitutes gross income from sources within the United States) of any nonresident alien individual or any foreign partnership shall deduct and withhold therefrom a tax equal to 30 percent thereof.[3]

Withholding agents are required to deposit withheld tax on a quarter-monthly, monthly or annual basis into an authorized financial institution. The frequency of deposits depends on the amount of tax withheld. Quarter-monthly deposits of tax are required if, at the end of any quarter-monthly period, total undeposited tax is $2,000 or more. Treas. Reg. §1.6302-2(a)(1). If tax withheld has not been deposited or paid as prescribed, it must be paid by the withholding agent when filing Form 1042 (discussed below) for the year. Treas. Reg. §1.1461-3(a)(2).

In addition to the requirements to withhold and deposit tax with respect to payments to nonresident aliens, foreign partnerships and foreign corporations, the payor of income subject to withholding under section 1441 or 1442 is required to file Forms 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) and 1042S (Foreign Person's U.S. Source Income Subject to Withholding).[4] Section 1461 makes the payor of section 1441 or 1442 items of income personally liable for the withholding tax, but section 1463 provides that a person who fails to deduct and withhold the requisite tax under section 1441 or 1442 (the "Withholding Agent") will not be liable for such withholding tax to the extent that the tax against which the withholding tax may be credited (the "Underlying Tax")

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[2] Unless otherwise indicated, all subsequent section references are to the Code.

[3] Section 1442 imposes a similar withholding obligation with respect to foreign corporations.

[4] Form 1042 is due on or before March 15 of the year following the calendar year in which the tax was required to be withheld and must be filed even though no tax was required to be withheld. Treas. Reg. § 1.1461-2(b). Likewise, a withholding agent must file Form 1042S on or before March 15 for various types of income, including interest subject to the portfolio interest exception. Treas. Reg. § 1.1461-2(c).

is subsequently paid by the recipient of the income.[5] Section 1463 further provides, however, that the Withholding Agent remains liable for interest or any penalties or additions to the tax otherwise applicable due to the failure to deduct and withhold.

If the Service were to recharacterize the Loans made by the Company to Enron as an equity interest in Enron owned by the Company, the interest payments on such Loans would be treated as dividends (to the extent of Enron's earnings and profits) from Enron to the Company. In such case, the dividends would be subject to the withholding requirements of section 1441 and Enron would face a withholding obligation for all such dividends paid to the Company. Assuming (as the Tax Opinion concludes) that the Company is treated as a partnership for federal income tax purposes, it would not pay any income tax on the dividends such that section 1463 would relieve Enron of its withholding liability. As a partnership, however, dividends paid by Enron to the Company would flow through the Company to the holders of Preferred Shares ("Preferred Shareholders").[6] We understand that the vast majority of the Preferred Shareholders are expected to be United States persons, and not nonresident aliens, foreign partnerships or foreign corporations,[7] and as such, the U.S. Preferred Shareholders would be subject to U.S. income taxation on the dividends received from the Company.[8] Therefore, pursuant to section 1463, Enron would not be liable for the 30 percent withholding tax on dividends paid to the Company for which the U.S. Preferred Shareholders subsequently paid the Underlying Tax.

If the Service were to recharacterize payments in respect of the Loans as interest or dividends paid by Enron to the Preferred Shareholders on the basis of a conduit analysis (*e.g.*, under regulations promulgated pursuant to section 7701(l)), the Company would be disregarded and Enron's withholding obligations under sections 1441 and 1442 would depend on the identity of the Preferred Shareholders as there would be no section 1441 or 1442 withholding obligations for payments made to U.S. Preferred Shareholders. Interest

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[5] Section 33 provides that there shall be allowed as a credit against the income taxes imposed by Subtitle A the amount of tax withheld at the source pursuant to sections 1441-1446. Likewise, section 1462 provides that income on which any tax is required to be withheld at the source under Chapter 3 shall be included in the recipient's return of such income, but that any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

[6] Partners are required to take into account their distributive shares of the partnership's separately stated items and nonseparately computed income. IRC § 702(a). *See also* IRC § 1441(b) and Treas. Reg. § 1.1441-3(f) (providing for withholding on a foreign partner's distributive share of a domestic partnership's section 1441 income, regardless of whether such income is distributed).

[7] Furthermore, based on the size and offering price of the Preferred Shares, a majority of Preferred Shareholders may be U.S. individuals.

[8] In the case of U.S. tax-exempt Preferred Shareholders not required to treat distributions from the Company as unrelated business taxable income, no tax would be due.

or dividends paid to nonresident aliens, foreign partnerships or foreign corporations generally would be subject to withholding by Enron. However, if treatment as indebtedness rather than equity prevailed, treatment of the interest as portfolio interest should exempt any interest payments made to foreign Preferred Shareholders from withholding pursuant to sections 1441 and 1442.[9] If the Enron payments were treated as dividends to the Preferred Shareholders, Enron would only be liable for section 1441 or 1442 withholding on payments made to foreign Preferred Shareholders.

To summarize, if the Company were disregarded under a conduit analysis, Enron's section 1441 or 1442 withholding obligations would apply only to Preferred Shareholders which are foreign persons, and then only with respect to payments recharacterized as dividends. In contrast, if the Company were respected as an entity but the Loans were recharacterized as Enron equity, section 1441 withholding would apply to all payments to the Company. Therefore, the greatest risk to Enron for liability in respect of a failure to withhold lies in the Service's reclassifying the Loans as an equity interest owned by the Company.

In the event of a recharacterization of the Loan transactions by the Service, Enron would not be liable for any withholding tax due pursuant to sections 1441 through 1464 for which the Preferred Shareholder subsequently pays the Underlying Tax.[10] The task of demonstrating that the Preferred Shareholders have subsequently paid the Underlying Tax on payments made either directly or indirectly to the Preferred Shareholders for purposes of section 1463 could prove difficult. As discussed in footnote 9, *supra* foreign Preferred Shareholders presumably would have Forms W-8 on file with the Company. Likewise, noncorporate U.S. Preferred Shareholders presumably would have Forms W-9 on file with the Company for backup withholding purposes. With access to the Forms W-8 and W-9 providing information on the foreign Preferred Shareholders and U.S. noncorporate Preferred Shareholders, Enron would only need to ascertain the identity of Preferred Shareholders which are U.S. corporations. With the names and tax identification numbers

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[9] We have assumed the filing of (i) Forms W-8 (Certificate of Foreign Status) or substitute forms which are substantially similar to Form W-8 by the foreign Preferred Shareholders as required to qualify for the portfolio interest exemption and (ii) Forms W-9 (Request for Taxpayer Identification Number and Certification) by noncorporate U.S. Preferred Shareholders to avoid backup withholding. This assumption is based on our belief that the foreign Preferred Shareholders will have filed Forms W-8 (or substitute Forms) and the noncorporate U.S. Preferred Shareholders will have filed Forms W-9 with the Company pursuant to the discussion regarding the tax treatment of United States Alien Holders on pages S-20 and S-21 of the Prospectus Supplement.

[10] In TAM 7827006 (no date given), the employer-taxpayer obtained and presented Forms 4669 (Statement of Payments Received) to the Service showing that the withholding tax at issue had been paid by the employees. In *Jones v. United States*, 79-1 USTC ¶9120 (E.D. Tex. 1978), the employer introduced income tax returns to establish that the independent contractor had paid his own withholding tax.

of the Preferred Shareholders, Enron could obtain information concerning the payment of Underlying Tax by the Preferred Shareholders from the Service pursuant to Form 4669 (Statement of Payments Received). *See* footnote 10, *supra*.

Section 6601(a) provides that interest is payable where the amount of any tax is not paid on or before the last date prescribed for its payment. Section 6601(b) provides that "the last date prescribed for payment" of a tax is determined under Chapter 62 or sections 6151-6167. Section 6151(a) provides the general rule that tax is due at the time and place fixed for filing the return. Thus, interest generally runs from the original due date for filing the tax return reporting the tax to the date payment is received and accrues during periods for which an extension has been granted.

In the case of any addition to tax for failure to file a return, for failure to pay stamp tax or for the accuracy-related and fraud penalties, interest is imposed on such penalties for the period beginning on the due date of the return (including extensions) and ending on the date the addition to tax is paid. Section 6601(e)(2)(B).

In a recent case involving the interest portion of the negligence penalty, the Tax Court was squarely presented with determining "the last date prescribed for payment" of the withholding tax imposed by sections 1442 and 1461. *Orban Co. v. Commissioner*, 90 T.C. 275 (1988). The Tax Court reasoned that a quarterly tax deposit made pursuant to section 6302 is not automatically equated with payment as the Treasury Regulations provide that deposits of tax withheld on income paid to nonresident aliens and foreign corporations "shall be considered as paid on the last day prescribed for filing the return (Form 1042) in respect of such tax (determined without regard to any extension of time for filing such return), or at the time deposited, whichever is later." Treas. Reg. § 1.6302-2(b)(5). Thus, the Tax Court concluded that "the last date prescribed for payment" of the 30 percent withholding tax imposed by sections 1442 and 1461[11] is the due date for filing the required return, Form 1042, *i.e.*, March 15, even though the taxes were required to be deposited during the preceding calendar year.

In Rev. Rul. 58-577, 1958-2 C.B. 74, as modified by Rev. Rul. 66-113, 1966-1 C.B. 244, as modified by Rev. Rul. 86-10, 1986-1 C.B. 358, an employer did not deduct and withhold any tax from the earnings of an individual which the employer considered to be an independent contractor. Upon subsequently determining that the individual was an employee, the employer filed the necessary supplemental returns and was assessed for the

[11] The same result would obtain in the case of a withholding tax imposed by section 1441 on the basis of Treas. Reg. § 1.6302-2(b)(5).

tax that should have been withheld plus interest.[12] The employee "timely filed" an income tax return and satisfied his income tax liability relating to the withholding. The ruling concludes that the employer is liable for interest assessed for the period beginning with the due date or dates for payment of the tax that the employer was required, but failed, to withhold, until the earlier of the following April 15 or date on which the employee satisfied the employee's individual income tax liability.[13]

Thus, in the event that the Loans are recharacterized by the Service, resulting in a withholding tax liability for Enron, Enron should be subject to interest on such tax liability from March 15 of the year following the recharacterized payments to the date payment is made by the Preferred Shareholders (presumably April 15, if the majority of Preferred Shareholders are U.S. individuals as expected).

Prior to the enactment of the Revenue Reconciliation Act of 1989 (the "1989 Act"), the Code provided that a penalty could be imposed on the Withholding Agent or the

[12] The ruling did not state whether the filing of the supplemental returns qualified as an adjustment within the meaning of section 6205(a)(1) such that no interest would have been due. Section 6205(a)(1) provides that if an employer withholds less than the correct amount of tax imposed by sections 3301, 3111, 3201, 3221, or 3402 with respect to the payment of wages or other compensation and the employer makes "proper adjustments," no interest will be charged on the tax due. Section 31.6205-1(c)(2)(I) of the Treasury Regulations sets forth the conditions under which an interest-free adjustment is made if an employer filed a return and reported either no income tax or less than the correct amount of income tax required to be withheld by the employer. The employer must adjust the error by either (i) reporting the additional amount due on a return for any quarter in the calendar year in which the wages were paid or (ii) reporting the additional amount on a supplemental return for the period in which the wages were paid. Such reporting constitutes an adjustment under section 6205(a) of the Code only if the return or supplemental return is filed on or before the due date for the return for the quarter in which the error is ascertained. An error is ascertained when the employer has sufficient knowledge of the error to be able to correct it. Treas. Reg. § 31.6205-1(a)(4). Although the availability of an interest-free payment of a withholding liability is addressed only in the employment context, Enron could attempt to argue by analogy pursuant to H.R. Rep. 101-247, 101st Cong., 1st Sess. at 295, 298 *discussed infra* that the principles of section 6205(a) should apply to Withholding Agents. However, there is no basis in the Code or the Treasury Regulations as currently written to support this argument.

[13] An argument can be made that a Preferred Shareholder's income tax return filed pursuant to a valid extension is "timely filed" such that interest would run on Enron's withholding liability only from March 15 until the original due date of the Preferred Shareholder's return (rather than until the date the withholding tax was actually paid by the Preferred Shareholder pursuant to a valid extension of the due date of the return). *See* Rev. Rul. 83-27, 1983-1 C.B. 338 (impliedly holding that a return filed pursuant to a valid extension is timely filed). However, under the Internal Revenue Code of 1954, the Second Circuit and the Claims Court ruled that a Form 7004, or corporate extension form, constituted a return within the meaning of section 6601 for purposes of computing the interest on tax due. *Hayden Publishing Co., Inc. v. United States*, 341 F.2d 646 (Cl. Ct. 1965); *Louillard Co. v. United States*, 64-2 USTC ¶9876 (2d Cir. 1964). Finally, the language of section 6601 is unequivocal in stating that interest accrues on an underpayment or nonpayment from the last date prescribed for payment (determined without regard to extension) until "the date paid."

recipient of section 1441 income by reason of a failure to pay withholding tax when the tax was subsequently paid by the recipient only if the failure were fraudulent and for the purposes of evading payment. Section 1463 before amendment by section 7743 of the 1989 Act. By contrast, U.S. employers remained liable for penalties and additions to tax where the employer failed to withhold income tax from the employee's wages even if the employee subsequently paid the tax. Section 3402(d). The 1989 Act amended section 1463 to provide that Withholding Agents would be subject to the same general approach applicable to U.S. employers who withhold income taxes from employees' wages. H.R. Rep. 101-247, 101st Cong., 1st Sess. at 295, 298 ("Conference Report"). To date, the Service has not provided any regulations or other guidance as to the application of amended section 1463. Moreover, few cases have addressed withholding issues in the context of Chapter 3 of Subtitle A of the Code (sections 1441 through 1446). Therefore, in keeping with the Congressional intent as expressed in the Conference Report, a taxpayer must generally look to the application of withholding principles in the employment context for guidance in applying the withholding provisions of Chapter 3, including the assertion of interest and penalties pursuant to section 1463.

There are a number of penalty provisions that can apply to various failures of a Withholding Agent. The following is a summary of the penalties typically assessed against Withholding Agents.

1. *Failure to collect and pay over tax* -- Section 6672 imposes a 100% penalty against a Withholding Agent or its officers for (i) a willful failure to collect tax, (ii) a willful failure to account truthfully for and pay over tax or (iii) a willful attempt to evade or defeat any tax or payment thereof. Although this provision may technically apply to Withholding Agents, the reported cases have generally concerned employers.

   The standard of willfulness applied by the courts does not embrace any bad motive or evil intent on the part of the responsible party. According to the Internal Revenue Manual - Administration, Section 5632.2(1) (6-3-91), willfulness is the attitude of a person who, having a free will or choice, either intentionally disregards the law or is plainly indifferent to its requirements. Most courts reject the contention that reasonable cause or justifiable excuse is a factor in determining whether a party's actions are willful. *Monday v. United States*, 421 F.2d 1210 (7th Cir. 1970), *cert. denied*, 400 U.S. 821. But see *Newsome v. United States*, 421 F.2d 215 (5th Cir. 1970) in which the Fifth Circuit held that reasonable cause is a limited part of the test for determining whether failure to collect, account for and pay over tax was willful. If the 100% penalty were asserted against Enron in a recharacterization of the Loans, Enron's reliance on the Tax Opinion should evidence

Enron's lack of intentional disregard of or conscious indifference to the law so as to negate the element of willfulness.

2. *Fraud penalty* -- Section 6663(a) imposes a 75% penalty with respect to any portion of an underpayment which is attributable to fraud. The fraud penalty is not imposed if the taxpayer shows that there was a reasonable cause for the underpayment and that the taxpayer acted in good faith with respect to such portion. Section 6664(c).

3. *Accuracy-Related Penalties.*

(a) Negligence penalty -- Sections 6662(a) and (b)(1) add a 20% penalty which applies to the portion of tax underpayment attributable to negligence or disregard of rules or regulations. The reasonable cause and good faith exception applies. Section 6664(c)(1).

(b) Substantial Understatement Penalty -- Section 6662(d) imposes a 20% penalty in the case of any substantial understatement of income tax unless the taxpayer demonstrates substantial authority for the position taken or that the position was adequately disclosed on the tax return and a reasonable basis exists for the position. This penalty may not apply to a Withholding Agent, however, as the Service has taken the position that a substantially similar penalty under pre-1989 Act law did not apply to Withholding Agents for two reasons: (i) Congress intended this penalty to apply to taxpayers who play the "audit lottery" and Withholding Agents are not in a position to play the "audit lottery" because the annual form which Withholding Agents must file does not provide for reporting of deductions and credits, and (ii) the penalty is in the form of an addition to "income tax" and the Service believes that the tax imposed on Withholding Agents is a "withholding tax" rather than an income tax because it is not imposed on the income of the Withholding Agent. GCM 39686 (Dec. 11, 1987).[14]

4. *Late Deposit Penalty* -- Section 6656 imposes this penalty on any person required to make timely deposits of withheld income tax who fails to

[14] A 1993 decision in which the Tax Court concluded that sections 1441 and 1461 impose *income taxes* casts doubt on the continuing vitality of the Service's position. *Northern Indiana Pub. Serv. Co. v. Commissioner*, 101 T.C. ___, No. 20 (1993).

do so. The amount of the penalty is time sensitive pursuant to a four-tiered penalty structure under which the penalty amount varies with the time in which the taxpayer corrects the failure. The penalty imposed due to the failure to timely and/or fully deposit withheld income tax may be avoided where it is shown that the failure was due to reasonable cause and not to willful neglect.[15] Section 6656(a). The late deposit penalty may not apply to Enron, however, if the Loans are subsequently recharacterized as the Service has concluded that the late deposit penalty prescribed in section 6656 applies if the employer withholds tax and does not deposit the required amounts, but does not apply to a failure to deposit if no tax, in fact, is withheld. Rev. Rul. 75-191, 1975-1 C.B. 376. *See also* GCM 36912 (Nov. 5, 1976) (late deposit penalty not applicable where employer did not withhold income tax from the employee in question).

5. *Failure to File Correct Information Returns or Payee Statements* – These penalties apply to failures to (i) file Form 1042S with the Service and (ii) provide Form 1042S to each payee.[16] Each Form 1042S required to be filed with the Service and provided to a payee is treated as an information return and also as a payee statement subject to separate penalties under sections 6722 and 6723. No penalty is imposed for either infraction if the failure was due to reasonable cause and not to willful neglect. Section 6724.

6. *Criminal Penalties* – The civil penalties have criminal counterparts, all of which involve the element of willfulness. The following is a partial list:

   (I) Attempt to Evade or Defeat Tax – Section 7201 provides that a Withholding Agent who willfully attempts to evade or defeat the payment of tax may be guilty of a felony and is punishable by a fine not to exceed $100,000 ($500,000 for a corporation), imprisonment for up to 5 years, or both, together with the costs of prosecution.

[15] The taxpayer must make an affirmative showing of all facts alleged as reasonable cause in a written statement containing a declaration that it is made under penalties of perjury.

[16] Form 1042 is not an information return, as it is a "return . . . of the tax" as required by Treas. Reg. § 1.1461-2(b). *See Northern Indiana Pub. Serv. Co. v. Commissioner*, 101 T.C. ___, No. 20 n.2 (1993).

(ii) **Willful Failure to Collect or Pay Over Tax** -- A Withholding Agent who willfully fails to collect, account for and pay over any tax may also be guilty of a felony and risks a fine not to exceed $10,000, imprisonment for up to 5 years, or both, together with the costs of prosecution. Section 7202.

(iii) **Willful Failure to File Return or Pay Tax** -- A Withholding Agent who willfully fails to pay a tax, file a return, keep required records or supply information may be guilty of a misdemeanor punishable by a fine not to exceed $25,000 ($100,000 for a corporation), imprisonment for up to 1 year, or both, together with the costs of prosecution. Section 7203.

The criminal sanctions that apply to employers and Withholding Agents required to withhold and pay withholding taxes generally require both an affirmative act and willfulness to obtain a conviction. *United States v. Burrell*, 505 F.2d 904 (5th Cir. 1974). Willfulness has been defined as the "voluntary, intentional violation of a known legal duty." *United States v. Kim*, 884 F.2d 189, 192 (5th Cir. 1989). Even gross negligence is insufficient to establish willfulness for purposes of asserting the Code's criminal penalties. Good faith reliance on the advice of counsel or an expert tax preparer after the complete disclosure of all relevant facts to the advisor is a defense to tax evasion. *United States v. Kelley*, 864 F.2d 569 (7th Cir. 1989).[17] There are no facts known to us which would support an attempt by the Service to impose a criminal penalty requiring willfulness on the Loan transactions.

Most civil penalties are subject to nonassertion or abatement if the taxpayer's failure to timely perform the required act is due to "reasonable cause." *See, e.g.,* sections 6651, 6652, 6656, 6664, 6686 and 6724. The Service has issued a consolidated penalty handbook which provides instructions for the Service with respect to all penalties imposed by the Code. The IRS Penalty Handbook, Part XX of the Internal Revenue Manual (the "Penalty Handbook"), sets forth procedures both for assessing and abating penalties, and contains discussions on topics such as the "reasonable cause" exception and procedures for appealing penalties.[18]

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[17] A good faith misunderstanding of the law is a defense to a tax crime and the Supreme Court has recently held in *Cheek v. United States*, 111 S. Ct. 604 (1991) that the defendant's misunderstanding of the law need not be objectively reasonable.

[18] The Penalty Handbook replaces all other Service internal management documents dealing with the administration of penalties, and is intended to be the primary source of authority for the administration of penalties by the Service. IRM (20)112 (7-27-92).

The reasonable cause standard is expressed in various ways throughout the Code. For example, some sections provide that a certain penalty does not apply if there is "reasonable cause and not willful neglect", while other sections provide that the penalty does not apply if there is "reasonable cause and good faith", "reasonable cause" or a "reasonable basis." Although expressed in different ways, the Penalty Handbook seems to apply these standards in essentially the same manner. However, neither the Code, the case law nor the Penalty Handbook provides a definitive explanation as to what constitutes reasonable cause.

The Penalty Handbook defines "reasonable cause" as those reasons deemed "administratively acceptable" to the Service for justifying the nonassertion or abatement of applicable penalties against taxpayers. IRM (20)310 (7-27-92). The Penalty Handbook includes a list of the most common reasons given by taxpayers which may be considered reasonable cause for many of the major penalties, one of which reasons is reliance on the advice of a competent tax advisor.[19] To qualify for this "administratively acceptable" reason, the taxpayer must have (i) received incorrect advice after contacting a tax advisor who is competent on the specific tax matter, (ii) furnished the necessary and relevant information to such tax advisor, and (iii) exercised ordinary business care and prudence in determining whether to obtain additional advice based on the taxpayer's own information and knowledge. IRM (20)333.7 (7-27-92). The Service considers the following factors in determining whether the taxpayer qualifies for the reliance on a competent tax advisor reasonable cause exception: (i) when and how the taxpayer became aware of the mistake, (ii) whether the taxpayer provided complete and accurate information to the tax advisor, (iii) whether the taxpayer actually relied on the advice of the tax advisor and (iv) supporting documentation, such as a copy of the advice requested, a copy of the advice provided and a statement from the tax advisor explaining the circumstances. *Id.*[20]

In addition to the Service's list of "administratively acceptable" reasons supporting a reasonable cause request, the courts have found that a taxpayer may have reasonable cause where it relied on the erroneous advice of counsel concerning a question of law such as whether the taxpayer was required to file a tax return or whether a tax liability exists. *United States v. Boyle*, 469 U.S. 241 (1985); *Estate of Paxton v. Commissioner*, 86 T.C. 785

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[19]A tax advisor is defined as a tax attorney, certified or licensed public accountant, or enrolled agent.

[20] Chared Corp. v. United States, 69-2 USTC ¶9535 (N.D. Tex. 1969), *aff'd*, 446 F.2d 745 (5th Cir. 1971), *vac'd and rem'd on other grounds*, 455 F.2d 928 (5th Cir. 1972) (taxpayer had reasonable cause for purposes of negating the negligence and failure to file withholding tax return penalties where it acted in good faith in the exercise of ordinary business prudence in relying on advice of tax experts who had been supplied with all the necessary information involving advances by a domestic subsidiary to its foreign parent treated as loans which the Service recharacterized as dividends).

(1986); *Lattman v. United States*, 92-2 USTC ¶50,423 (N.D. N.Y. 1992).[21] Although the Penalty Handbook requires that the taxpayer exercise ordinary care in determining whether to obtain additional advice to qualify for reasonable cause treatment, the Supreme Court has noted that requiring the taxpayer to seek a second opinion or attempt to monitor counsel on the analysis of the Code nullifies the original purpose of seeking the advice of a presumed expert. *Boyle*, 469 U.S. at 246. Thus, the courts generally have not imposed as stringent a burden on the taxpayer as the Service to show reasonable cause.

The civil penalties which the Service would likely assert against Enron in the event of a Loan recharacterization and associated withholding tax assessment are subject to nonassertion or abatement if Enron's failure to timely withhold and deposit the tax is due to reasonable cause. Enron should be able to meet the reasonable cause standard as described in the Penalty Handbook based on its reliance on the conclusions in the Tax Opinion that the Loans should be characterized and treated as indebtedness of Enron to the Company for federal income tax purposes and, as such, the related interest paid by Enron to the Company would qualify for the portfolio interest exemption from withholding. Because the determination of whether an interest is debt or equity for federal income tax purposes is essentially a facts and circumstances analysis in which no single factor is determinative, the Service would find it difficult to argue successfully that Enron's management did not exercise ordinary business care and prudence in relying on the Tax Opinion. A similar analysis would apply to any attempt by the Service to recharacterize payments from Enron to the Company pursuant to the Loans as made by Enron to the Preferred Shareholders under the conduit regulations contemplated by section 7701(l) or the existing conduit authorities noted in the Tax Opinion. Therefore, because Enron (i) consulted with a tax advisor, (ii) supplied the tax advisor with the relevant information regarding the Loan transactions and (iii) exercised ordinary business care and prudence in relying upon the advice of the tax advisor, it should meet the Service's criteria for reasonable cause so as to justify nonassertion or abatement of the applicable civil penalties.

CONCLUSION

If the Service were to recharacterize the Loans as (i) an equity interest in Enron owned by the Company or (ii) an equity interest in Enron owned by the Preferred Shareholders, Enron would be liable for withholding tax pursuant to sections 1441 and 1442 with respect to dividend payments made pursuant to the Loans to the extent the Underlying Tax were not subsequently paid by any Preferred Shareholders. If the Service were to

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[21] Furthermore, the courts have found that a taxpayer's good faith belief alone that no return is due may constitute reasonable cause for late filing. *See, e.g., Diaz v. United States*, 90-1 USTC ¶50,209 (C.D. Cal. 1990) (good faith belief that employees were independent contractors is reasonable cause for failure to file employment tax returns).

** TOTAL PAGE.014 **

recharacterize the Loans as indebtedness from Enron to the Preferred Shareholders, Enron should not be liable for withholding tax pursuant to sections 1441 and 1442 except with respect to foreign Preferred Shareholders which failed to supply the Company (or Enron) with Forms W-8 (or substitute forms) so as to qualify for the portfolio interest exemption. The reasonable cause exception is available for the various civil penalties which the Service might attempt to impose on Enron in the event of a recharacterization of the Loan transactions,[22] and Enron should qualify for the reasonable cause exception based on the stated criteria in the IRS Penalty Handbook. Consequently, Enron should not be subject to any applicable penalties or interest thereon. Enron, however, would be liable for interest on the amount of tax which should have been withheld under sections 1441 or 1442 from March 15 of the calendar year following the year in which the tax should have been withheld until the Underlying Tax is paid (either by the Preferred Shareholders or Enron).

Very truly yours,

Vinson & Elkins L.L.P.

Vinson & Elkins L.L.P.

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[22] As discussed above, the Service would not have any credible grounds for asserting the Code's criminal penalties in the event of a recharacterization of the Loans.

ARTHUR
ANDERSEN

ARTHUR ANDERSEN & CO. SC

Arthur Andersen & Co.

1345 Avenue of the Americas
New York NY 10105
Writer's Direct Dial
[212] 708-4930

September 13, 1993

Goldman, Sachs, & Co.
85 Broad Street
New York, New York 10004

Dear Sir or Madam:

We have been engaged to report on the appropriate application of United States generally accepted accounting principles (US GAAP) to the hypothetical transaction described below. This report is being issued to Goldman, Sachs, & Co. for assistance in evaluating accounting principles for the described hypothetical transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Transaction:

1) Corp forms a Special Purpose Corporation (SPC) created and incorporated under the laws of the Grand Cayman Islands or Turks and Caicos Islands. In the event that SPC is a resident of the Turks and Caicos Islands, it will be a 150 year limited duration company. SPC issues common stock all of which is owned by Corp.

2) SPC will sell perpetual preferred stock to unrelated parties, possibly in a public offering. The preferred stock will carry a vote only upon a default in dividends.

3) The Bylaws and Charter of SPC specify that its business is limited to selling stock to raise equity capital and loaning that capital to Corp or another related entity.

4) The preferred stock of SPC will pay a dividend fixed at issuance.

5) SPC will loan its equity proceeds to Corp under a bullet loan, which pays interest at a rate fixed at the time of issuance. Corp has the right to repay the loan on any interest date that the SPC has called the preferred stock.

6) As a matter of its organizational documents, Corp will be liable for SPC expenses in excess of SPC assets; preferred dividends are not considered expenses for this purpose.

7) SPC will dissolve upon bankruptcy of Corp unless the SPC preferred stock holders vote otherwise.

8) Corp may unilaterally pass a resolution to dissolve SPC at any time.

Accounting Discussion:

You have asked us to address the US GAAP accounting for SPC in the consolidated financial statements of Corp. The rules for consolidation of subsidiaries are set forth in Accounting Research Bulletin No. 51 (ARB 51), Opinion No. 18 of the Accounting Principles Board (APB 18) and Statement No. 94 of the Financial Accounting Standards Board (FASB 94). These rules specify that a company should generally consolidate the accounts of an investee when it has a controlling financial interest in the investee. The usual condition for a controlling financial interest is ownership of a majority voting interest. Accordingly, Corp will consolidate SPC.

In our opinion, and in practice, the non affiliate shareholders of a subsidiary are treated as minority interests (i.e., not included in debt or consolidated stockholders' equity) in the US GAAP consolidated financial statements. Hence, we believe that the non affiliate investments in SPC would be reflected as minority interest in Corp's US GAAP consolidated financial statements. While some may argue that where a subsidiary's only role is to loan funds to others in the consolidated group and the non affiliated stockholders of the subsidiary can gain control of its Board in the event of default on the loan, the non affiliate stockholders of the subsidiary should be treated as creditors in the consolidated financial statements of the group, this is not practice.

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The ultimate responsibility for the decision on the appropriate application of generally accepted accounting principles for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountants. Our judgment on the appropriate application of generally accepted accounting principles for the described hypothetical transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change. We have not been asked to address and have not addressed any tax matters relating to this transaction.

Our opinion is as of the date of this letter and we do not assume an obligation to update this opinion for subsequent changes in relevant rules or practice.

Very truly yours,

Arthur Andersen & Co.

TW

Office Symbols: CC:DOM:FS:FI&P
Case Number: TL-6149-98

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MEMORANDUM FOR DISTRICT COUNSEL
MIDSTATES REGION CC:MSR:HOU
Attn: Janet Balboni

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)

Internal Revenue Service National Office Field Service Advice

This Field Service responds to your memorandum dated May 6, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A	=	Enron Corp.
B	=	Enron Capital LLC
C	=	Enron Capital Resources L.P.
D	=	Enron Preferred Capital Corp.
E	=	Organizational Partner, Inc.
F	=	Enron Oil & Gas Company
INSTRUMENT A	=	Monthly Income Preferred Shares ("MIPS")
INSTRUMENT B	=	Cumulative Preferred Shares
YEAR 1	=	1993
YEAR 2	=	1994
DATE 1	=	December 31, 1992
DATE 2	=	October 25, 1993
DATE 3	=	November 4, 1993
DATE 4	=	November 15, 1993
DATE 5	=	November 30, 1993
DATE 6	=	November, 1993
DATE 7	=	December 31, 1993
DATE 8	=	July 15, 1994
DATE 9	=	August 3, 1994
DATE 10	=	August 31, 1994
DATE 11	=	August, 1994

DATE 12	=	March 1, 1998
DATE 13	=	November 30, 1998
DATE 14	=	August 31, 1999
DATE 15	=	August 31, 2024
DATE 16	=	November 30, 2043
DATE 17	=	November 30, 2093
F MONTHS	=	18 Months
G MONTHS	=	60 Months
H YEARS	=	30 Years
I YEARS	=	49 Years
J YEARS	=	50 Years
K YEARS	=	60 Years
L YEARS	=	100 Years
M %	=	8 Percent
N %	=	8.2 Percent
O %	=	8.9 Percent
P %	=	9 Percent
Q %	=	10 Percent
R %	=	21 Percent
S %	=	66-2/3 Percent
T %	=	100 Percent
$U	=	$25.00
$V	=	$2,137,497
$W	=	$3,512,658
$X	=	$19,936,709
$Y	=	$21,645,596
$Z	=	$53,165,000
$AA	=	$75,000,000
$BB	=	$94,936,709
$CC	=	$200,000,000
$DD	=	$253,165,000
$EE	=	$270,569,621
FF	=	1
GG	=	4,997
HH	=	4,998
II	=	5,000
JJ	=	1,200,000
KK	=	3,000,000
LL	=	8,000,000
MM	=	9,200,000
NN	=	1.2:1
OO	=	1:1
PP	=	30
COUNTRY A	=	Turks and Caicos Islands
YEAR 1 Prospectus	=	Enron Capital LLC 1993 Supplement

		to Prospectus (October 25, 1993)
YEAR 1 Terms	=	Terms of the 8% MIPS of Enron Capital LLC, November 4, 1993
YEAR 1 Loan Agreement	=	Loan Agreement, November 15, 1993
YEAR 1 Guarantee	=	Payment and Guarantee Agreement, November 15, 1993
YEAR 2 Prospectus	=	Enron Capital Resources 1994 Prospectus Supplement (July 15, 1994)
YEAR 2 Loan Agreement	=	Loan Agreement, August 3, 1994
YEAR 2 Guarantee	=	Payment and Guarantee Agreement, August 3, 1994

<u>ISSUES</u>:

(1) Whether the Loans from B and C to A should be respected as debt?

(2) Whether the Service may disallow the interest paid to B and C on the Loans because of a lack of economic substance?

(3) Whether B and C should be treated as partnerships or as associations taxable as corporations for federal income tax purposes?

<u>CONCLUSION</u>:

Based upon a review of the documents, the YEAR 1 Loan from B to A and the YEAR 2 Loan from C to A should be respected as debt. Further, the interest deductions on the debt should not be disallowed because the Loans possess economic substance.

The use of partnerships to issue INSTRUMENT A and INSTRUMENT B is not an abuse of the partnership entity. Accordingly, we do not recommend challenging the federal income tax classification of such partnerships. Furthermore, the following analysis concludes that reclassifying these entities as associations taxable as corporations rather than as partnerships is unlikely to succeed.

<u>FACTS</u>:

<u>INSTRUMENT A</u>

A borrowed an aggregate principal amount of $DD from B. A paid interest on this amount, and took an interest deduction of $V in YEAR 1, and an interest deduction of $Y in YEAR 2.

Examination stated in the Statutory Notice of Deficiency (hereinafter referred to as the "Stat. Notice") dated DATE 12, that it determined that the amounts paid by A to B are not deductible interest payments, the obligations do not constitute indebtedness, and the obligations under which payments were accrued do not constitute indebtedness because the entity with whom A contracted is not sufficiently distinct to be considered an unrelated party contracting at arm's-length. Examination has proposed to reduce the interest expense in the amount of $V for YEAR 1 and $Y for YEAR 2.

A formed B under the law of COUNTRY A as a limited life company for the sole purpose of issuing shares and lending the net proceeds to A. B was a T % subsidiary of A, and as of YEAR 1, A owned directly GG of the outstanding and issued common shares of B, out of II shares. YEAR 1 Prospectus at S-6. D, a T % subsidiary of A, owned FF shares. A purchased the common shares of B for approximately $Z. YEAR 1 Prospectus at S-14.

In DATE 6, B authorized MM shares of M % INSTRUMENT A. YEAR 1 Terms at 1. Of the authorized INSTRUMENT A, B issued LL shares at $U per share, for a total of $CC. The unissued JJ shares of INSTRUMENT A were reserved for the Underwriters' over-allotment option. YEAR 1 Prospectus at S-6.

B loaned to A both the $Z proceeds from the sale of the common shares to A, and the $CC proceeds from the sale of the INSTRUMENT A for an aggregate principal amount of $DD (hereinafter referred to as the "YEAR 1 Loan"). YEAR 1 Prospectus at S-14. However, the YEAR 1 Loan Agreement states that B agreed to make loans to A in the principal amount of $EE in next day funds. YEAR 1 Loan Agreement at 1. The YEAR 1 Loan to A bears interest at an annual rate equal to M % until maturity; this is the same rate as the M % "dividend" rate payable on INSTRUMENT A. YEAR 1 Loan Agreement at 3. Interest on the Loan was payable on the last day of each calendar month of each year beginning on DATE 5. YEAR 1 Prospectus at S-15.

The YEAR 1 Loan Agreement between B and A states that the Loan shall be due as follows:

> The entire principal amount of the Loans shall become due and payable, together with any accrued and unpaid interest thereon, including Additional Interest as defined below, if any, on the earliest of [DATE 16], or the date upon which [A] is dissolved, wound-up or liquidated or the date upon which [B] is dissolved, wound-up or liquidated.

YEAR 1 Loan Agreement at 2.

Upon repayment of the YEAR 1 Loan, B can redeem INSTRUMENT A or reloan these funds to A. The amounts can be reloaned to A only if: (a) A is not in bankruptcy; (b) A is not in default on any loan relating to the INSTRUMENT A; (c) A has made timely payments on the repaid loan for the preceding F MONTHS; (d) B is not in arrears in dividend payments; (e) A is expected to be able to make timely payment of principal and interest on the Loan; (f) the Loan is being made on terms, and under circumstances, that are consistent with those which a lender would require for a loan to an unrelated party; (g) the Loan is being made at a rate sufficient to pay dividends that accrue on the shares; (h) the senior unsecured long-term debt of A is rated BBB- or better by Standard & Poor or Baa3 or better by Moody's, or the equivalent by another rating organization; (i) the Loan is made for a term that is consistent with market circumstances and A's financial condition; and (j) the final maturity can be no later than the L YEARS anniversary of the issuance of the INSTRUMENT A, or DATE 17. YEAR 1 Terms at 3-4. A has the right to prepay the YEAR 1 Loan without premium or penalty on or after DATE 13. YEAR 1 Loan Agreement at 2.

A has the right to extend the interest payment period for up to F MONTHS. At the end of this, A shall pay all accumulated and unpaid interest. YEAR 1 Loan Agreement at 4. During any extended interest payment period, neither A nor any majority owned subsidiary of A will declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment or Guarantee Payment with respect to any of its capital stock (other than Guarantee Payments). YEAR 1 Loan Agreement at 4.

A also guarantees the full payment, when due, of any of the indebtedness and liabilities of B. Agreement as to Expenses and Liabilities, DATE 4, at 1.

In the event of default by A in the payment of interest, in the payment of principal when due, in the event of a dissolution, winding up or liquidation of B, upon the bankruptcy, insolvency or liquidation of A, or upon the breach of any covenants, B shall have the following rights:

> to declare the principal of and the interest on the Loans (including any Additional Interest and any interest subject to an extension of the interest payment period) and any other amounts payable on the Loans to be forthwith due and payable, whereupon the same shall become and be forthwith due and payable without presentment, demand, protest or other notice of any kind, all of which are hereby expressly waived, anything in this Agreement to the contrary notwithstanding.

YEAR 1 Loan Agreement at 10-11. An event of default is defined as a default by A in repayment of the principal or interest on the Loans when due, the dissolution, winding up or liquidation of B, the bankruptcy, insolvency or liquidation of A, or the breach of any covenant in the Loan Agreement. YEAR 1 Prospectus at S-18.

The YEAR 1 Loan is "subordinate and junior in right of payment to all Senior Indebtedness of A as provided herein." YEAR 1 Loan Agreement at 5. The Senior Indebtedness of A's includes the principal, premium, and interest on:

> (i) all indebtedness of [A], whether outstanding on the date hereof or hereafter created, incurred or assumed, which is for money borrowed, or evidenced by a note or similar instrument given in connection with the acquisition of any business, properties or assets, including securities, (ii) any indebtedness of others of the kinds described in the preceding clause (i) for the payment of which [A] is responsible or liable (directly or indirectly, contingently or non-contingently) as guarantor or otherwise, (iii) any indebtedness secured by a lien upon property owned by [A] and upon which indebtedness [A] customarily pays interest, even though [A] has not assumed or become liable for the payment of such indebtedness and (iv) amendments, renewals, extensions and refunding of any such indebtedness unless ... it is expressly provided that the indebtedness is not superior in right of payment to the Loans.

YEAR 1 Loan Agreement at 5.

If A defaults in the payment of principal, premium or interest on any Senior Indebtedness when it becomes due and payable, or in the event of a default on the Senior Indebtedness, then until such default has been cured or waved, no direct or indirect payment will be made on the YEAR 1 Loan. YEAR 1 Loan Agreement at 6.

In the event of insolvency, bankruptcy, receivership, liquidation, reorganization, composition, or similar proceeding against A or its property, all Senior Indebtedness of A's shall be paid in full before any payment or distribution of the YEAR 1 Loan. YEAR 1 Loan Agreement at 6-7.

B has no right to participate in the management of A; however, the holders of the INSTRUMENT A will have creditors' rights against A if B fails to pay "dividends" on the INSTRUMENT A for F MONTHS (consecutive monthly dividend periods), if an event of default occurs or if A is in default on any of its payment or other obligation under the Guarantee Agreement. YEAR

1 Terms at 6. The holders of a majority in liquidation preference of INSTRUMENT A in YEAR 1 will be entitled to the following rights:

> to appoint and authorize a trustee to enforce [B's] creditor rights under the Loans against [A], enforce the obligations undertaken by [A] under the Guarantee Agreement and the Agreement as to Expenses and Liabilities pursuant to which [A] will agree to guarantee payment of any liabilities incurred by [B] (other than obligations to holders of [INSTRUMENT A] in their capacities as holders)... and declare and pay dividends on [INSTRUMENT A].

YEAR 1 Terms at 6. Not later than PP days after such right to appoint a trustee arises, the manager will convene a general meeting for the above purpose. If the manager fails to convene a meeting, the INSTRUMENT A holders of Q % in liquidation preference of outstanding shares will be entitled to convene the meeting. YEAR 1 Terms at 6.

The holders of the INSTRUMENT A shall have the following rights:

> If any resolution is proposed for adoption by the shareholders of [B] providing for, or the Manager otherwise proposes to effect, (x) any variation or abrogation of the rights, preferences and privileges of [INSTRUMENT A], whether by way of amendment of [B]'s Articles of Association ... or (y) the liquidation, dissolution or winding up of [B], then the holders of outstanding [INSTRUMENT A] will be entitled to vote on such resolution or action of the Manager (but not on any other resolution or action), and such resolution or action shall not be effective except with approval of the holders of [S] % in liquidation preference of the outstanding [INSTRUMENT A]....

YEAR 1 Terms at 6-7.

In the event of any voluntary or involuntary liquidation, dissolution or winding up of B, the INSTRUMENT A holders will be entitled to receive out of the assets of B available for distribution to shareholders, before any distribution of assets is made to holders of common shares or any other class of shares of B ranking junior to INSTRUMENT A, an amount equal to the stated liquidation preference of $U per share and all accumulated and unpaid "dividends" to the date of payment. YEAR 1 Terms at 5.

The holders of the INSTRUMENT A are entitled to receive, when, as and if declared by B out of funds held and legally available, cumulative cash "dividends" at the annual rate of M % of the stated liquidation preference of $U per share per annum. The "dividends", payable in U.S. dollars monthly in arrears on the last day of each calendar month, will accrue and be cumulative whether or not they have been declared and whether or not there are profits, surplus or other funds of B legally available. YEAR 1 Terms at 2. "Dividends" must be declared on the INSTRUMENT A in any calendar year to the extent that A reasonably anticipates that at the time of payment B will have and must pay cash on hand that is sufficient to permit such payments. YEAR 1 Terms at 2.

B will not pay any dividends on any shares of B ranking junior to the INSTRUMENT A, or redeem, purchase or otherwise acquire any junior shares of B, until such time as all accumulated and unpaid "dividends" on the INSTRUMENT A have been paid in full. YEAR 1 Terms at 3.

In YEAR 1, A had a debt-to-equity ratio of approximately NN. YEAR 1 Prospectus at S-5.

The obligation at issue between A and B is labeled as a loan in the YEAR 1 Prospectus. YEAR 1 Prospectus at S-14. The YEAR 1 Loan Agreement, as well as all other documents reviewed, labels the obligation as a loan.

A used the proceeds from the YEAR 1 Loan from B to repay other indebtedness, and for general corporate purposes. YEAR 1 Prospectus at S-5. In the Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (hereinafter referred to as the "10-K" for YEAR 1) that A filed with the Securities and Exchange Commission for YEAR 1, A reported that "the average cost of long-term debt declined to N % at DATE 7 from O % at DATE 1. The decline was accomplished primarily through the retirement of additional higher coupon long-term debt which was subject to call provisions during [YEAR 1]." YEAR 1 A 10-K at 32.

A has irrevocably and unconditionally agreed to pay the holders of the INSTRUMENT A the following Guarantee Payments, in the event that B fails to pay: any accumulated and unpaid "dividends" declared on the INSTRUMENT A from legally available funds; the $U redemption price per preferred share, from legally available funds; the lesser of either the liquidation preference of $U per share plus accumulated and unpaid "dividends" or the amount of assets of B available for distribution to INSTRUMENT A holders; and any interest payable on the INSTRUMENT A. YEAR 1

Guarantee at 2. A irrevocably and unconditionally agrees to pay in full to the INSTRUMENT A holders the Guarantee Payments when due, except to the extent paid by B, regardless of any defense, right of set-off or counterclaim that B may have or assert. YEAR 1 Guarantee at 2. A's obligation to make Guarantee Payments may be satisfied by direct payment by A to the INSTRUMENT A holders or by causing B to pay such amounts to the holders. YEAR 1 Guarantee at 2-3.

This Guarantee Agreement is an unsecured obligation of A, the Guarantor, and is subordinate and junior in right of payment to all of the liabilities of A, is *pari passu* with the most senior preferred or preference stock, and is senior to A's common stock. YEAR 1 Guarantee at 6. A's obligations under the Guarantee Agreement are independent of B's obligations with respect to the INSTRUMENT A. In addition, A will be liable as principal and sole debtor to make the Guarantee Payments.

If any INSTRUMENT A remain outstanding and A is in default with respect to its obligations under the Guarantee Agreement or the Loan Agreement, then neither A nor any majority owned subsidiary of A will declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment or guarantee payment with respect to, any of its capital stock. YEAR 1 Guarantee at 5.

Under the Guarantee Agreement, A covenants that, as long as the INSTRUMENT A remain outstanding, it will maintain direct or indirect ownership of the common shares of B, maintain R % of the value as common shares, and not voluntarily dissolve, wind up or liquidate B or cause it to lose its status as an LLC. YEAR 1 Guarantee at 5.

INSTRUMENT B

In YEAR 2, A borrowed an aggregate principal amount of $BB from C and paid $W in interest expenses to C.

Examination stated in the Stat. Notice that it determined that the amounts paid by A to C in YEAR 2 are not deductible as interest payments, and the obligations under which payments were accrued do not constitute indebtedness because the entity with whom A contracted is not sufficiently distinct to be considered an unrelated party contracting at arm's-length. Examination has proposed to reduce A's interest expense in the amount of $W in YEAR 2.

A and E (a T % subsidiary of A) formed C as a limited partnership organized under the laws of Delaware. A, as a general partner, holds an R % interest in the partnership; the remainder of C is owned by the holders of INSTRUMENT B. E withdrew after the issuance of INSTRUMENT B. C exists solely for the purpose of issuing limited partner interests and lending the net proceeds from the interests to A. YEAR 2 Prospectus at S-2. A paid $X to C for the partnership interest.

A, as general partner, will furnish to each cumulative preferred instrument holder a Schedule K-1 each year setting forth the holder's allocable share of income for the prior calendar year. YEAR 2 Prospectus at S-21.

C issued KK shares of P % INSTRUMENT B, Series A, in DATE 11. Each instrument was issued at $U per individual INSTRUMENT B, for a total of $AA. Although these INSTRUMENT B are not INSTRUMENT A, the two instruments are similar. The holders of the instruments shall be entitled to "dividends", fixed at a rate per annum of P % per $U per INSTRUMENT B. Amended and Restated Agreement of Limited Partnership of C at 14. "Dividends" must be paid on the INSTRUMENT B in any calendar year to the extent that A reasonably anticipates that at the time of payment C will have and must legally pay funds available for the payment of such "dividends", and sufficient cash to permit such payments. YEAR 2 Prospectus at S-8.

C loaned to A the proceeds from the sales of both the capital shares and the INSTRUMENT B, an aggregate principal amount of $BB (hereinafter referred to as the "YEAR 2 Loan"). YEAR 2 Prospectus at S-16.

The YEAR 2 Loan bears interest at an annual rate equal to P % until maturity, with interest payable on the last day of each calendar year as of DATE 10. The YEAR 2 Loan Agreement between C and A provides for the following:

> The entire principal amount of the Loan shall become due and payable, together with any accrued and unpaid interest thereon, including Additional Interest as defined below, if any, on the earliest of [DATE 15] or the date upon which A is dissolved, wound-up or liquidated or the date upon which [C] is dissolved, wound-up or liquidated.

YEAR 2 Loan Agreement at 2.

A has the right to prepay the Loan at any time on or after DATE 14, without premium or penalty, and if legislation is enacted or existing law is modified that causes C to be treated as an association taxable as a corporation, provided that C has elected to redeem the instruments. YEAR 2 Loan Agreement at 2. The INSTRUMENT B instruments are redeemable at the option of C and subject to the consent of A on or after DATE 14, at the redemption price of $U per instrument plus accumulated "dividends". YEAR 2 Prospectus at S-9.

Upon any repayment or prepayment of principal on the YEAR 2 Loan, the proceeds from such payment will be applied to redeem INSTRUMENT B. However, such amounts may be reloaned to A, and not used for redemption, if at the time of such loan: (a) A is not in bankruptcy; (b) A is not in default on any loan relating the INSTRUMENT B; (c) A has made timely payments on the Loan for the immediately preceding F MONTHS; (d) C is not in arrears on payments of the "dividends" on INSTRUMENT B; (e) A is expected to be able to make timely payments of principal and interest on the Loan; (f) the Loan is made on terms and under circumstances that are consistent with one made to an outside party; (g) the rate on the Loan is sufficient to provide for dividends on the INSTRUMENT B; (h) the senior unsecured long-term debt of A is rated BBB- or better by Standard & Poor or Baa3 or better by Moody's or the equivalent; (i) the terms are consistent with market and A's financial condition; (j) the term of the Loan is no more than H YEARS; and (k) the final maturity of such Loan is not later than the I YEARS anniversary of the issuance of the INSTRUMENT B. YEAR 2 Prospectus at S-9-S-10.

A has the right to an extended interest period on the YEAR 2 Loan, to extend the interest payment period on the YEAR 2 Loan for up to G MONTHS (consecutive), deferring also the monthly dividend payments on the INSTRUMENT B. YEAR 2 Prospectus at S-4. However, the interest will continue to accrue and will be paid after the G MONTHS period. YEAR 2 Loan Agreement at 3. During any extended interest payment period, A will not declare or pay any dividend on, redeem, purchase, acquire or make a liquidation payment with respect to any of its capital stock. YEAR 2 Loan Agreement at 3.

The YEAR 2 Loan Agreement "constitutes the valid and legally binding obligation of A enforceable in accordance with its terms, subject to bankruptcy, insolvency, fraudulent transfer, reorganization, moratorium and similar laws of general applicability relating to or affecting creditors' rights and to general equity principles." YEAR 2 Loan Agreement at 7.

In the event of a default by A, C:

> will have the right to declare the principal of and interest on the Loan (including any Additional Interest and any interest subject to an extension of the interest payment period) and any other amounts payable on the Loan to be forthwith due and payable, whereupon the same shall become and be forthwith due and payable without presentment, demand, protest or other notice of any kind, all of which are hereby expressly waived, anything in this Agreement to the contrary notwithstanding.

YEAR 2 Loan Agreement at 8.

An event of default is defined as a default by A in the payment of interest or principal on the YEAR 2 Loan, the dissolution, winding up or liquidation of C, the bankruptcy, insolvency or liquidation of A, and any breach of the Loan Agreement covenants. YEAR 2 Loan Agreement at 8. Thus, upon A's default, C may enforce its creditor rights by declaring the principal and interest on the YEAR 2 Loan to be due and payable (without presentment, demand, protest or other notice).

The YEAR 2 Loan is subordinated as follows:

> the Loan is subordinate and junior in right of payment to all Senior Indebtedness as provided herein. The term 'Senior Indebtedness' shall mean the principal, premium, if any, and interest on (i) all indebtedness of [A], ... incurred or assumed, which is for money borrowed, or evidenced by a note or similar instrument given in connection with the acquisition of any business, properties, or assets, including securities....

YEAR 2 Loan Agreement at 4. Senior Indebtedness also includes any similar debt on which A is liable as a guarantor, any indebtedness secured by a lien on property which A owns and for which A customarily pays interest, and any amendments, renewals, extensions and refundings of any such indebtedness. YEAR 2 Loan Agreement at 4.

If A defaults on any payments of any principal or interest upon its Senior Indebtedness, no direct or indirect payments shall be made on the YEAR 2 Loan. YEAR 2 Loan Agreement at 5. The Senior Indebtedness shall also be paid in full prior to payments made on the YEAR 2 Loan in the event of insolvency, bankruptcy, receivership, liquidation, reorganization, composition or similar proceeding relating to A; and liquidation, dissolution or winding up of A; any assignment by A for the benefit of its creditors; and any other marshalling of A's assets. YEAR 2 Loan Agreement at 5.

Senior Indebtedness does not include "the indebtedness pursuant to the Loan Agreement dated as of DATE 4 between [A] and [B] and any extensions or refundings thereof (the 'Pari Passu Debt')." YEAR 2 Loan Agreement at 4. The YEAR 2 Loan shall not be subordinate to any other liabilities of A. YEAR 2 Prospectus at S-17.

C has no right to participate in the management of A. However, the holders of INSTRUMENT B shall be entitled to appoint and authorize a trustee to enforce C's creditor rights under the YEAR 2 Loan against A and pay "dividends" if C fails to pay "dividends" in full, or in the event of default by A on principal or interest on the Loan. YEAR 2 Prospectus at S-11.

Not later than PP days after such right to appoint a trustee arises, the general partner, A, will convene a general meeting. If the general partner fails to convene such a meeting, the cumulative preferred instrument holders of Q % in liquidation preference will be entitled to convene the meeting. YEAR 2 Prospectus at S-11.

If any amendment to the C Partnership Agreement is proposed for adoption providing for any variation or abrogation of the rights, preferences and privileges of the INSTRUMENT B, or the liquidation, dissolution, or winding up of C, then the holders of the INSTRUMENT B will be entitled to vote on such proposal. YEAR 2 Prospectus at S-11.

In YEAR 2, A had a debt-to-equity ratio of approximately OO. YEAR 2 Prospectus at S-7, S-19.

A purportedly used the YEAR 2 Loan for general corporate purposes including the repayment of indebtedness. YEAR 2 Prospectus at S-7. A's estimated fair market value of its long-term debt decreased in YEAR 2; the fair market value of debt includes the estimated cost to acquire the debt. YEAR 2 Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (hereinafter referred to as the "10-K" for YEAR 2).

A labeled this obligation between A and C as a loan in the Prospectus that it submitted to the Securities and Exchange Commission for YEAR 2. YEAR 2 Prospectus at S-16. A also labeled the obligation as a loan in the YEAR 2 Loan Agreement and other documents.

Holders of the INSTRUMENT B shall also be entitled to enforce the obligation undertaken by A under the Guarantee Agreement, should C fail to pay "dividends", in the event of a default, or if A is in default on any of its payment or other obligations under the Guarantee. YEAR 2 Prospectus at S-11.

A has also irrevocably and unconditionally agreed to pay the holders of the INSTRUMENT B certain Guarantee Payments in the event that C fails to do so. YEAR 2 Guarantee at 1-2. Guarantee Payments are defined as accumulated and unpaid dividends, the redemption price of $U, the lesser of either the $U liquidation preference plus accumulated and unpaid dividends or assets of C available for distribution, and any additional interest, to the extent that these are not paid by C. YEAR 2 Guarantee at 1-2. A's obligation to make a Guarantee Payment may be satisfied by direct payment by A to the holders of the instruments or by causing C to pay such amounts to the holders.

A's obligations under the Guarantee Agreement are independent of C's obligations with respect to the INSTRUMENT B. A is liable as principal and sole debtor to make the Guarantee Payments.

If any INSTRUMENT B remain outstanding and A is in default under the Guarantee Agreement, the Expense Agreement, or the Loan Agreement, then A shall not declare or pay any dividend on or redeem, purchase, acquire or make a liquidation payment with respect to any of its capital stock. YEAR 2 Guarantee at 4.

Under the Guarantee Agreement, A covenants that, as long as the INSTRUMENT B remain outstanding, it will maintain direct or indirect ownership of the general partner interest in C, it will cause at least R % of the value of C to be represented as a general partner interest, it will not voluntarily dissolve, wind up or liquidate C, and will make every effort to cause C to remain a limited partnership and will perform duties as a general partner. YEAR 2 Guarantee at 4-5.

The Guarantee Agreement is an unsecured obligation of A and ranks subordinate and junior in right of payment to all liabilities of A other than the YEAR 1 INSTRUMENT A Guarantee Agreement, *pari passu* with the most senior preferred or preference stock, and senior to A's common stock. YEAR 2 Guarantee at 5.

ISSUE 1:

Whether the Loans from B and C to A should be respected as debt?

LAW AND ANALYSIS:

I.R.C. § 385 of the Internal Revenue Code of 1986, as amended, ("the Code") discusses the treatment of certain investments in corporations as stock or indebtedness. Both section 385(a) and 385(b) require regulations to be effective. Since neither had regulations in effect for the years in issue, a facts and circumstances approach is required.

Under section 385(c)(1), the characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness is binding on the issuer and on all holders of such interest (but is not binding on the Secretary of the Treasury).

Notice 94-47, 1994-1 C.B. 357, provides guidance in the determination of whether an instrument is debt or equity for federal income tax purposes. Notice 94-47 addresses potential abuses of the tax law by instruments that contain both debt and equity characteristics.

The eight factors to be considered under Notice 94-47 are:

(a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;

(b) whether holders of the instruments possess the right to enforce the payment of principal and interest;

(c) whether the rights of the holders of the instruments are subordinate to rights of general creditors;

(d) whether the instruments give the holders the right to participate in the management of the issuer;

(e) whether the issuer is thinly capitalized;

(f) whether there is identity between holders of the instruments and stockholders of the issuer;

(g) the label placed upon the instruments by the parties; and

(h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). The Notice is primarily concerned with instruments that combine long maturities (greater than 50 years) with other substantial equity characteristics.

We shall discuss the facts relating to each factor in the Notice in sequence. This analysis is focused on the Loans because the narrow issue is whether the payments made pursuant to the Loans represent interest upon debt.

(a) Whether there is an unconditional promise to pay by the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future. The presence of a fixed maturity date indicates a definite obligation to repay, which is a debt characteristic. Both the YEAR 1 and the YEAR 2 Loans contain a promise by A to pay the principal and interest by a fixed maturity date.

The entire principal amount and interest on the YEAR 1 Loan are due and payable on DATE 16, or earlier if either A or B is dissolved, wound-up or liquidated. YEAR 1 Loan Agreement at 2.

If A repays the YEAR 1 Loan when due or prepays the Loan, the proceeds from the repayment of principal and interest shall be applied to redeem the INSTRUMENT A; alternatively, the proceeds could be reloaned to A for an additional maximum J YEARS, so that the Loan maturity can be no longer than the L YEARS anniversary of the issuance of the INSTRUMENT A. YEAR 1 Prospectus at S-7. Thus, the YEAR 1 Loan could have an effective maximum maturity date of L YEARS, if the optional J YEARS extension is exercised. The YEAR 1 Loan will become due and payable earlier if B redeems the INSTRUMENT A. YEAR 1 Prospectus at S-14. B may redeem the INSTRUMENT A at its option after DATE 13, but redemption is subject to the prior consent of A. YEAR 1 Prospectus at S-7.

Although A may extend the interest payment period for up to F MONTHS, the interest will continue to accrue. YEAR 1 Prospectus at S-20.

Principal and interest on the YEAR 2 Loan are due and payable on DATE 15, or when A or C is dissolved, wound-up or liquidated. YEAR 2 Loan Agreement at 2. If A repays the YEAR 2 Loan when due or prepays the Loan, the proceeds from the repayment will be applied to redeem the INSTRUMENT B, or the funds could be reloaned to A. YEAR 2 Prospectus at S-9. Upon C's redemption of the INSTRUMENT B, the principal and interest on the Loan shall become due and payable; while the INSTRUMENT B are redeemable at the option of C, redemption is subject to the consent of A. YEAR 2 Prospectus at S-9, S-16. If the Loan is paid by A and subsequently reloaned to A, the final maturity of the Loan can be no later than the I YEARS anniversary of the issuance of the INSTRUMENT B. YEAR 2 Prospectus at S-10. Thus, the YEAR 2 Loan could have an effective maximum maturity date of I YEARS, if the extension is exercised.

Additionally, upon an event of default by A on its payments, the YEAR 2 Loan will be forthwith due and payable. If the holders of the INSTRUMENT B fail to receive "dividends" from C, they have creditors' rights against A, and thus, A is obligated to C's holders.

The facts in these documents indicate that A has made an unconditional promise to pay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future for both Loans. A fixed maturity date indicates a fixed obligation to repay, which is a characteristic of debt. Mixon v. United States, 464 F.2d 394, 404 (5th Cir. 1972). Therefore, based upon the information contained in the available documents, these facts are more indicative of debt.

(b) Whether the holders of the instruments possess the right to enforce payment of principal and interest. Both of the holders of the Loans, B and C, possess the right to enforce payment of the Loans by A.

The YEAR 1 Loan Agreement "constitutes the valid and legally binding obligation of A enforceable in accordance with its terms, subject to bankruptcy, insolvency, fraudulent transfer, reorganization...." YEAR 1 Loan Agreement at 8-9.

Upon an event of default on the YEAR 1 Loan, B has the right to declare the principal and interest forthwith due and payable. YEAR 1 Loan Agreement at 10.

Similarly, C has the right to enforce the YEAR 2 Loan Agreement and the repayment of the YEAR 2 Loan. YEAR 2 Loan Agreement at 7. C has creditor's rights as against A and has the right to declare the principal and interest of the YEAR 2 Loan due and payable upon an event of default by A. YEAR 2 Loan Agreement at 8.

B and C are, in effect, controlled by A, and therefore the rights of these two intermediaries could be questioned. However, A's obligations under the Loans are also for the benefit of the holders of INSTRUMENT A and INSTRUMENT B, and these holders are entitled to enforce the Loan Agreements directly against A. The facts in these documents indicate that holders of the Loan instruments possess the right to enforce payment as creditors. A definite obligation to repay an advance is an indication of a loan. Mixon, 464 F.2d at 405. This factor is more indicative of debt.

(c) Whether the rights of the holders of the instruments are subordinate to the rights of general creditors. The rights of the holders of the YEAR 1 Loan and of the YEAR 2 Loan are not subordinate to the rights of the general creditors of A.

The YEAR 1 Loan is subordinate only to the Senior Indebtedness. The Senior Indebtedness shall be paid first in full before any payment or distribution is made on the YEAR 1 Loans, in the event of insolvency, bankruptcy, receivership, liquidation, reorganization, or the dissolution or winding up of A. YEAR 1 Loan Agreement at 7. See supra at 6. Senior Indebtedness includes generally the principal and interest on all indebtedness of A, evidenced by a note or another instrument, but it does not include debts to general creditors. YEAR 1 Loan Agreement at 5. In addition, the Loan ranks superior to the claims of A's stockholders. YEAR 1 Guarantee at 5.

The YEAR 2 Loan is also subordinate only to the Senior Indebtedness. YEAR 2 Loan Agreement at 4. The definition of Senior Indebtedness for the YEAR 2 Loan is nearly identical to that of the YEAR 1 Loan, that is, both include generally the principal and interest on all indebtedness of A, evidenced by a note or another instrument, but do not include debts to general creditors. YEAR 2 Loan Agreement at 4-5.

If the holder of the obligation has rights that take precedence over the rights of shareholders, this suggests that the instrument is debt, although it is not dispositive. Monon Railroad v. Commissioner, 55 T.C. 345, 360 (1970), acq., 1973-2 C.B. 2. The facts available in these documents indicate that the obligations are not subordinated to the level of general creditors, and therefore the obligations resemble debt more than equity.

(d) Whether the instruments give the holders the right to participate in the management of the issuer. Neither the holder of the YEAR 1 Loan, B, nor the holder of the YEAR 2 Loan, C, has rights to participate in the management of the issuer of the Loans, A.

The holders of B's INSTRUMENT A and the holders of the INSTRUMENT B of C have certain limited creditors' rights as against A. Upon B's failure to pay "dividends" for F MONTHS , (consecutive dividend periods), the INSTRUMENT A holders will be entitled to appoint and authorize a trustee to enforce B's creditor rights against A. YEAR 1 Terms at 6. Also, if a resolution is proposed to effect any variation or abrogation of the rights of the INSTRUMENT A holders or that would effect the liquidation, dissolution or winding up of B by way of an amendment to B's Articles of Association, then the holders will be entitled to vote on such resolution or action. YEAR 1 Terms at 6-7.

The holders of the INSTRUMENT B have been granted similar creditors' rights to appoint a trustee to enforce C's creditors' rights under the YEAR 2 Loan against A and also the right to vote upon certain proposals to amend the Partnership Agreement. YEAR 2 Prospectus at S-11.

Also, during any extended interest period under the Loan, neither A nor any majority owned subsidiary can declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment with respect to any of its capital stock. YEAR 1 Loan Agreement at 4; YEAR 2 Loan Agreement at 3. (Under the YEAR 1 Loan this limitation does not apply to certain payments; in particular, the dividends paid by F on its common stock.)

These rights to vote for a trustee, to vote upon certain

Articles of Association or Partnership Agreement amendments should B or C fail to pay "dividends", and to restrict certain payments on A's capital stock during an extended interest period do not qualify as giving the holder of the instrument, either B or C, the right to participate in the management of the issuer, A. Rather, B's and C's holders are granted rights as creditors against A only.

Creditors are not usually entitled to vote in the affairs of the debtor corporation, or participate in its management, including electing corporate directors, unlike stockholders. Monon, 55 T.C. at 359-360. Based upon the information provided, there is no indication that B or C have any rights to participate in the management of A, or have any voting rights in A. Therefore, these facts are more indicative of debt.

(e) Whether the issuer is thinly capitalized. If a corporation has a nominal stock investment coupled with excessive debt, this fact would tend to indicate that an instrument labeled debt might constitute stock. As a result, the debt-to-equity ratio is another factor used to determine whether an instrument is debt or equity. The ratio indicates to what extent a corporation may suffer losses without impairment of the interests of the corporation's creditors. A high ratio lowers the protection afforded to the creditors against sudden business slumps. As a result, a high ratio of debt-to-equity indicates that the issuance of the instrument is a contribution to capital rather than a bona fide loan.

In YEAR 1, A had a debt-to-equity ratio of approximately NN. YEAR 1 Prospectus at S-5. In YEAR 2, A had a debt-to-equity ratio of approximately OO. YEAR 2 Prospectus at S-7, S-19.

A at no time has had a debt-to-equity ratio in excess of 2:1. See J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451, 459 (8th Cir. 1967) ("The debt to equity ratio of 2 to 1 is patently not so inordinately high as to qualify this as a 'thin capitalization' case."). A is not thinly capitalized, a factor which is more indicative of debt.

(f) Whether there is identity between holders of the instruments and stockholders of the issuer. This factor is usually relevant only when a corporation's shareholders have advanced money to the corporation. Advances made by stockholders in proportion to their respective stock ownership are an indication of equity, but a sharply disproportionate ratio is an indication of debt. Mixon, 464 F.2d at 409.

B is T % owned by A, except for T % of the issued and outstanding INSTRUMENT A, which are publicly held. A owns directly or indirectly T % of the HH issued and outstanding common shares of B out of II common shares. A also owns T % of the partnership interests in C other than the interests represented by the INSTRUMENT B, which are publicly held. A is a publicly-held utility company, with millions of dollars of common and preferred stock outstanding. The stockholders of A indirectly own the common shares of B and C through A's ownership. However, other than the shares owned by A, the outstanding instruments of B and C, the INSTRUMENT A and the INSTRUMENT B, are publicly owned.

For purposes of this characteristic, there is no identity between the holders of the instruments and the stockholders of the issuer, and therefore, this indicates debt.

(g) <u>The label placed upon the instruments.</u> The instruments between A and B and C have been consistently characterized as Loans in the documents available. YEAR 1 Loan Agreement, YEAR 2 Loan Agreement.

In addition, under section 385(c), the issuer's characterization of an instrument as of the time of the issuance as either debt or equity is binding on the issuer and on all holders of the instrument. However, this characterization is not binding on the Service or on a holder that discloses that it is treating the instrument in a manner inconsistent with the issuer's characterization.

The labels on these instruments are not the same as the labels on the INSTRUMENT A and the INSTRUMENT B. However, since the form of the pass-through entities will be respected, and B and C will be treated as partnerships separate and distinct from A, then the label on the obligations (the INSTRUMENT A and INSTRUMENT B) that B and C have with the holders of their instruments will not affect the label on the obligations (the Loans) that A has with either B or C.

Therefore, because the available documents show that A has consistently labeled and treated these obligations as debt, this fact is indicative of debt. <u>See</u> <u>Mixon</u>, 464 F.2d at 403.

(h) <u>Whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.</u> There is no indication that the parties have treated the instruments (the Loans) between A and B and C as anything except debt. A labeled the obligations as loans in its YEAR 1 and YEAR 2 Prospectuses submitted to the Securities and Exchange Commission, and also indicated that the income on the shares is taxable as interest income rather than dividend income.

The labels placed upon the INSTRUMENT A and the INSTRUMENT B are different from the labels placed on the Loans. Thus, even though Moody's may have included the YEAR 1 INSTRUMENT A and the

YEAR 2 INSTRUMENT B in with A's capital stock, and INSTRUMENT A and INSTRUMENT B may give A some "equity credit" for purposes of the rating agencies, like Standard & Poor's and Moody's, Solomon B. Samson, Credit Comments: A Hierarchy of Hybrid Securities, Standard & Poor's Creditweek, March 25, 1996, at 43, this fact has no bearing on the analysis of whether the Loans are properly labeled for federal tax purposes.

The obligations have been treated consistently as Loans by A, a factor more indicative of debt. See Crown Iron Works v. Commissioner, 245 F.2d 357, 359 (8th Cir. 1957).

Unreasonably Long Maturity

Notice 94-47 focuses on "recent offerings of instruments that combine long maturities with substantial equity characteristics," and cites to Monon, 55 T.C. 345. The Service cautions taxpayers of the following:

> even in the case of an instrument having a term of less than 50 years, Monon Railroad generally does not provide support for treating an instrument as debt for federal income tax purposes if the instrument contains significant equity characteristics not present in that case. The reasonableness of an instrument's term (including that of any relending obligation or similar arrangement) is determined based on all the facts and circumstances, including the issuer's ability to satisfy the instrument. A maturity that is reasonable in one set of circumstances may be unreasonable in another if sufficient equity characteristics are present.

In Monon, the court determined that a 50-year maturity term on a debt instrument was not unreasonable in light of the fact that the corporation had been in existence for many years.

There is no bright-line test to determine whether a maturity date for a particular instrument is in the reasonably foreseeable future. In determining whether a maturity date for a particular instrument is a reasonable date, the courts have considered a number of factors, including the nature of the taxpayer's business, the financial condition of the taxpayer, the length of time the taxpayer has been in existence, and how likely it is that the taxpayer will be in existence when the instrument matures.

A was in existence for over K YEARS when the INSTRUMENT A and INSTRUMENT B were issued. In addition, A is a substantial operating business. Therefore, in this case, the J YEARS and H

YEARS maturity dates appear to be reasonable, as does the extended I YEAR extended term for the YEAR 2 issuance. The L YEARS extended term for the YEAR 1 Loan may appear to be unreasonable on its face. In light of the other characteristics of debt, however, it is not enough to cause recharacterization.

Based on a review of the documents, we do not recommend recharacterizing the debt as equity.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

This analysis has focused on the Loans because the narrow issue is whether the Loans represent debt or equity. The forms of the partnerships (the intermediate entities) are to be respected, as will be discussed infra, at 26. If facts were present in this case that caused the forms of the partnerships to not be respected, the conclusions would not be different, and the instruments would still be properly characterized as debt.

The foregoing analysis is based on the information and documents that we have been given and independent legal research. We have no knowledge that A has acted other than as a debtor or that the intermediaries have not at all times acted as creditors.

If you wish to determine if A has not acted as described in the documents, the following may be considered: Whether A has actually paid the interest or principal on the Loans when payment was due? Has A requested any extensions of time for repayment? Whether B and C have had any reason to enforce the agreements, and if so, whether they have enforced the obligations against A?

These issues may be developed by a review of the intermediaries' operating documents, corporate minutes and all correspondence between the parties regarding these instruments.

Based on a review of the documents, the litigating hazards on this issue are significant, and consequently, we recommend that this issue not be litigated. If you determine that A has not acted consistently with its documents, call us to determine what strategies to pursue.

ISSUE 2:

Whether the Service may disallow the interest paid to B and C on the Loans because of a lack of economic substance?

LAW AND ANALYSIS:

Section 163 allows as a deduction interest paid or accrued within the taxable year on indebtedness.

In United States v. Wexler, 31 F.3d 117, 122-23 (3d Cir.

1994), the court determined that, while section 163 does not expressly require that the transactions that gave rise to deductions have a business purpose or profit motive, nevertheless, case law establishes that the sham transaction doctrine bars interest deductions under section 163 if the underlying transaction does not have a business purpose or profit motive.

In Wexler, the taxpayer took deductions on interest paid on "repo to maturity" transactions involving sales and repurchases of government securities. The interest deduction and the income from the transactions were divided up into different years, and the mismatching of the deduction and income caused the income to be deferred for a second year. Wexler, 31 F.2d at 120. The court determined that none of the debt obligations were entered into for any reason other than for the tax benefits of deducting the interest on the obligations. Wexler, 31 F.3d at 126. In many of the cases upon which the court relied, it found that "a key requirement is that the interest obligation be *economically substantive*, defined in every decision ... to mean that the transaction have a potential non-tax benefit." Wexler, 31 F.3d at 127.

The taxpayers in Sheldon v. Commissioner, 94 T.C. 738 (1990), entered into eleven "repo" transactions involving sales and repurchases of U.S. Treasury Bills, or T-Bills. The repos involved were purchases of T-bills financed through repurchase agreements. The court determined that, although ten of these eleven transactions were real and had actually occurred, the transactions were lacking in the requisite substance and denied the interest deductions. Sheldon, 94 T.C. at 769.

The Sheldon court found that the taxpayers' sole objective was to obtain the interest deduction for transactions that had locked-in losses with no potential for any profit. Sheldon, 94 T.C. at 767. In 1981 and 1982 the partners in the transaction were locked in for a loss in the amount of $60,000, but received more than $5,000,000 in interest deductions to offset against their ordinary income. Sheldon, 94 T.C. at 769. Most of the transactions resulted in a loss, that is, the average interest rates on the repos were higher than the yield upon the maturity of the T-Bills that the taxpayers were to receive. Sheldon, 94 T.C. 746. In addition, the transactions were structured at year end to accommodate the mismatching of the income and deductions, thus creating a large tax benefit. Sheldon, 94 T.C. at 766.

"[L]oans or other financing transactions will merit respect and give rise to deductible interest only if there is some tax-independent purpose for the transactions." Sheldon, 94 T.C. at 759. Interest is not deductible if the underlying transaction is a sham or if it has no purpose, substance, or utility apart from the expected tax consequences. Sheldon, 94 T.C. at 760. "The need for a profit objective" was of little or insignificant importance in the analysis of the interest deduction for transactions occurring in 1981 and 1982, the years in issue. Sheldon, 94 T.C. at 760. However, the ability to profit is a part of the overall inquiry into purpose, substance and utility. Sheldon, 94 T.C. at 767. The court determined that the transactions at issue were real, but were entered into irrespective of the gain or loss potential, and solely for the tax benefits, and therefore lacked the purpose, substance and utility required for the deduction. Sheldon, 94 T.C. at 769.

In Bealor v. Commissioner, T.C. Memo. 1996-435, the Tax Court reiterated that the substance of the underlying debt must be genuine in order for interest to be deductible under section 163(a).

The taxpayers in Bealor structured highly complex employee leasing transactions between a fuel trucking corporation and numerous partnerships. One of the primary corporations contracted its employees and independent contractors from a different partnership each year, but the partnerships had common partners and were pre-planned. All of the partnerships, which were the investment vehicles in this transaction, reported substantial losses. The tax benefits of the partnerships were sometimes touted to investors. Investor-partners for the most part did not receive any cash return on their investments.

The Tax Court determined that the taxpayers were not entitled to interest and loss deductions because the transactions giving rise to the claimed deductions had neither economic substance nor a profit objective. Bealor, T.C. Memo. 1996-435. In its analysis of the economic substance of the overall transaction, the Tax Court examined the real parties in interest, the structure of the financing, the taxpayers' prospects of actually making payments on their obligations, arm's-length negotiations, the parties' adherence to the contractual terms, the reasonableness of the income projections, and the introduction of new entities to buffer the existing parties from liability. Bealor, T.C. Memo. 1996-435. The court noted that "where a debt transaction is not conducted at arm's-length by two economically self-interested parties, or where a debt is incurred in 'peculiar circumstances' indicating that it will not be paid, we have disregarded that debt for tax purposes." Bealor, T.C. Memo. 1996-435.

Under the profit objective analysis of the overall transaction, the Tax Court looked to the parties' intent and ability to profit from the transactions, specifically that the partners often could not recover any money from their investments.

Upon a realistic view of the employee leasing transactions under the foregoing factors, the Bealor court found that the transactions were shams lacking in economic substance, and the parties at issue did not demonstrate that they had profit as their primary purpose or any actual and honest profit objectives. Therefore, the losses and deductions were properly denied.

A stated in its YEAR 1 Prospectus and YEAR 2 Prospectus that the Loans would be used for general corporate purposes including the repayment of indebtedness. YEAR 1 Prospectus at S-5; YEAR 2 Prospectus at S-7. In the A 10-K for YEAR 1, A stated that the average cost of its long term debt declined. Additionally, A's debt-to-equity ratios decreased from YEAR 1 to YEAR 2, from approximately NN to OO. These statements indicate that A did possess a business reason for entering into the transaction, and that the transactions possess the requisite economic substance.

Because part of the funds loaned to A are from A's own contributions to the capital of B and C, there may be questions concerning the circular flow of funds. However, nothing in the documents indicates that the money from the contributions to capital are treated any differently from the proceeds from the public offerings in either the YEAR 1 or the YEAR 2 Loan documents.

In the balance, it appears from the available information that A entered into the transactions to obtain loans at lower interest rates and at lower costs generally, and therefore the underlying transactions possess economic substance. Thus, the interest deduction should not be disallowed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We have analyzed the transaction based upon the documents available to us, and conclude that this issue should not be pursued. Should you discover that the parties have acted inconsistently with these documents, we recommend that you review the minutes of the meetings of the Board of Directors of A, B and C, corporate correspondences, notes, and additional corporate documents.

You may inquire further into A's uses of the Loan proceeds if you have general questions on the economic substance. You may inquire into whether A benefitted from the transaction (from its use of the Loan proceeds), and verify that A paid off higher-rate debt as it claims to have done. You may also inquire into what it would have cost A to have issued straight corporate debt, projecting the interest rates and the transactional costs.

The litigating hazards on this issue are significant, and as such, disallowance of the interest deductions should not be pursued. If you find that the parties have acted inconsistently with the agreements and documents, contact us to discuss further strategy.

ISSUE 3:

Whether B and C should be treated as partnerships or as associations taxable as corporations for federal income tax purposes?

LAW AND ANALYSIS:

Treas. Reg. § 301.7701-3(f)(2) of the regulations (finalized on December 17, 1996) provides that in the case of a business entity that is not automatically treated as a corporation under Treas. Reg. §§ 301.7701-2(b)(1), (3), (4), (5), (6), or (7), and that was in existence prior to January 1, 1997, the entity's claimed classification will be respected for all periods prior to January 1, 1997 if -

> (i) The entity had a reasonable basis (within the meaning of section 6662) for its claimed classification;
>
> (ii) The entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and
>
> (iii) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

Treas. Reg. § 301.7701-3(f)(2).

You have indicated that neither B nor C, nor any member therein, was notified in writing on or before May 8, 1996, that the classification of the entity was under examination by the Service. If we assume that there was no change in the entity's classification within the sixty months prior to January 1, 1997, then the tax treatment of B and C must be respected if B and C had a "reasonable basis" for their claimed classifications.

B

COUNTRY A amended its corporate laws to permit limited life companies in a YEAR 1 Ordinance. This entity does not appear on the list of foreign entities that automatically will be treated as "per se" corporations under current Treas. Reg. § 301.7701-

2(b)(8).

A conclusive response concerning B's tax classification would require a careful review of B's organizational documents, which have not been provided to us. However, B was formed under a modern LLC statute which permits the formation of entities which should be taxed as partnerships. It appears very likely that the taxpayers had a "reasonable basis" for B's claimed classification as a partnership, and that this classification must be respected under current Treas. Reg. § 301.7701-3(f)(2).

C

C was formed under Delaware's version of the Revised Uniform Limited Partnership Act (RULPA), which corresponds with the Uniform Limited Partnership Act (ULPA) for purposes of Treas. Reg. § 301.7701-2. Rev. Rul. 95-2, 1995-1 C.B. 221. Limited partnerships which were formed pursuant to a statute corresponding to the ULPA will lack two or more corporate characteristics. Therefore, the taxpayers had a "reasonable basis" for C's claimed classification as a partnership, and this classification must be respected under current Treas. Reg. § 301.7701-3(f)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The litigating hazards on this issue are considerable. Upon review of this memorandum, please call us to discuss resolution of these issues.

If you have any further questions, please call (202) 622-7870.

DEBORAH A. BUTLER

By: ______________________
JOEL E. HELKE
Chief
Field Service, Financial
Institutions and Products

CC:MSR:TL-6149-98
RLHunn

COUNSEL SETTLEMENT MEMORANDUM
MIPS ISSUES

In re: Enron Corporation & Consolidated Subsidiaries
Docket Number 6149-98

ISSUES:

(1) Whether the Loans from Enron Capital LLC and Enron Capital Resources L.P. to Enron Corp. should be respected as debt.

(2) Whether the Service may disallow the interest paid to Enron Capital LLC and Enron Capital Resources L.P. on the Loans because of a lack of economic substance.

(3) Whether Enron Capital LLC and Enron Capital Resources L.P. should be treated as partnerships or as associations taxable as corporations for federal income tax purposes.

CONCLUSION:

On August 3, 1993, the National Office issued a Field Service advice recommending that we concede the MIPS issues in this case. We concur with that advice. National Office's advice was based upon a review of the available evidence. It concluded that the 1993 Loan from Enron Capital LLC to Enron Corp. and the 1994 Loan from Enron Capital Resources L.P. to Enron Corp. should be respected as debt. Further, the interest deductions on the debt should not be disallowed because the Loans possess economic substance.

The evidence in this case did not establish that the use of partnerships to issue Monthly Income Preferred Shares ("MIPS") and Cumulative Preferred Shares was an abuse of the partnership entity. Accordingly, we concluded that we should not challenge the federal income tax classification of such partnerships. Furthermore, the following analysis concludes that reclassifying these entities as associations taxable as corporations rather than as partnerships is unlikely to succeed.

FACTS:

1993--Monthly Income Preferred Shares ("MIPS")

In 1993, Enron Corp. borrowed an aggregate principal amount of $253,165,000 from Enron Capital LLC. Enron Corp. paid interest on this amount, and took an interest deduction of

$2,137,497 in 1993, and an interest deduction of $21,645,596 in 1994.

Examination stated in the Statutory Notice of Deficiency (hereinafter referred to as the "Stat. Notice") dated March 1, 1998, that it determined that the amounts paid by Enron Corp. to Enron Capital LLC are not deductible interest payments, the obligations do not constitute indebtedness, and the obligations under which payments were accrued do not constitute indebtedness because the entity with whom Enron Corp. contracted is not sufficiently distinct to be considered an unrelated party contracting at arm's-length. Examination proposed to reduce the interest expense in the amount of $2,137,497 for 1993 and $21,645,596 for 1994.

Enron Corp. formed Enron Capital LLC under the law of Turks and Caicos Islands as a limited life company for the sole purpose of issuing shares and lending the net proceeds to Enron Corp. Enron Capital LLC was a 100 percent subsidiary of Enron Corp., and as of 1993, Enron Corp. owned directly 4,997 of the outstanding and issued common shares of Enron Capital LLC, out of 5,000 shares. 1993 Prospectus at S-6. Enron Preferred Capital Corp., a 100 percent subsidiary of Enron Corp., owned 1 share. Enron Corp. purchased the common shares of Enron Capital LLC for approximately $53,165,000. 1993 Prospectus at S-14.

In November, 1993, Enron Capital LLC authorized 9,200,000 shares of 8 percent MIPS. 1993 Terms at 1. Of the authorized MIPS, Enron Capital LLC issued 8,000,000 shares at $25.00 per share, for a total of $200,000,000. The unissued 1,200,000 shares of MIPS were reserved for the Underwriters' over-allotment option. 1993 Prospectus at S-6.

Enron Capital LLC loaned to Enron Corp. both the $53,165,000 proceeds from the sale of the common shares to Enron Corp., and the $200,000,000 proceeds from the sale of the MIPS for an aggregate principal amount of $253,165,000 (hereinafter referred to as the "1993 Loan"). 1993 Prospectus at S-14. However, the 1993 Loan Agreement states that Enron Capital LLC agreed to make loans to Enron Corp. in the principal amount of $270,569,621 in next day funds. 1993 Loan Agreement at 1. The 1993 Loan to Enron Corp. bears interest at an annual rate equal to 8 percent until maturity; this is the same rate as the 8 percent "dividend" rate payable on the MIPS. 1993 Loan Agreement at 3. Interest on the Loan was payable on the last day of each calendar month of each year beginning on November 30, 1993. 1993 Prospectus at S-15.

The 1993 Loan Agreement between Enron Capital LLC and Enron Corp. states that the Loan shall be due as follows:

> The entire principal amount of the Loan shall become due and payable, together with any accrued and unpaid interest thereon, including Additional Interest as defined below, if any, on the earliest of [November 30, 2043], or the date upon which [Enron Corp.] is dissolved, wound-up or liquidated or the date upon which [Enron Capital LLC] is dissolved, wound-up or liquidated.

1993 Loan Agreement at 2.

Upon repayment of the 1993 Loan, Enron Capital LLC can redeem the MIPS or reloan these funds to Enron Corp. The amounts can be reloaned to Enron Corp. only if: (a) Enron Corp. is not in bankruptcy; (b) Enron Corp. is not in default on any loan relating to the MIPS; (c) Enron Corp. has made timely payments on the repaid loan for the preceding 18 months; (d) Enron Capital LLC is not in arrears in dividend payments; (e) Enron Corp. is expected to be able to make timely payment of principal and interest on the Loan; (f) the Loan is being made on terms, and under circumstances, that are consistent with those which a lender would require for a loan to an unrelated party; (g) the Loan is being made at a rate sufficient to pay dividends that accrue on the shares; (h) the senior unsecured long-term debt of Enron Corp. is rated BBB- or better by Standard & Poor or Baa3 or better by Moody's, or the equivalent by another rating organization; (i) the Loan is made for a term that is consistent with market circumstances and A's financial condition; and (j) the final maturity can be no later than the 100 years anniversary of the issuance of the MIPS, or November 30, 2093. 1993 Terms at 3-4. Enron Corp. has the right to prepay the 1993 Loan without premium or penalty on or after November 30, 1998. 1993 Loan Agreement at 2.

Enron Corp. has the right to extend the interest payment period for up to 18 months. At the end of this, Enron Corp. shall pay all accumulated and unpaid interest. 1993 Loan Agreement at 4. During any extended interest payment period, neither Enron Corp. nor any majority owned subsidiary of Enron Corp. will declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment or Guarantee Payment with respect to any of its capital stock (other than Guarantee Payments). 1993 Loan Agreement at 4.

Enron Corp. also guarantees the full payment, when due, of any of the indebtedness and liabilities of Enron Capital LLC. Agreement as to Expenses and Liabilities, November 15, 1993, at 1.

In the event of default by Enron Corp. in the payment of interest, in the payment of principal when due, in the event of a dissolution, winding up or liquidation of Enron Capital LLC, upon the bankruptcy, insolvency or liquidation of Enron Corp., or upon the breach of any covenants, Enron Capital LLC shall have the following rights:

> to declare the principal of and the interest on the Loans (including any Additional Interest and any interest subject to an extension of the interest payment period) and any other amounts payable on the Loans to be forthwith due and payable, whereupon the same shall become and be forthwith due and payable without presentment, demand, protest or other notice of any kind, all of which are hereby expressly waived, anything in this Agreement to the contrary notwithstanding.

1993 Loan Agreement at 10-11. An event of default is defined as a default by Enron Corp. in repayment of the principal or interest on the Loans when due, the dissolution, winding up or liquidation of Enron Capital LLC, the bankruptcy, insolvency or liquidation of Enron Corp., or the breach of any covenant in the Loan Agreement. 1993 Prospectus at S-18.

The 1993 Loan is "subordinate and junior in right of payment to all Senior Indebtedness of Enron Corp. as provided herein." 1993 Loan Agreement at 5. The Senior Indebtedness of Enron Corp. includes the principal, premium, and interest on:

> (i) all indebtedness of [Enron Corp.], whether outstanding on the date hereof or hereafter created, incurred or assumed, which is for money borrowed, or evidenced by a note or similar instrument given in connection with the acquisition of any business, properties or assets, including securities, (ii) any indebtedness of others of the kinds described in the preceding clause (i) for the payment of which [Enron Corp.] is responsible or liable (directly or indirectly, contingently or non-contingently) as guarantor or otherwise,

> (iii) any indebtedness secured by a lien upon property owned by [Enron Corp.] and upon which indebtedness [Enron Corp.] customarily pays interest, even though [Enron Corp.] has not assumed or become liable for the payment of such indebtedness and (iv) amendments, renewals, extensions and refunding of any such indebtedness unless ... it is expressly provided that the indebtedness is not superior in right of payment to the Loans.

1993 Loan Agreement at 5.

If Enron Corp. defaults in the payment of principal, premium or interest on any Senior Indebtedness when it becomes due and payable, or in the event of a default on the Senior Indebtedness, then until such default has been cured or waved, no direct or indirect payment will be made on the 1993 Loan. 1993 Loan Agreement at 6.

In the event of insolvency, bankruptcy, receivership, liquidation, reorganization, composition, or similar proceeding against Enron Corp. or its property, all Senior Indebtedness of Enron Corp. shall be paid in full before any payment or distribution of the 1993 Loan. 1993 Loan Agreement at 6-7.

Enron Capital LLC has no right to participate in the management of Enron Corp.; however, the holders of the MIPS will have creditors' rights against Enron Corp. if Enron Capital LLC fails to pay "dividends" on the MIPS for 18 months (consecutive monthly dividend periods), if an event of default occurs or if Enron Corp. is in default on any of its payment or other obligation under the Guarantee Agreement. 1993 Terms at 6. The holders of a majority in liquidation preference of MIPS in 1993 will be entitled to the following rights:

> to appoint and authorize a trustee to enforce [Enron Capital's] creditor rights under the Loans against [Enron Corp.], enforce the obligations undertaken by [Enron Corp.] under the Guarantee Agreement and the Agreement as to Expenses and Liabilities pursuant to which [Enron Corp.] will agree to guarantee payment of any liabilities incurred by [Enron Capital LLC] (other than obligations to holders of [MIPS] in their capacities as holders)... and declare and pay dividends on [MIPS].

1993 Terms at 6. Not later than 30 days after such right to appoint a trustee arises, the manager will convene a general meeting for the above purpose. If the manager fails to convene a meeting, the MIPS holders of 10 percent in liquidation preference of outstanding shares will be entitled to convene the meeting. 1993 Terms at 6.

The holders of the MIPS shall have the following rights:

> If any resolution is proposed for adoption by the shareholders of [Enron Capital LLC] providing for, or the Manager otherwise proposes to effect, (x) any variation or abrogation of the rights, preferences and privileges of [MIPS], whether by way of amendment of [Enron Capital LLC]'s Articles of Association ... or (y) the liquidation, dissolution or winding up of [Enron Capital LLC], then the holders of outstanding [MIPS] will be entitled to vote on such resolution or action of the Manager (but not on any other resolution or action), and such resolution or action shall not be effective except with approval of the holders of [66-2/3] % in liquidation preference of the outstanding [MIPS]....

1993 Terms at 6-7.

In the event of any voluntary or involuntary liquidation, dissolution or winding up of Enron Capital LLC, the MIPS holders will be entitled to receive out of the assets of Enron Capital LLC available for distribution to shareholders, before any distribution of assets is made to holders of common shares or any other class of shares of Enron Capital LLC ranking junior to MIPS, an amount equal to the stated liquidation preference of $25.00 per share and all accumulated and unpaid "dividends" to the date of payment. 1993 Terms at 5.

The holders of the MIPS are entitled to receive, when, as and if declared by Enron Capital LLC out of funds held and legally available, cumulative cash "dividends" at the annual rate of 8 percent of the stated liquidation preference of $25.00 per share per annum. The "dividends," payable in U.S. dollars monthly in arrears on the last day of each calendar month, will accrue and be cumulative whether or not they have been declared and whether or not there are profits, surplus or other funds of Enron Capital LLC legally available. 1993 Terms at 2. "Dividends" must be declared on the MIPS in any calendar year to the extent that Enron Corp. reasonably anticipates that at the time of payment Enron Capital LLC will have and must pay cash on hand that is sufficient to permit such payments. 1993 Terms at 2.

Enron Capital LLC will not pay any dividends on any shares of Enron Capital LLC ranking junior to the MIPS, or redeem, purchase or otherwise acquire any junior shares of Enron Capital LLC, until such time as all accumulated and unpaid "dividends" on the MIPS have been paid in full. 1993 Terms at 3.

In 1993, Enron Corp. had a debt-to-equity ratio of approximately 1.2:1. 1993 Prospectus at S-5.

The obligation at issue between Enron Corp. and Enron Capital LLC is labeled as a loan in the 1993 Prospectus. 1993 Prospectus at S-14. The 1993 Loan Agreement, as well as all other documents reviewed, labels the obligation as a loan.

Enron Corp. used the proceeds from the 1993 Loan from Enron Capital LLC to repay other indebtedness, and for general corporate purposes. 1993 Prospectus at S-5. In the Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (hereinafter referred to as the "10-K" for 1993) that Enron Corp. filed with the Securities and Exchange Commission for 1993, Enron Corp. reported that "the average cost of long-term debt declined to 8.2 percent at December 31, 1993 from 8.9 percent at December 31, 1992. The decline was accomplished primarily through the retirement of additional higher coupon long-term debt which was subject to call provisions during [1993]." 1993 Enron Corp. 10-K at 32.

Enron Corp. has irrevocably and unconditionally agreed to pay the holders of the MIPS the following Guarantee Payments, in the event that Enron Capital LLC fails to pay: any accumulated and unpaid "dividends" declared on the MIPS from legally available funds; the $25.00 redemption price per preferred share, from legally available funds; the lesser of either the liquidation preference of $25.00 per share plus accumulated and unpaid "dividends" or the amount of assets of Enron Capital LLC available for distribution to MIPS holders; and any interest payable on the MIPS. 1993 Guarantee at 2. Enron Corp. irrevocably and unconditionally agrees to pay in full to the MIPS holders the Guarantee Payments when due, except to the extent paid by Enron Capital LLC, regardless of any defense, right of set-off or counterclaim that Enron Capital LLC may have or assert. 1993 Guarantee at 2. Enron Corp.'s obligation to make Guarantee Payments may be satisfied by direct payment by Enron

Corp. to the MIPS holders or by causing Enron Capital LLC to pay such amounts to the holders. 1993 Guarantee at 2-3.

This Guarantee Agreement is an unsecured obligation of Enron Corp., the Guarantor, and is subordinate and junior in right of payment to all of the liabilities of Enron Corp., is *pari passu* with the most senior preferred or preference stock, and is senior to Enron Corp.'s common stock. 1993 Guarantee at 6. Enron Corp.'s obligations under the Guarantee Agreement are independent of Enron Capital's obligations with respect to the MIPS. In addition, Enron Corp. will be liable as principal and sole debtor to make the Guarantee Payments.

If any MIPS remain outstanding and Enron Corp. is in default with respect to its obligations under the Guarantee Agreement or the Loan Agreement, then neither Enron Corp. nor any majority owned subsidiary of Enron Corp. will declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment or guarantee payment with respect to, any of its capital stock. 1993 Guarantee at 5.

Under the Guarantee Agreement, Enron Corp. covenants that, as long as the MIPS remain outstanding, it will maintain direct or indirect ownership of the common shares of Enron Capital LLC, maintain 21 percent of the value as common shares, and not voluntarily dissolve, wind up or liquidate Enron Capital LLC or cause it to lose its status as an LLC. 1993 Guarantee at 5.

<u>1994--Cumulative Preferred Shares</u>

In 1994, Enron Corp. borrowed an aggregate principal amount of $94,936,709 from Enron Capital Resources L.P. and paid $3,512,658 in interest expenses to Enron Capital Resources L.P.

Examination stated in the Stat. Notice that it determined that the amounts paid by Enron Corp. to Enron Capital Resources L.P. in 1994 are not deductible as interest payments, and the obligations under which payments were accrued do not constitute indebtedness because the entity with whom Enron Corp. contracted is not sufficiently distinct to be considered an unrelated party contracting at arm's-length. Examination has proposed to reduce Enron Corp.'s interest expense in the amount of $3,512,658 in 1994.

Enron Corp. and Organizational Partner, Inc. (a 100 percent subsidiary of Enron Corp.) formed Enron Capital Resources L.P. as a limited partnership organized under the laws of Delaware.

Enron Corp., as a general partner, holds an 21 percent interest in the partnership; the remainder of Enron Capital Resources L.P. is owned by the holders of Cumulative Preferred Shares. Organizational Partner, Inc. withdrew after the issuance of the Cumulative Preferred Shares. Enron Capital Resources L.P. exists solely for the purpose of issuing limited partner interests and lending the net proceeds from the interests to Enron Corp. 1994 Prospectus at S-2. Enron Corp. paid $19,936,709 to Enron Capital Resources L.P. for the partnership interest.

Enron Corp., as general partner, will furnish to each cumulative preferred instrument holder a Schedule K-1 each year setting forth the holder's allocable share of income for the prior calendar year. 1994 Prospectus at S-21.

Enron Capital Resources L.P. issued 3,000,000 shares of 9 percent Cumulative Preferred Shares, Series A, in August, 1994. Each instrument was issued at $25.00 per individual Cumulative Preferred Share, for a total of $75,000,000. Although these Cumulative Preferred Shares are not MIPS, the two instruments are similar. The holders of the instruments shall be entitled to "dividends" fixed at a rate per annum of 9 percent per $25.00 per Cumulative Preferred Shares. Amended and Restated Agreement of Limited Partnership of Enron Capital Resources L.P. at 14. "Dividends" must be paid on the Cumulative Preferred Shares in any calendar year to the extent that Enron Corp. reasonably anticipates that at the time of payment Enron Capital Resources L.P. will have and must legally pay funds available for the payment of such "dividends" and sufficient cash to permit such payments. 1994 Prospectus at S-8.

Enron Capital Resources L.P. loaned to Enron Corp. the proceeds from the sales of both the capital shares and the Cumulative Preferred Shares, an aggregate principal amount of $94,936,709 (hereinafter referred to as the "1994 Loan"). 1994 Prospectus at S-16.

The 1994 Loan bears interest at an annual rate equal to 9 percent until maturity, with interest payable on the last day of each calendar year as of August 31, 1994. The 1994 Loan Agreement between Enron Capital Resources L.P. and Enron Corp. provides for the following:

> The entire principal amount of the Loan shall become due and payable, together with any accrued and unpaid interest thereon, including Additional Interest as defined below, if any, on the earliest of [August 31, 2024] or the date

> upon which Enron Corp. is dissolved, wound-up or liquidated or the date upon which [Enron Capital Resources L.P.] is dissolved, wound-up or liquidated.

1994 Loan Agreement at 2.

Enron Corp. has the right to prepay the Loan at any time on or after August 31, 1999, without premium or penalty, and if legislation is enacted or existing law is modified that causes Enron Capital Resources L.P. to be treated as an association taxable as a corporation, provided that Enron Capital Resources L.P. has elected to redeem the instruments. 1994 Loan Agreement at 2. The Cumulative Preferred Shares instruments are redeemable at the option of Enron Capital Resources L.P. and subject to the consent of Enron Corp. on or after August 31, 1999, at the redemption price of $25.00 per instrument plus accumulated "dividends." 1994 Prospectus at S-9.

Upon any repayment or prepayment of principal on the 1994 Loan, the proceeds from such payment will be applied to redeem Cumulative Preferred Shares. However, such amounts may be reloaned to Enron Corp., and not used for redemption, if at the time of such loan: (a) Enron Corp. is not in bankruptcy; (b) Enron Corp. is not in default on any loan relating the Cumulative Preferred Shares; (c) Enron Corp. has made timely payments on the Loan for the immediately preceding 18 months; (d) Enron Capital Resources L.P. is not in arrears on payments of the "dividends" on Cumulative Preferred Shares; (e) Enron Corp. is expected to be able to make timely payments of principal and interest on the Loan; (f) the Loan is made on terms and under circumstances that are consistent with one made to an outside party; (g) the rate on the Loan is sufficient to provide for dividends on the Cumulative Preferred Shares; (h) the senior unsecured long-term debt of Enron Corp. is rated BBB- or better by Standard & Poor or Baa3 or better by Moody's or the equivalent; (i) the terms are consistent with market and A's financial condition; (j) the term of the Loan is no more than 30 years; and (k) the final maturity of such Loan is not later than the 49 years anniversary of the issuance of the Cumulative Preferred Shares. 1994 Prospectus at S-9-S-10.

Enron Corp. has the right to an extended interest period on the 1994 Loan, to extend the interest payment period on the 1994 Loan for up to 60 months (consecutive), deferring also the monthly dividend payments on the Cumulative Preferred Shares. 1994 Prospectus at S-4. However, the interest will continue to accrue and will be paid after the 60 months period. 1994 Loan Agreement at 3. During any extended interest payment period, Enron Corp. will not declare or pay any dividend on, redeem, purchase, acquire or make a liquidation payment with respect to any of its capital stock. 1994 Loan Agreement at 3.

The 1994 Loan Agreement "constitutes the valid and legally binding obligation of Enron Corp. enforceable in accordance with its terms, subject to bankruptcy, insolvency, fraudulent transfer, reorganization, moratorium and similar laws of general applicability relating to or affecting creditors' rights and to general equity principles." 1994 Loan Agreement at 7.

In the event of a default by Enron Corp., Enron Capital Resources L.P.:

> will have the right to declare the principal of and interest on the Loan (including any Additional Interest and any interest subject to an extension of the interest payment period) and any other amounts payable on the Loan to be forthwith due and payable, whereupon the same shall become and be forthwith due and payable without presentment, demand, protest or other notice of any kind, all of which are hereby expressly waived, anything in this Agreement to the contrary notwithstanding.

1994 Loan Agreement at 8.

An event of default is defined as a default by Enron Corp. in the payment of interest or principal on the 1994 Loan, the dissolution, winding up or liquidation of Enron Capital Resources L.P., the bankruptcy, insolvency or liquidation of Enron Corp., and any breach of the Loan Agreement covenants. 1994 Loan Agreement at 8. Thus, upon Enron Corp.'s default, Enron Capital Resources L.P. may enforce its creditor rights by declaring the principal and interest on the 1994 Loan to be due and payable (without presentment, demand, protest or other notice).

The 1994 Loan is subordinated as follows:

> the Loan is subordinate and junior in right of payment to all Senior Indebtedness as provided herein. The term 'Senior Indebtedness' shall mean the principal, premium, if any, and interest on (i) all indebtedness of [Enron Corp.], ... incurred or assumed, which is for money borrowed, or evidenced by a note or similar instrument given in connection with the acquisition of any business, properties, or assets, including securities....

1994 Loan Agreement at 4. Senior Indebtedness also includes any similar debt on which Enron Corp. is liable as a guarantor, any indebtedness secured by a lien on property which Enron Corp. owns and for which Enron Corp. customarily pays interest, and any amendments, renewals, extensions and refundings of any such indebtedness. 1994 Loan Agreement at 4.

If Enron Corp. defaults on any payments of any principal or interest upon its Senior Indebtedness, no direct or indirect payments shall be made on the 1994 Loan. 1994 Loan Agreement at 5. The Senior Indebtedness shall also be paid in full prior to payments made on the 1994 Loan in the event of insolvency, bankruptcy, receivership, liquidation, reorganization, composition or similar proceeding relating to Enron Corp.; and liquidation, dissolution or winding up of Enron Corp.; any assignment by Enron Corp. for the benefit of its creditors; and any other marshalling of Enron Corp.'s assets. 1994 Loan Agreement at 5.

Senior Indebtedness does not include "the indebtedness pursuant to the Loan Agreement dated as of November 15, 1993 between [Enron Corp.] and [Enron Capital LLC] and any extensions or refundings thereof (the 'Pari Passu Debt')." 1994 Loan Agreement at 4. The 1994 Loan shall not be subordinate to any other liabilities of Enron Corp. 1994 Prospectus at S-17.

Enron Capital Resources L.P. has no right to participate in the management of Enron Corp. However, the holders of Cumulative Preferred Shares shall be entitled to appoint and authorize a trustee to enforce Enron Capital Resources' creditor rights under the 1994 Loan against Enron Corp. and pay "dividends" if Enron Capital Resources L.P. fails to pay "dividends" in full, or in the event of default by Enron Corp. on principal or interest on the Loan. 1994 Prospectus at S-11.

Not later than 30 days after such right to appoint a trustee arises, the general partner, Enron Corp., will convene a general meeting. If the general partner fails to convene such a meeting, the cumulative preferred instrument holders of 10 percent in liquidation preference will be entitled to convene the meeting. 1994 Prospectus at S-11.

If any amendment to the Enron Capital Resources L.P. Partnership Agreement is proposed for adoption providing for any variation or abrogation of the rights, preferences and privileges of the Cumulative Preferred Shares, or the liquidation, dissolution, or winding up of Enron Capital Resources L.P., then the holders of the Cumulative Preferred Shares will be entitled to vote on such proposal. 1994 Prospectus at S-11.

In 1994, Enron Corp. had a debt-to-equity ratio of approximately 1:1. 1994 Prospectus at S-7, S-19.

Enron Corp. purportedly used the 1994 Loan for general corporate purposes including the repayment of indebtedness. 1994 Prospectus at S-7. Enron Corp.'s estimated fair market value of its long-term debt decreased in 1994; the fair market value of debt includes the estimated cost to acquire the debt. 1994 Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (hereinafter referred to as the "10-K" for 1994).

Enron Corp. labeled this obligation between Enron Corp. and Enron Capital Resources L.P. as a loan in the Prospectus that it submitted to the Securities and Exchange Commission for 1994. 1994 Prospectus at S-16. Enron Corp. also labeled the obligation as a loan in the 1994 Loan Agreement and other documents.

Holders of the Cumulative Preferred Shares shall also be entitled to enforce the obligation undertaken by Enron Corp. under the Guarantee Agreement, should Enron Capital Resources L.P. fail to pay "dividends," in the event of a default, or if Enron Corp. is in default on any of its payment or other obligations under the Guarantee. 1994 Prospectus at S-11.

Enron Corp. has also irrevocably and unconditionally agreed to pay the holders of the Cumulative Preferred Shares certain Guarantee Payments in the event that Enron Capital Resources L.P. fails to do so. 1994 Guarantee at 1-2. Guarantee Payments are defined as accumulated and unpaid dividends, the redemption price of $25.00, the lesser of either the $25.00 liquidation preference plus accumulated and unpaid dividends or assets of Enron Capital Resources L.P. available for distribution, and any additional interest, to the extent that these are not paid by Enron Capital Resources L.P. 1994 Guarantee at 1-2. Enron Corp.'s obligation to make a Guarantee Payment may be satisfied by direct payment by Enron Corp. to the holders of the instruments or by causing Enron Capital Resources L.P. to pay such amounts to the holders.

Enron Corp.'s obligations under the Guarantee Agreement are independent of Enron Capital Resources' obligations with respect to the Cumulative Preferred Shares. Enron Corp. is liable as principal and sole debtor to make the Guarantee Payments.

If any Cumulative Preferred Shares remain outstanding and Enron Corp. is in default under the Guarantee Agreement, the Expense Agreement, or the Loan Agreement, then Enron Corp. shall not declare or pay any dividend on or redeem, purchase, acquire or make a liquidation payment with respect to any of its capital stock. 1994 Guarantee at 4.

Under the Guarantee Agreement, Enron Corp. covenants that, as long as the Cumulative Preferred Shares remain outstanding, it will maintain direct or indirect ownership of the general partner interest in Enron Capital Resources L.P., it will cause at least 21 percent of the value of Enron Capital Resources L.P. to be represented as a general partner interest, it will not voluntarily dissolve, wind up or liquidate Enron Capital Resources L.P., and will make every effort to cause Enron Capital Resources L.P. to remain a limited partnership and will perform duties as a general partner. 1994 Guarantee at 4-5.

The Guarantee Agreement is an unsecured obligation of Enron Corp. and ranks subordinate and junior in right of payment to all liabilities of Enron Corp. other than the 1993 MIPS Guarantee Agreement, *pari passu* with the most senior preferred or preference stock, and senior to A's common stock. 1994 Guarantee at 5.

ISSUE 1:

Whether the Loans from Enron Capital LLC and Enron Capital Resources L.P. to Enron Corp. should be respected as debt.

LAW AND ANALYSIS:

I.R.C. § 385 of the Internal Revenue Code of 1986, as amended, ("the Ccde") discusses the treatment of certain investments in corporations as stock or indebtedness. Both section 385(a) and 385(b) require regulations to be effective. Since neither had regulations in effect for the years in issue, a facts and circumstances approach is required.

Under section 385(c)(1), the characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness is binding on the issuer and on all holders of such interest (but is not binding on the Secretary of the Treasury).

Notice 94-47, 1994-1 C.B. 357, provides guidance in the determination of whether an instrument is debt or equity for federal income tax purposes. Notice 94-47 addresses potential abuses of the tax law by instruments that contain both debt and equity characteristics.

The eight factors to be considered under Notice 94-47 are:

(a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;

(b) whether holders of the instruments possess the right to enforce the payment of principal and interest;

(c) whether the rights of the holders of the instruments are subordinate to rights of general creditors;

(d) whether the instruments give the holders the right to participate in the management of the issuer;

(e) whether the issuer is thinly capitalized;

(f) whether there is identity between holders of the instruments and stockholders of the issuer;

(g) the label placed upon the instruments by the parties; and

(h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). The Notice is primarily concerned with instruments that combine long maturities (greater than 50 years) with other substantial equity characteristics.

We shall discuss the facts relating to each factor in the Notice in sequence. This analysis is focused on the Loans because the narrow issue is whether the payments made pursuant to the Loans represent interest upon debt.

(a) <u>Whether there is an unconditional promise to pay by the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future.</u> The presence of a fixed maturity date indicates a definite obligation to repay, which is a debt characteristic. Both the 1993 and the 1994 Loans contain a promise by Enron Corp. to pay the principal and interest by a fixed maturity date.

The entire principal amount and interest on the 1993 Loan are due and payable on November 30, 2043, or earlier if either Enron Corp. or Enron Capital LLC is dissolved, wound-up or liquidated. 1993 Loan Agreement at 2.

If Enron Corp. repays the 1993 Loan when due or prepays the Loan, the proceeds from the repayment of principal and interest shall be applied to redeem the MIPS; alternatively, the proceeds could be reloaned to Enron Corp. for an additional maximum 50 years, so that the Loan maturity can be no longer than the 100 years anniversary of the issuance of the MIPS. 1993 Prospectus at S-7. Thus, the 1993 Loan could have an effective maximum maturity date of 100 years, if the optional 50 years extension is exercised. The 1993 Loan will become due and payable earlier if Enron Capital LLC redeems the MIPS. 1993 Prospectus at S-14. Enron Capital LLC may redeem the MIPS at its option after November 30, 1998, but redemption is subject to the prior consent of Enron Corp. 1993 Prospectus at S-7.

Although Enron Corp. may extend the interest payment period for up to 18 months, the interest will continue to accrue. 1993 Prospectus at S-20.

Principal and interest on the 1994 Loan are due and payable on August 31, 2024, or when Enron Corp. or Enron Capital Resources L.P. is dissolved, wound-up or liquidated. 1994 Loan Agreement at 2. If Enron Corp. repays the 1994 Loan when due or prepays the Loan, the proceeds from the repayment will be applied to redeem the Cumulative Preferred Shares, or the funds could be reloaned to Enron Corp. 1994 Prospectus at S-9. Upon Enron Capital Resources' redemption of the Cumulative Preferred Shares, the principal and interest on the Loan shall become due and payable; while the Cumulative Preferred Shares are redeemable at the option of Enron Capital Resources L.P., redemption is subject to the consent of Enron Corp. 1994 Prospectus at S-9, S-16. If the Loan is paid by Enron Corp. and subsequently reloaned to Enron Corp., the final maturity of the Loan can be no later than the 49 years anniversary of the issuance of the Cumulative Preferred Shares. 1994 Prospectus at S-10. Thus, the 1994 Loan could have an effective maximum maturity date of 49 years, if the extension is exercised.

Additionally, upon an event of default by Enron Corp. on its payments, the 1994 Loan will be forthwith due and payable. If the holders of the Cumulative Preferred Shares fail to receive "dividends" from Enron Capital Resources L.P., they have creditors' rights against Enron Corp., and thus, Enron Corp. is obligated to Enron Capital Resources' holders.

The evidence indicates that Enron Corp. has made an unconditional promise to pay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future for both Loans. A fixed maturity date indicates a fixed obligation to repay, which is a characteristic of debt. Mixon v. United States, 464 F.2d 394, 404 (5th Cir. 1972).

(b) Whether the holders of the instruments possess the right to enforce payment of principal and interest. Both of the holders of the Loans, Enron Capital LLC and Enron Capital Resources L.P., possess the right to enforce payment of the Loans by Enron Corp.

The 1993 Loan Agreement "constitutes the valid and legally binding obligation of Enron Corp. enforceable in accordance with its terms, subject to bankruptcy, insolvency, fraudulent transfer, reorganization...." 1993 Loan Agreement at 8-9.

Upon an event of default on the 1993 Loan, Enron Capital LLC has the right to declare the principal and interest forthwith due and payable. 1993 Loan Agreement at 10.

Similarly, Enron Capital Resources L.P. has the right to enforce the 1994 Loan Agreement and the repayment of the 1994 Loan. 1994 Loan Agreement at 7. Enron Capital Resources L.P. has creditor's rights as against Enron Corp. and has the right to declare the principal and interest of the 1994 Loan due and payable upon an event of default by Enron Corp. 1994 Loan Agreement at 8.

Enron Capital LLC and Enron Capital Resources L.P. are, in effect, controlled by Enron Corp., and therefore the rights of these two intermediaries could be questioned. However, Enron Corp.'s obligations under the Loans are also for the benefit of the holders of MIPS and Cumulative Preferred Shares, and these holders are entitled to enforce the Loan Agreements directly against Enron Corp. The facts in these documents indicate that holders of the Loan instruments possess the right to enforce payment as creditors. A definite obligation to repay an advance is an indication of a loan. Mixon, 464 F.2d at 405. This factor is more indicative of debt.

(c) Whether the rights of the holders of the instruments are subordinate to the rights of general creditors. The rights of the holders of the 1993 Loan and of the 1994 Loan are not subordinate to the rights of the general creditors of Enron Corp.

The 1993 Loan is subordinate only to the Senior Indebtedness. The Senior Indebtedness shall be paid first in full before any payment or distribution is made on the 1993 Loans, in the event of insolvency, bankruptcy, receivership, liquidation, reorganization, or the dissolution or winding up of Enron Corp. 1993 Loan Agreement at 7. See supra at 6. Senior Indebtedness includes generally the principal and interest on all indebtedness of Enron Corp., evidenced by a note or another instrument, but it does not include debts to general creditors. 1993 Loan Agreement at 5. In addition, the Loan ranks superior to the claims of A's stockholders. 1993 Guarantee at 5.

The 1994 Loan is also subordinate only to the Senior Indebtedness. 1994 Loan Agreement at 4. The definition of Senior Indebtedness for the 1994 Loan is nearly identical to that of the 1993 Loan, that is, both include generally the principal and interest on all indebtedness of Enron Corp., evidenced by a note or another instrument, but do not include debts to general creditors. 1994 Loan Agreement at 4-5.

If the holder of the obligation has rights that take precedence over the rights of shareholders, this suggests that the instrument is debt, although it is not dispositive. Monon Railroad v. Commissioner, 55 T.C. 345, 360 (1970), acq., 1973-2 C.B. 2. The evidence indicates that the obligations are not subordinated to the level of general creditors, and therefore the obligations resemble debt more than equity.

(d) Whether the instruments give the holders the right to participate in the management of the issuer. Neither the holder of the 1993 Loan, Enron Capital LLC, nor the holder of the 1994 Loan, Enron Capital Resources L.P., has rights to participate in the management of the issuer of the Loans, Enron Corp.

The holders of Enron Capital's MIPS and the holders of the Cumulative Preferred Shares of Enron Capital Resources L.P. have certain limited creditors' rights as against Enron Corp. Upon Enron Capital's failure to pay "dividends" for 18 months (consecutive dividend periods), the MIPS holders will be entitled to appoint and authorize a trustee to enforce B's creditor rights against Enron Corp. 1993 Terms at 6. Also, if a resolution is proposed to effect any variation or abrogation of the rights of the MIPS holders or that would effect the liquidation, dissolution or winding up of Enron Capital LLC by way of an amendment to B's Articles of Association, then the holders will be entitled to vote on such resolution or action. 1993 Terms at 6-7.

The holders of the Cumulative Preferred Shares have been granted similar creditors' rights to appoint a trustee to enforce C's creditors' rights under the 1994 Loan against Enron Corp. and also the right to vote upon certain proposals to amend the Partnership Agreement. 1994 Prospectus at S-11.

Also, during any extended interest period under the Loan, neither Enron Corp. nor any majority owned subsidiary can declare or pay any dividend on, or redeem, purchase, acquire or make a liquidation payment with respect to any of its capital stock. 1993 Loan Agreement at 4; 1994 Loan Agreement at 3. (Under the 1993 Loan this limitation does not apply to certain payments; in particular, the dividends paid by Enron Oil & Gas Company on its common stock.)

These rights to vote for a trustee, to vote upon certain Articles of Association or Partnership Agreement amendments should Enron Capital LLC or Enron Capital Resources L.P. fail to pay "dividends," and to restrict certain payments on Enron Corp.'s capital stock during an extended interest period do not qualify as giving the holder of the instrument, either Enron Capital LLC or Enron Capital Resources L.P., the right to participate in the management of the issuer, Enron Corp. Rather, B's and C's holders are granted rights as creditors against Enron Corp. only.

Creditors are not usually entitled to vote in the affairs of the debtor corporation, or participate in its management, including electing corporate directors, unlike stockholders. Monon, 55 T.C. at 359-360. Based upon the information provided, there is no indication that Enron Capital LLC or Enron Capital Resources L.P. have any rights to participate in the management of Enron Corp., or have any voting rights in Enron Corp. Therefore, these facts are more indicative of debt.

(e) Whether the issuer is thinly capitalized. If a corporation has a nominal stock investment coupled with excessive debt, this fact would tend to indicate that an instrument labeled debt might constitute stock. As a result, the debt-to-equity ratio is another factor used to determine whether an instrument is debt or equity. The ratio indicates to what extent a corporation may suffer losses without impairment of the interests of the corporation's creditors. A high ratio lowers the protection afforded to the creditors against sudden business slumps. As a result, a high ratio of debt-to-equity indicates that the issuance of the instrument is a contribution to capital rather than a bona fide loan.

In 1993, Enron Corp. had a debt-to-equity ratio of approximately 1.2:1. 1993 Prospectus at S-5. In 1994, Enron Corp. had a debt-to-equity ratio of approximately 1:1. 1994 Prospectus at S-7, S-19.

Enron Corp. at no time has had a debt-to-equity ratio in excess of 2:1. See J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451, 459 (8th Cir. 1967) ("The debt to equity ratio of 2 to 1 is patently not so inordinately high as to qualify this as a 'thin capitalization' case."). Enron Corp. is not thinly capitalized, a factor which is more indicative of debt.

(f) Whether there is identity between holders of the instruments and stockholders of the issuer. This factor is usually relevant only when a corporation's shareholders have advanced money to the corporation. Advances made by stockholders in proportion to their respective stock ownership are an indication of equity, but a sharply disproportionate ratio is an indication of debt. Mixon, 464 F.2d at 409.

Enron Capital LLC is 100 percent owned by Enron Corp., except for 100 percent of the issued and outstanding MIPS, which are publicly held. Enron Corp. owns directly or indirectly 100 percent of the 4,998 issued and outstanding common shares of Enron Capital LLC out of 5,000 common shares. Enron Corp. also owns 100 percent of the partnership interests in Enron Capital Resources L.P. other than the interests represented by the Cumulative Preferred Shares, which are publicly held. Enron Corp. is a publicly-held utility company, with millions of dollars of common and preferred stock outstanding. The stockholders of Enron Corp. indirectly own the common shares of Enron Capital LLC and Enron Capital Resources L.P. through Enron Corp.'s ownership. However, other than the shares owned by Enron Corp., the outstanding instruments of Enron Capital LLC and Enron Capital Resources L.P., the MIPS and the Cumulative Preferred Shares, are publicly owned.

For purposes of this characteristic, there is no identity between the holders of the instruments and the stockholders of the issuer, and therefore, this indicates debt.

(g) The label placed upon the instruments. The instruments between Enron Corp. and Enron Capital LLC and Enron Capital Resources L.P. have been consistently characterized as Loans in the documents available. 1993 Loan Agreement, 1994 Loan Agreement.

In addition, under section 385(c), the issuer's characterization of an instrument as of the time of the issuance as either debt or equity is binding on the issuer and on all holders of the instrument. However, this characterization is not binding on the Service or on a holder that discloses that it is treating the instrument in a manner inconsistent with the issuer's characterization.

The labels on these instruments are not the same as the labels on the MIPS and the Cumulative Preferred Shares. However, since the form of the pass-through entities will be respected, and Enron Capital LLC and Enron Capital Resources L.P. will be treated as partnerships separate and distinct from Enron Corp., then the label on the obligations (the MIPS and Cumulative Preferred Shares) that Enron Capital LLC and Enron Capital Resources L.P. have with the holders of their instruments will not affect the label on the obligations (the Loans) that Enron Corp. has with either Enron Capital LLC or Enron Capital Resources L.P.

Therefore, because the evidence shows that Enron Corp. has consistently labeled and treated these obligations as debt, this fact is indicative of debt. See Mixon, 464 F.2d at 403.

(h) Whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes. There is no indication that the parties have treated the instruments (the Loans) between Enron Corp. and Enron Capital LLC and Enron Capital Resources L.P. as anything except debt. Enron Corp. labeled the obligations as loans in its 1993 and 1994 Prospectuses submitted to the Securities and Exchange Commission, and also indicated that the income on the shares is taxable as interest income rather than dividend income.

The labels placed upon the MIPS and the Cumulative Preferred Shares are different from the labels placed on the Loans. Thus, even though Moody's may have included the 1993 MIPS and the 1994 Cumulative Preferred Shares in with Enron Corp.'s capital stock, and MIPS and Cumulative Preferred Shares may give Enron Corp. some "equity credit" for purposes of the rating agencies, like Standard & Poor's and Moody's, Solomon B. Samson, Credit

Comments: A Hierarchy of Hybrid Securities, Standard & Poor's Creditweek, March 25, 1996, at 43, this fact has no bearing on the analysis of whether the Loans are properly labeled for federal tax purposes.

The obligations have been treated consistently as Loans by Enron Corp., a factor more indicative of debt. See Crown Iron Works v. Commissioner, 245 F.2d 357, 359 (8th Cir. 1957).

Unreasonably Long Maturity

Notice 94-47 focuses on "recent offerings of instruments that combine long maturities with substantial equity characteristics," and cites to Monon, 55 T.C. 345. The Service cautions taxpayers of the following:

> even in the case of an instrument having a term of less than 50 years, Monon Railroad generally does not provide support for treating an instrument as debt for federal income tax purposes if the instrument contains significant equity characteristics not present in that case. The reasonableness of an instrument's term (including that of any relending obligation or similar arrangement) is determined based on all the facts and circumstances, including the issuer's ability to satisfy the instrument. A maturity that is reasonable in one set of circumstances may be unreasonable in another if sufficient equity characteristics are present.

In Monon, the court determined that a 50-year maturity term on a debt instrument was not unreasonable in light of the fact that the corporation had been in existence for many years.

There is no bright-line test to determine whether a maturity date for a particular instrument is in the reasonably foreseeable future. In determining whether a maturity date for a particular instrument is a reasonable date, the courts have considered a number of factors, including the nature of the taxpayer's business, the financial condition of the taxpayer, the length of time the taxpayer has been in existence, and how likely it is that the taxpayer will be in existence when the instrument matures.

Enron Corp. was in existence for over 60 years when the MIPS and Cumulative Preferred Shares were issued. In addition, Enron

Corp. is a substantial operating business. Therefore, in this case, the 50-year and 30-year maturity dates appear to be reasonable, as does the 49-year extended term for the 1994 issuance. The 100-year extended term for the 1993 Loan may appear to be unreasonable on its face. In light of the other characteristics of debt, however, it is not enough to cause recharacterization.

Based on this review of the evidence, we concluded that attempting to recharacterize the debt as equity was unlikely to succeed.

This analysis has focused on the Loans because the narrow issue is whether the Loans represent debt or equity. The forms of the partnerships (the intermediate entities) should be respected, as will be discussed <u>infra</u>, at 26. If facts were present in this case that caused the forms of the partnerships to not be respected, the conclusions would not be different, and the instruments would still be properly characterized as debt.

<u>ISSUE 2</u>:

Whether the Service may disallow the interest paid to Enron Capital LLC and Enron Capital Resources L.P. on the Loans because of a lack of economic substance.

<u>LAW AND ANALYSIS</u>:

Section 163 allows as a deduction interest paid or accrued within the taxable year on indebtedness.

In <u>United States v. Wexler</u>, 31 F.3d 117, 122-23 (3d Cir. 1994), the court determined that, while section 163 does not expressly require that the transactions that gave rise to deductions have a business purpose or profit motive, nevertheless, case law establishes that the sham transaction doctrine bars interest deductions under section 163 if the underlying transaction does not have a business purpose or profit motive.

In <u>Wexler</u>, the taxpayer took deductions on interest paid on "repo to maturity" transactions involving sales and repurchases of government securities. The interest deduction and the income from the transactions were divided up into different years, and the mismatching of the deduction and income caused the income to be deferred for a second year. <u>Wexler</u>, 31 F.2d at 120. The court determined that none of the debt obligations were entered into for any reason other than for the tax benefits of deducting the interest on the obligations. Wexler, 31 F.3d at 126. In many of the cases upon which the court relied, it found that "a key requirement is that the interest obligation be *economically substantive*, defined in every decision ... to mean that the transaction have a potential non-tax benefit." Wexler, 31 F.3d at 127.

The taxpayers in Sheldon v. Commissioner, 94 T.C. 738 (1990), entered into eleven "repo" transactions involving sales and repurchases of U.S. Treasury Bills, or T-Bills. The repos involved were purchases of T-bills financed through repurchase agreements. The court determined that, although ten of these eleven transactions were real and had actually occurred, the transactions were lacking in the requisite substance and denied the interest deductions. Sheldon, 94 T.C. at 769.

The Sheldon court found that the taxpayers' sole objective was to obtain the interest deduction for transactions that had locked-in losses with no potential for any profit. Sheldon, 94 T.C. at 767. In 1981 and 1982 the partners in the transaction were locked in for a loss in the amount of $60,000, but received more than $5,000,000 in interest deductions to offset against their ordinary income. Sheldon, 94 T.C. at 769. Most of the transactions resulted in a loss, that is, the average interest rates on the repos were higher than the yield upon the maturity of the T-Bills that the taxpayers were to receive. Sheldon, 94 T.C. 746. In addition, the transactions were structured at year end to accommodate the mismatching of the income and deductions, thus creating a large tax benefit. Sheldon, 94 T.C. at 766.

"[L]oans or other financing transactions will merit respect and give rise to deductible interest only if there is some tax-independent purpose for the transactions." Sheldon, 94 T.C. at 759. Interest is not deductible if the underlying transaction is a sham or if it has no purpose, substance, or utility apart from the expected tax consequences. Sheldon, 94 T.C. at 760. "The need for a profit objective" was of little or insignificant importance in the analysis of the interest deduction for transactions occurring in 1981 and 1982, the years in issue. Sheldon, 94 T.C. at 760. However, the ability to profit is a part of the overall inquiry into purpose, substance and utility. Sheldon, 94 T.C. at 767. The court determined that the transactions at issue were real, but were entered into irrespective of the gain or loss potential, and solely for the tax benefits, and therefore lacked the purpose, substance and utility required for the deduction. Sheldon, 94 T.C. at 769.

In Bealor v. Commissioner, T.C. Memo. 1996-435, the Tax Court reiterated that the substance of the underlying debt must be genuine in order for interest to be deductible under section 163(a).

The taxpayers in Bealor structured highly complex employee leasing transactions between a fuel trucking corporation and numerous partnerships. One of the primary corporations contracted its employees and independent contractors from a different partnership each year, but the partnerships had common partners and were pre-planned. All of the partnerships, which were the investment vehicles in this transaction, reported substantial losses. The tax benefits of the partnerships were sometimes touted to investors. Investor-partners for the most part did not receive any cash return on their investments.

The Tax Court determined that the taxpayers were not entitled to interest and loss deductions because the transactions giving rise to the claimed deductions had neither economic substance nor a profit objective. Bealor, T.C. Memo. 1996-435. In its analysis of the economic substance of the overall transaction, the Tax Court examined the real parties in interest, the structure of the financing, the taxpayers' prospects of actually making payments on their obligations, arm's-length negotiations, the parties' adherence to the contractual terms, the reasonableness of the income projections, and the introduction of new entities to buffer the existing parties from liability. Bealor, T.C. Memo. 1996-435. The court noted that "where a debt transaction is not conducted at arm's-length by two economically self-interested parties, or where a debt is incurred in 'peculiar circumstances' indicating that it will not be paid, we have disregarded that debt for tax purposes." Bealor, T.C. Memo. 1996-435.

Under the profit objective analysis of the overall transaction, the Tax Court looked to the parties' intent and ability to profit from the transactions, specifically that the partners often could not recover any money from their investments.

Upon a realistic view of the employee leasing transactions under the foregoing factors, the Bealor court found that the transactions were shams lacking in economic substance, and the parties at issue did not demonstrate that they had profit as their primary purpose or any actual and honest profit objectives. Therefore, the losses and deductions were properly denied.

Enron Corp. stated in its 1993 Prospectus and 1994 Prospectus that the Loans would be used for general corporate purposes including the repayment of indebtedness. 1993 Prospectus at S-5; 1994 Prospectus at S-7. In the Enron Corp. 10-K for 1993, Enron Corp. stated that the average cost of its long term debt declined. Additionally, Enron Corp.'s debt-to-equity ratios decreased from 1993 to 1994, from approximately 1.2:1 to 1:1. These statements indicate that Enron Corp. did possess a business reason for entering into the transaction, and that the transactions possess the requisite economic substance.

Because part of the funds loaned to Enron Corp. are from Enron Corp.'s own contributions to the capital of Enron Capital LLC and Enron Capital Resources L.P., there may be questions concerning the circular flow of funds. However, nothing in the evidence indicates that the money from the contributions to capital are treated any differently from the proceeds from the public offerings in either the 1993 or the 1994 Loan documents.

In the balance, it appears from the available information that Enron Corp. entered into the transactions to obtain loans at lower interest rates and at lower costs generally, and therefore the underlying transactions possess economic substance.

The taxpayer asserts that it followed the form of its transaction. Appeals does not dispute this assertion. Appeals' principal point of contention, as we understand it, is that the intermediate affiliates should be treated as shams, because there was no business purpose for interposing them between Enron and the third party investors. If this is accomplished, Appeals believes the MIPS are equity and Enron gets no interest deduction. The first problem with this is that, during conferences with Counsel and Appeals, Enron articulated more fully its business purpose for utilizing the affiliates. If Enron had issued the MIPS directly and they were considered equity, this would have diluted Enron's earnings per share in its financial reports. If it had issued them directly and they were considered debt, this would have harmed Enron's credit rating. The second problem is that, even if the intermediaries were treated as shams, the MIPS are more like debt than equity and so Enron would still have an interest deduction.

ISSUE 3:

Whether Enron Capital LLC and Enron Capital Resources L.P. should be treated as partnerships or as associations taxable as corporations for federal income tax purposes.

LAW AND ANALYSIS:

Treas. Reg. § 301.7701-3(f)(2) of the regulations (finalized on December 17, 1996) provides that in the case of a business entity that is not automatically treated as a corporation under Treas. Reg. §§ 301.7701-2(b)(1), (3), (4), (5), (6), or (7), and that was in existence prior to January 1, 1997, the entity's claimed classification will be respected for all periods prior to January 1, 1997 if -

> (i) The entity had a reasonable basis (within the meaning of section 6662) for its claimed classification;
>
> (ii) The entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and
>
> (iii) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

Treas. Reg. § 301.7701-3(f)(2).

Neither Enron Capital LLC nor Enron Capital Resources L.P., nor any member therein, was notified in writing on or before May 8, 1996, that the classification of the entity was under examination by the Service. If we assume that there was no change in the entity's classification within the sixty months prior to January 1, 1997, then the tax treatment of Enron Capital LLC and Enron Capital Resources L.P. must be respected if Enron Capital LLC and Enron Capital Resources L.P. had a "reasonable basis" for their claimed classifications.

Enron Capital, LLC

Turks and Caicos Islands amended its corporate laws to permit limited life companies in a 1993 Ordinance. This entity does not appear on the list of foreign entities that automatically will be treated as "per se" corporations under current Treas. Reg. § 301.7701-2(b)(8).

A conclusive response concerning B's tax classification would require a careful review of B's organizational documents, which have not been provided to us. However, Enron Capital LLC was formed under a modern LLC statute which permits the formation of entities which should be taxed as partnerships. It appears very likely that the taxpayers had a "reasonable basis" for Enron Capital's claimed classification as a partnership, and that this classification must be respected under current Treas. Reg. § 301.7701-3(f)(2).

Enron Capital Resources, L.P.

Enron Capital Resources L.P. was formed under Delaware's version of the Revised Uniform Limited Partnership Act (RULPA), which corresponds with the Uniform Limited Partnership Act (ULPA) for purposes of Treas. Reg. § 301.7701-2. Rev. Rul. 95-2, 1995-1 C.B. 221. Limited partnerships which were formed pursuant to a statute corresponding to the ULPA will lack two or more corporate characteristics. Therefore, the taxpayers had a "reasonable basis" for Enron Capital Resources' claimed classification as a partnership, and this classification must be respected under current Treas. Reg. § 301.7701-3(f)(2).

Our conclusions herein are based on a Field Service Advice from the National Office dated August 3, 1998. We concur with the Field Service Advice and have conceded the issue.

2/23/99
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Special Trial Attorney

APPROVED:

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MEMORANDUM

Confidential
Attorney-Client Communications

TO: Jordan Mintz

FROM: Morris R. Clark

DATE: September 22, 1999

RE: **Federal Income Tax Treatment of Prepayments**

This memorandum addresses the federal income tax treatment of the receipt of certain prepayment proceeds. In particular, the **Factual Background** provides a brief overview the various Enron Corp. ("Enron") prepayment transactions and how such transactions were historically treated for federal income tax and accounting purposes. The **Short Answer** and **Discussion** provide both a synopsis and a more detailed discussion of the rules governing the **recipient's** treatment of prepayment transactions for federal income tax purposes. The **Discussion** also addresses our recommendations regarding the most tax efficient method of executing future prepayment transactions.

I. Factual Background

By way of background, Enron and its affiliates have entered into approximately $3 billion in prepayment transactions since 1992. Enron's prepayment transactions are generally structured as forward oil or gas sale contracts with a counterparty arranged by a financial institution. Historically, Enron's prepayment transactions have fallen into two categories: (i) taxable income accelerated ("TIA") prepayments – that is, prepayments where Enron needed to accelerate the recognition of income in order to take advantage of particular tax attributes; or (ii) strategic cash flow payments, where Enron entered into a prepayment simply as a means to generate cash flow. (In addition, Enron has, on one isolated occasion, entered into a commercial prepayment with an industry participant).

As alluded to above, Enron has elected to treat the TIA prepayment proceeds -- which originated from the 1992 and early 1993 prepay transactions -- as taxable income in the year of receipt in order to take advantage of certain Internal Revenue Code ("Code") § 29 tax credits available in those years. However, Enron elected to defer the recognition of income from the later strategic prepayment transactions because it had no desire to accelerate taxable income in those later years. Typically, once a taxpayer elects to either accelerate or defer recognition of prepayment proceeds, such election becomes irrevocable absent the express consent of the Internal Revenue Service ("Service"). However, Enron was able to both accelerate and defer recognition of certain prepayment proceeds by using separate entities to effectuate certain transactions. (<u>See</u> **Discussion - Section C**, below for a discussion of the particular elections made by the various Enron entities).

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For financial accounting ("book") purposes, prepayment transactions are generally treated as a component of Enron's price risk management liability[1] and income (including an interest component) is recognized as the "commodity" is delivered to satisfy the prepayment. (See **Attachment A** for a summary of the book/tax treatment of the various prepayment transactions).

II. Issue Presented

What is the proper treatment of Enron's receipt of prepayment or advance payment proceeds for federal income tax purposes?

III. Short Answer

Briefly stated, prepayments or advance payments[2] relating to non-inventoriable goods (goods not properly includible in the inventory of the taxpayer) must be included in the income of the recipient in either: (i) the taxable year of receipt; or (ii) the taxable year in which such prepayment would be properly accruable under the taxpayer's method of tax accounting, provided such method results in income being recognized no later than the time such payments are included in gross income for financial reporting purposes.

For example, a typical accrual method taxpayer would recognize income no later than year of receipt. However, manufacturers can use a modified accrual method which allows income recognition to be deferred until the goods are shipped, delivered or accepted. Furthermore, under certain limited circumstances, an accrual basis taxpayer can recognize proceeds received to modify certain "take or pay" contracts into income ratably over the life the contract.

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[1] Although the prepayment is treated as price risk management liability for financial accounting purposes, it is our understanding that the transaction is not treated as debt for credit rating purposes; rather, the prepayment is viewed as part of Enron's overall price risk management activity. Once the prepayment transaction is executed the commodity volumes that will be delivered in the future are recorded on the Company's commodity risk books. Since such books are accounted for under the mark-to-market method of accounting, the prepay transaction ultimately results in the recording of a mark-to-market liability; however, once the prepay transaction is recorded on its risk books, Enron, if necessary, will then enter into a financial swap to hedge the price and basis exposure associated with the prepay liability.

[2] The terms "prepayment" and "advance payment" are synonymous and are used interchangeably. Simply put, advance payments or prepayments are defined as any amount which is received in a taxable year by a taxpayer using an accrual method of accounting and such amount is made pursuant to an agreement for the sale of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business and such agreement is not completed within the taxable year. Treas. Reg. § 1.451-5(a)(1)(i). For consistency purposes, such payments will be referred to as "prepayments".

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Notwithstanding the above, however, special rules relating to prepayments for inventoriable goods (e.g. gas, power[3] and other commodities) provide that such prepayments must be included in the recipient's income no later than the second taxable year following the receipt of a "substantial advance payment" -- effectively resulting in a two year deferral of income recognition. In the event that prepayment proceeds are taken into income in the second taxable year under the inventoriable goods exception, then the taxpayer must take into account the estimated cost of goods necessary to satisfy the agreement in the second taxable year. As a result, only the net prepayment amount will be subject to tax in the second year following receipt.

Generally, Enron's prepayment transactions involve goods held in inventory (e.g. oil or natural gas) and, as such, fall under the inventoriable goods exception. However, it should be noted that Enron does not have to defer recognition of the income; rather, it could choose to accelerate the recognition of income in the year of receipt as Enron has done historically with TIA prepayments. Although Enron could choose to recognize income in the year of receipt, it could defer recognition of the related cost of goods sold over time as product is delivered – thus creating, if needed, a significant mismatching of income and expense. (See **Discussion – Section B-1**).

IV. Discussion

A. Overview of Timing Rules

1. General Rule for Taxable Year of Inclusion

Generally, receipts should be included in gross income in the year in which they are actually or constructively received by the taxpayer, unless such receipts should be included in a different year in accordance with the taxpayer's method of tax accounting. Treas. Reg. § 1.451-1(a). For instance, under an accrual method of accounting, income is included in gross receipts **when all the events have occurred** which fix the right to receive such income and the amount of such income can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii). "All events" are normally deemed to occur at the earlier of when: (i) the required performance under the contract occurs; (ii) payment is due; or (iii) payment is made. (See Rev. Rul. 74-607, 1974-2 CB 149 where the Service applied the above rule to the accrual of interest and held that interest should be included in income ratably over the life of the loan since performance, i.e. making of the loan, occurred before payment).

[3] Although the Service has not explicitly addressed whether power should be considered inventory for purposes of the prepayment rules, the Service has held that electricity is an inventoriable good in several non-prepayment contexts. For example, Technical Advice Memorandum 9523001 held that the taxpayer (an independent power producer – "IPP" or qualifying facility – "QF") must use the accrual method of accounting because electricity was inventoriable merchandise. See also Private Letter Ruling 961004 (holding that capacity payments made by an electric utility to a QF should be included in the utility's electricity inventory costs).

In addition to these general accrual rules, a taxpayer engaged in a manufacturing business may account for sales under a modified accrual method where taxable income is recognized when either: (i) the goods are shipped; (ii) the product is delivered or accepted; or (iii) title to the goods passes to the customer. Treas. Reg. § 1.446-1(c)(2)(C). Although a taxpayer using a modified accrual method has some flexibility regarding the timing of income recognition, the accrual method selected must clearly reflect income and must be consistently used by the taxpayer from year to year. Id. In that event, income realization may be pushed out a bit further.

The interaction of the general accrual rules with the modified accrual method can be illustrated by the following example:

> S, a manufacturer, uses the traditional accrual method for tax and financial accounting purposes. S has a contract with B which calls for S to provide 100 widgets to B each month. S usually ships the widgets to B on the 20th of each month. S also bills B on the 20th of each month with payment due by the 30th of each month. B typically receives the goods 7 days after shipping (when title passes) and has 5 days to inspect and accept the goods. Under the traditional accrual method of accounting, "all events" would occur when the required performance under the contract occurs -- that is on the 20th, the shipping date. However, if S used a modified accrual method, S could choose to recognize income when the widgets are accepted -- 12 days after the shipping date.

Thus, as a manufacturer, the taxpayer can elect to defer recognition of income until after the shipping date provided that its method of accounting is both consistent and clearly reflects income.

It should also be noted that in certain circumstances, the Service has allowed a limited exception to the "all events" test with regards to certain "take or pay" or other similar payments. Under this exception, an accrual basis taxpayer may be able to defer recognition of proceeds if the payment is made to modify an existing contract rather than terminate such contract. In these limited circumstances, the Service will allow the taxpayer to take the modification payment into income over the life of the modified contract. For example, the tax accounting rules relating to "take or pay" contracts has been invoked in certain prepay transactions involving the restructuring of power purchase agreements ("PPAs") between utilities and IPPs located in the Northeast United States (e.g. Connecticut Light & Power/AES and New England Power/Haverhill recently entered into PPA modifications structured as prepayments). (See **Discussion - Section A-2-b,** below for further discussion of the tax treatment of the recent IPP restructurings).

2. Rules Governing Prepayments

(a) *General Rule*

In addition to the all events test, there are two special rules governing taxable income

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recognition of prepayment proceeds. The first rule, the general prepayment rule, governs prepayments for **non-inventoriable goods** (e.g. relating to an agreement for the sale of goods that are not includible in the taxpayers inventory). It provides that a prepayment should be included in income in either:

(i) the taxable year of receipt;

(ii) the taxable year in which properly accruable under the taxpayer's method of accounting (provided that such method does not result in including prepayments in income later than the time such payments are included in gross receipts for financial reporting purposes); or

(iii) if the taxpayer's method of accounting does result in including prepayments in gross receipts for financial reporting purposes earlier than for tax purposes, then in the taxable year that such payments are included in gross receipts for financial reporting purposes. Treas. Reg. § 1.451-5(b).

Thus, in a non-inventory prepayment, the recipient can either recognize prepayment proceeds in the year received or defer recognition under an accrual method (e.g. a manufacturing company would be able recognize income under an accrual method as goods are shipped or delivered) provided that such deferral does not result in income being recognized later than for financial reporting purposes.

The general prepayment rules can be illustrated by the following example:

> S, a retailer, for tax and financial accounting purposes, follows an accrual method of accounting under which it accounts for its sales when the goods are shipped. S receives an advance payment for such goods. Such advance payment must be included in gross receipts for tax purposes either in the taxable year the payments are received or in the taxable year such goods are shipped.

Thus, as a retailer, the taxpayer can defer recognition of the prepayment proceeds for tax purposes until the taxable year that the goods are shipped, provided that such income is not recognized any earlier for financial accounting purposes.

(b) *Contrast with Loan Treatment*

The above example assumes that the prepayment will be settled by delivering the physical commodity. This is important because, by definition, a prepayment must be made pursuant to an agreement for the sale of goods. (See footnote 2, above). As such, the prepayment transaction must actually provide for the sale of the underlying physical commodity. A purported prepayment transaction that merely requires the prepayment recipient to pay a specific amount of money based on the notional principal amount of an indexed commodity would be analyzed as a loan for federal income tax purposes. Notwithstanding the sale of goods requirement, a prepayment recipient can arrange to market or sell the underlying physical commodity on behalf of the counterparty as long as the actual cash proceeds from such sale are remitted to the counterparty. Furthermore, unlike a loan, the counterparty must assume the price risk of the sale – that is, the prepayment recipient cannot guarantee a certain return from the actual sale of the commodity.

It should also be noted that a production payment, another financing vehicle commonly used in the energy industry, is statutorily required to be treated as a loan for tax purposes. (See Code § 636). As such, a production payment does not have to undergo the same structural guidelines as a prepayment in order to obtain favorable tax treatment, ie. loan or deferral.

(c) *Exception for Prepayments Relating to Inventory Goods*

Notwithstanding the general prepayment rule, if an accrual basis taxpayer receives a prepayment with respect to an agreement for the sale of goods that are properly includible in its inventory (e.g. commodities) and on the last day of such taxable year:

(i) the taxpayer has goods on hand (or available through normal sources of supply) to satisfy the agreement in such year; and
(ii) the taxpayer has received "substantial advance payments" [4] under such agreement,

then **all prepayments received by the last day of the second taxable year following the year in which such "substantial advance payments" are received (and not previously included in income in accordance with the taxpayer's accrual method of tax accounting) must be included in income in such second taxable year.** However, such deferral cannot result in a taxpayer recognizing income later than for financial reporting purposes. Treas. Reg. § 1.451-5(b)(ii) and (c). As such, this two year deferral is not available if Enron recognizes prepayment income under the mark-to-market method of accounting for financial reporting purposes.

In the event that prepayments are required to be taken into income under the inventoriable goods exception, then the taxpayer must take into account the estimated cost of goods necessary to satisfy the agreement.[5] As such, only the net prepayment amount will be subject to tax in the second year following receipt.

[4] "Substantial advance payments" are deemed to exist if the sum of all prepayments equal or exceed the total estimated costs and expenditures necessary to satisfy the agreement. Treas. Reg. § 1.451-5(c)(3). The substantial advance payment rules can be illustrated by the following example: X enters into a prepayment contract for the sale of goods over a five year period for a total contract price of $100. X estimates that his total inventoriable costs and expenditures for the goods will be $50. X receives a "substantial advance payment" in the year that he receives $50 or more under the contract, determined in the aggregate.

[5] However, it should be noted that a taxpayer only has to take into account the estimated cost of goods sold if the taxpayer has elected to defer the recognition of income under the inventoriable goods exception. For

The inventoriable goods prepayment exception can be illustrated by the following example:

> S, a retailer, uses for tax and financial accounting purposes an accrual method of accounting under which it accounts for its sales when the goods are shipped. During 1998, S receives an advance payment for goods currently held in its inventory in the amount of $100. These goods will be shipped over three years from 2001 through 2003. The estimated cost of such goods is $50. Under the non-inventory prepayment rules, S could elect to defer recognition of the prepayment proceeds until the goods are shipped – in years 2001, 2002, and 2003. However, under the inventoriable goods exception, S could only defer recognition of the prepayment until the second taxable year following receipt - or in year 2000. However, S would be able to take into account the estimated cost of the goods ($50) such that S would only take into account $50 of income in year 2000.

(d) *Taxable Income Accelerated Prepayments*

As noted above, the prepayment timing recognition rules allow a taxpayer the flexibility to elect to either: (i) recognize prepayment proceeds in the year of receipt; or (ii) defer recognition of the prepayment proceeds until a later tax year (no later than the second taxable year following receipt of the proceeds for an inventoriable goods transaction). Treas. Reg. § 1.451-5(b) and (c). Thus, a taxpayer who elects to recognize the prepayment proceeds in the year of receipt effectively elects out of the complicated deferral regime of Treas. Reg. § 1.451-5. (See Treas. Reg. § 1.451-5(b) and (c)(ii)).

By effectively electing out of the § 451-5 deferral rules, a taxpayer who recognizes prepayment proceeds in the year of receipt does not have to take into the estimated cost of goods sold on an accelerated basis. Rather, the taxpayer would recognize the cost of goods sold over time as product was delivered under traditional accrual principles – thus creating a significant timing mismatch.

By way of summary, if the prepayment relates to non-inventoriable goods, S would have to either: (i) recognize the prepayment proceeds in taxable income in the year of receipt; or (ii) defer recognition under an accrual method (e.g. S recognizes income as goods are shipped or delivered). On the other hand, prepayment proceeds for inventoriable goods should be included in S' taxable income no later than the second year after receipt of payment.

In light of recent developments in the power industry, it is also important to note that several recent PPA modifications were structured as prepayments for non-inventoriable goods. The IPPs have claimed that power was not an inventoriable good because of their status as QFs for federal energy regulatory purposes. As a QF, power can only be

instance, a taxpayer who elects to recognize the prepayment proceeds in the year of receipt would recognize the cost of goods sold over time under normal accrual rules. (See **Discussion – Section A-2-d**, above).

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supplied from limited sources – mainly from itself or other QFs. As such, the IPPs contended that: (i) they did not currently have the power on hand; and (ii) the power was "not readily available" because it could not get the power on the open market due to regulatory limitations. However, in discussing this approach with outside counsel, the IPP's position was considered very aggressive because their reliance on federal regulatory interpretations are not binding on the Service.

B. Enron Prepayment Transactions

As noted at the outset of this memorandum, Enron has been involved in approximately $3 billion in prepayment transactions since 1992. Historically, Enron's prepayment transactions have fallen into two categories: (i) taxable income accelerated ("TIA") prepayments -- that is, prepayments where Enron needed to accelerate the recognition of income in order to take advantage of certain tax credits or losses; or (ii) strategic cash flow prepayments, where Enron has entered into a prepayment simply as a means to generate significant cash flow. (In addition, Enron has, on one isolated occasion, entered into commercial prepayments with an industry participant. However, this prepayment transaction has been completed and product is no longer being delivered pursuant to such transaction.)

The appropriate Enron entities that should be used to effectuate the various prepayment transactions is discussed in **Discussion - Section C,** below.

1. Taxable Income Accelerated Prepayments

Enron entered into three TIA prepayments during 1992 and 1993. (See **Exhibit B** for a list of prepayment transactions). These prepayments were entered into primarily as a means for generating taxable income in order to take advantage of § 29 credits generated by EOG which, at that time, was part of Enron's consolidated group. By way of overview, § 29 credits are used against regular tax liability, but cannot be used against the alternative minimum tax ("AMT"). Further, the Code does not authorize § 29 credits to be carried forward and, as such, a taxpayer loses the benefit of the credits if it does not have sufficient regular taxable income. (However, such credits would be added to the taxpayer's AMT credit carryforward). Therefore, Enron had to create regular taxable income to realize the benefit of the credits, thereby helping to reduce its effective tax rate.

The TIA prepayments were typically structured as forward oil sale contracts with a counterparty arranged by a financial institution (Chase Manhattan or Citibank), whereby the counterparty would make a significant up-front payment in exchange for Enron's obligation to deliver oil on a monthly basis over a 3 to 4 year period.[6] Since Enron holds oil in its inventory, these prepayment transactions were subject to the inventoriable goods exception which requires income to be recognized in either the year of receipt or deferred

[6] Typically, the financial institution counterparty does not actually take delivery of the oil or gas over the term of the prepayment. Instead, Enron will act as a marketer for the counterparty and sell the agreed upon volume of oil or gas in the open market and pay the proceeds from such sale to the counterparty.

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for a period no longer than two years. Again, in order to use the § 29 credits, Enron elected to recognize the proceeds from these prepayments in the year of receipt.

It should also be noted that since Enron elected to accelerate the recognition of income, it did not have to take into account the estimated costs of goods sold on an accelerated basis. Treas. Reg. § 1.451-5(c)(ii). Rather, Enron was able to recognize the cost of goods sold over time as product was delivered (under normal accrual methodology) – a timing mismatch that worked in Enron's favor since it needed to produce as much taxable income as possible during the tax years at issue.

For financial accounting purposes, the TIA prepayments are essentially treated as deferred revenue (a component of the price risk management liability) and income (with an interest component) is recognized under an accrual model over time as the product is delivered in satisfaction of the prepayment. The transaction is not treated as traditional debt for accounting and credit rating purposes, but rather, the prepayment is viewed as a part of Enron's overall price risk management activity. (See footnote 1, above).

2. Strategic Cash Flow Prepayments

The majority of Enron's prepayments have been structured as strategic cash flow prepayments and we anticipate additional prepayments this year. Rather than entering into these prepayments to manage our tax situation, these prepayments were entered into primarily as a means of generating cash flow for Enron. These strategic prepayment transactions were typically structured as either forward oil sale contracts or natural gas forward sale contracts with a counterparty arranged by a financial institution (Chase Manhattan), whereby the counterparty would make a significant up front payment in exchange for an Enron obligation to deliver oil or natural gas on a monthly basis over a period of several years (3-6 years). As previously explained, after EOG was deconsolidated from the Enron group, there was less of a need to generate regular taxable income to use § 29 credits. As a result, Enron elected to defer recognition of these prepayment proceeds. However, since both natural gas and oil are carried in Enron's inventory, these prepayments fall under the inventoriable goods exception and, as such, gain recognition may only be deferred for a period of two years after the year of receipt. (See **Discussion - Section A-2**, above).

For financial accounting purposes, the cash flow prepayments are treated as a component of Enron's price risk management liability with income, including an interest component, recognized over time as the product is delivered in satisfaction of the prepayment. However, the prepayments are not treated as traditional debt for balance sheet purposes, but rather, are treated as a fixed price commodity contract as part of Enron's overall price risk management activity.

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3. Commercial Prepayments

Enron entered into one commercial prepayment in 1992. This prepayment was not entered into for tax or cash management reasons, but was merely entered into as a part of an underlying commercial transaction. This transaction was structured as forward oil sale contract with Texas Utilities Fuel Co. ("Tufco") as the counterparty. The prepayment amount was considerably smaller than any of the other accelerated or strategic prepayments. Since oil is an inventoriable good with respect to Enron, it could either recognize the prepayment income in the year of receipt or elect to defer recognition of such income for period not to exceed two years. However, because EOG had § 29 credits readily available in 1992, Enron, nevertheless, elected to accelerate the recognition of the Tufco prepayment proceeds.

Again, for financial accounting purposes, commercial prepayments are treated as a part of Enron's price risk management liability with income, including an interest component, recognized over time as the product is delivered. However, the prepayments are not treated as traditional debt for balance sheet or credit rating purposes.

C. Enron Prepayment Entities

As stated earlier, a taxpayer who receives prepayment proceeds has the option of either recognizing income in the year of receipt or deferring recognition until a later year. Although the taxpayer does not have to make an affirmative election on any particular tax form, the taxpayer must include an annual information schedule with its income tax return reflecting: (i) the particular recognition method used; (ii) the amount of prepayment proceeds recognized in the current year; and (iii) the total amount of payments received but not yet recognized. Treas. Reg. § 1.451-5(d). (See **Attachment C** for a copy of the annual information statement that is filed with Enron's consolidated tax return).

Once a taxpayer elects to either include prepayment proceeds in the year of receipt or to defer recognition until a later year, such tax treatment becomes the taxpayer's method of accounting for prepayments. The consequence of a prepayment election becoming a method of accounting is that the taxpayer cannot change such method of accounting without consent from the Service. Treas. Reg. § 1.446-1(e).

1. Entities Electing to Include Prepayments In Year of Receipt

The Enron entities used to facilitate the accelerated prepayments were Enron Reserve Acquisition Corp. ("ERAC"), Enron Power Services ("EPS") and EGS Hydrocarbon Corp. ("EGS"). ERAC and EPS made the accelerated recognition election in 1992, while EGS made its election in 1993.

At the end of 1994, EPS was merged (along with several other entities) into Enron Risk Management Services ("ERMS") as part of the "mega-merger" that created Enron Capital

& Trade Resources Corp. ("ECT"). Thus, under the tax attribution rules of Code § 381, ECT (and now Enron North America Corp. – "ENA") must continue to use the prepayment accounting method of EPS under the "principal accounting method test". Treas. Reg. § 1.381(c)(4)-1(c)(2)(iv). As such, ECT has effectively elected to accelerate the recognition of any prepayment proceeds. Thus, although ECT may be the preferred entity to effectuate prepayment transactions from a commercial or legal perspective (since the counterparty may already have a master swap agreement in place with ECT or because the counterparty otherwise has familiarity with ECT from other commercial deals), ECT may not be the preferred entity from a tax perspective (See discussion of recommended entities in **Discussion - Section D** below).

2. Entities Electing to Defer Recognition of Prepayments

The Enron entities used to facilitate the strategic prepayments were Enron Hydrocarbons Marketing Corp. ("Hydrocarbons"), Enron Cushing Oil Marketing, Inc. ("Cushing Oil") and Enron Natural Gas Marketing ("ENGM"). As stated earlier, these entities elected to defer recognition of prepayment proceeds because there were no readily available tax credits to justify accelerating the recognition of taxable income. Hydrocarbons' election was made in 1993[7], Cushing Oil's election was made in 1994, and ENGM's election was made in 1995.[8] ENGM continues to have 1997 prepayment proceeds that have not been fully recognized as income.

D. Future Prepayment Transactions

1. TIA Prepayments

As noted above, TIA prepayment transactions are entered into to generate taxable income to offset expiring tax attributes (tax credits or net operating losses). As such, these transactions should be effectuated with an entity that has elected to recognize prepayment proceeds in the year of receipt. It is recommended that ENA be used for any future TIA prepayments.

In light of the current focus on utilizing the Enron consolidated net operating loss ("NOL"), all future prepayment transactions (particularly year-end 1999 transactions) should be examined to determine whether it is feasible to recognize such prepayment proceeds in the year of receipt.

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[7] It should be noted that Hydrocarbons entered into prepayment transactions with Chase in both 1993 and 1994. Although Treas. Reg. § 1.451-5 requires that all remaining income from the 1994 prepayment transaction (as well as the estimated remaining cost of sales) should have been recognized in 1996, such amounts were not reported in 1996. Rather, such amounts have been reported as deliveries are made. This prepayment is scheduled to expire in 1999.

[8] From 1993 to 1996, Enron created a new entity every year to effectuate its prepayment transactions. The new entities were created to isolate the particular transactions and in order to make the desired deferral election – which typically was not known until some time after the transaction was consummated.

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2. Financial Prepayments

Financial prepayments are entered into as a means of generating strategic cash flow. Since these transactions do not involve the utilization of offsetting tax attributes, financial payments should be effectuated with an entity that elects to defer recognition of prepayment proceeds. As such, ENGM should continue to be the entity used for all future strategic prepayment transactions.

Notwithstanding the above, however, there may be a number of circumstances where ENA is the preferred entity from a commercial or legal perspective (ie. ENA already has a master agreement in place with the counterparty or the counterparty would prefer to deal with ENA because of familiarity). In the event that commercial realities mandate that ENA act as the prepayment entity, we will consider whether it is feasible to change ENA's prepayment accounting method and use it for these transactions.

3. Commercial Prepayments

As noted above, commercial prepayments are entered into as part of an underlying commercial transaction. Although we have rarely entered into commercial prepayments, it is anticipated that we may have opportunities to enter into more of these transactions in the future. For financial accounting purposes, these transactions are currently treated as deferred revenue. However, there have been ongoing discussions regarding whether commercial prepayments can be accounted for under MTM. In the event that MTM is used for future prepayment transactions then, regardless of the entity used to effectuate the transaction, proceeds from commercial prepayments must be taken into taxable income no later than the time such income is recognized for financial accounting purposes – or the year of receipt for MTM income.

V. Conclusion

Generally, an accrual basis taxpayer must include income in gross receipts when all events have occurred which fix the right to receive such payment and the amount of income can be determined with reasonable accuracy. However, pursuant to special prepayment rules, **all non-inventory prepayment proceeds should be included in income in either the taxable year of receipt or defer recognition under an accrual method** (e.g. recognize income as goods are shipped or when goods are delivered) provided that such deferral does not result in income being recognized later than for financial reporting purposes.

In the case of prepayments relating to inventoriable goods, **the taxpayer must recognize taxable income from the prepayment no later than the second year after receipt** provided the prepayment constitutes a "substantial advance payment" and the taxpayer has goods on hand (or available through normal sources) to satisfy the commodity

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contract. Again, this two year deferral is only available if such deferral does not result in income being recognized later than for financial reporting purposes. It should also be noted that due to this two year limitation, structuring a transaction as a loan rather than a prepayment (e.g. production payment) may be more advantageous to the recipient.

Enron has effectively elected to accelerate the recognition of income related to prepayments executed by ECT. As such, we should be careful to avoid using ECT (or now, ENA) as the counterparty for any future prepayment transactions until we further consider whether ENA can change its prepayment accounting method, or until we determine that the tax consequences should be accelerated to utilize the NOL. Rather, Enron should continue to use ENGM to effectuate future prepayment transactions so that we defer recognition of proceeds until after receipt. However, in light of circumstances where ECT is the preferred counterparty from a commercial or legal perspective, we may want to consider the feasibility of changing ECT's prepayment accounting method.

MRC

Attachment A

TAXATION OF PREPAYMENTS

Outline of Book/Tax Treatment

I. Financial Prepayments

A. Book Treatment

- Treated as deferred revenue and income recognized over time as product is delivered to satisfy the prepayment; also has an interest component
- Not treated as debt on balance sheet but is treated as a price risk management liability

B. Tax

- Election to defer under accrual method
- Inventoriable goods exception would limit the deferral to the second taxable year following the year of receipt (2 year deferral)
- Also takes into account the estimated cost of goods, thus resulting in reporting of net revenue

II. Commercial Prepayments

A. Book Treatment

- Treated as deferred revenue and income recognized over time as product is delivered to satisfy the prepayment; also has an interest component
- Discussions ongoing regarding recognition under MTM

B. Tax

- Election to defer under accrual method
- Inventoriable goods exception would limit the deferral to the second taxable year following the year of receipt (2 year deferral)
- Also take into account the estimated cost of goods

IF MTM is adopted for future transactions:

- Must take into income no later than the year taken into income for financial accounting purposes (*Ie*. Year 1 for MTM)
- Must take gross revenue into account
- Cost of goods are taken into account as product is delivered thereby potentially creating a substantial timing difference

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III. Taxable Income Accelerated Prepayments

A. Book Treatment

- Treated as a loan and income recognized over time as product is delivered to satisfy the prepayment; also has an interest component
- Not treated as debt on balance sheet

B. Tax

- Recognize proceeds in income in year of receipt
- Must take gross revenue into account
- Cost of goods are taken into account as product is delivered thereby potentially creating a substantial timing difference – which is a positive from a tax acceleration standpoint

Attachment B

Enron Capital & Trade Resources Corp.

Schedule of Prepayments

Enron Company Name	Prepay Counterparty	Contract Date		Amount ($)	Taxed in Year of Receipt?
Enron Reserve Acquisition Corp.	Chase Manhattan & Bankers Trust	1992		$ 225,309,396.00	Yes
Enron Power Services, Inc.	Tufco	1992		$ 35,000,000.00	Yes
Enron Hydrocarbons Marketing Corp.	Chase Manhattan	1993		$ 230,006,022.00	No
EGS Hydrocarbon Corp.	Citibank	1993		$ 149,887,713.00	Yes
Enron Hydrocarbons Marketing Corp.	Chase Manhattan	1994	(1)	$ 207,901,069.00	No
Enron Cushing Oil Marketing, Inc.	Chase Manhattan	1994		$ 124,951,430.00	No
Enron Natural Gas Marketing	Chase Manhattan	1995		$ 224,440,450.00	No
Enron Natural Gas Marketing	Chase Manhattan	1996		$ 224,233,880.00	No
Enron Natural Gas Marketing	Chase Manhattan	1996		$ 124,549,095.00	No
Enron Natural Gas Marketing	Chase Manhattan	1997		$ 299,991,679.00	No
Enron Natural Gas Marketing	Chase Manhattan	1998		$ 249,062,500.00	No
Enron Natural Gas Marketing	Chase - Mahonia	1998		$ 249,619,352.00	No
Enron Natural Gas Marketing	Citibank-Delta/Vega	1998		$ 308,358,349.00	No
Enron Natural Gas Marketing	Citibank-Delta/Vega	1998		$ 190,000,000.00	No
Enron Natural Gas Marketing	American Public Energy Agency	1999		$ 250,000,000.00	
				$ 3,093,310,935.00	

Footnote (1): Tax inadvertently took the prepayment proceeds into income over the life of the prepayment delivery schedule, rather than in accordance with the prepayment rules of Treas. Reg. § 1.451-5.

Enron Corp. And Subsidiaries (47-0255140)
Corporation Income Tax Return
For The Year Ended 12/31/96

<u>Statement Pursuant to Regulation 1.451-5(d)
for Enron Natural Gas Marketing (76-0481290)</u>

Advanced Payments Received 1/1/96 to 12/31/96 Not Taken into Taxable Income Currently	$348,782,975
Advanced Payments Received Prior to 1/1/96 Taken into Taxable Income Currently	$ 49,673,885

DRAFT

Interoffice Memorandum

To: Jim Sandt

From: AnnMarie Tiller and Brent Vasconcellos

Department: Corporate Tax Planning

Subject: Enron Credit Linked Notes Due 2005

Date: April 10, 2001

Background

On August 25, 2000, at the direction of the Enron Global Finance department, Enron North America ("ENA," a wholly-owned subsidiary of Enron Corp.) borrowed a total of $499,995,000 from Citibank N.A. ("Citibank") in a transaction that took the form of a $474,995,000 prepaid swap (the "Swap") and in a related transaction, Enron Corp. borrowed $25M from Citibank in the form of a direct loan. (ENA and Enron Corp. are hereafter referred to in the aggregate as "Enron.") To the extent the borrowing is characterized as a Swap, it appears on Enron's financial statements as a price risk management liability rather than a loan. The format is beneficial to Citibank as well because the transaction is reported as part of the bank's credit derivative activities rather than as a loan to Enron. **[Travis Winfrey is checking into whether the $5,000 difference is attributable to fees or a trading spread paid to Delta under the Swap or an error.]**

In order to avoid utilizing Citibank's limited capacity for Enron credit, Citibank and Enron designed the Swap to be part of a larger contemporaneous transaction which had the result of transferring Citibank's Enron credit risk related to the Swap over to investors who purchased the securities of a special purpose trust established on August 11, 2000 by Citibank called the Enron Credit Linked Notes Trust (the "Trust").

Trust Notes

At the same time that ENA and Citibank entered into the Swap, the Trust issued $500M 8.00% Enron Credit Linked Notes due 2005 (the "Notes") in a 144A offering and $50M 9.00% Trust Certificates (the "Certificates") to one entity, the Royal Bank of Canada Europe Limited ("RBC"). The certificates in the Trust represent beneficial interests in the Trust and are subordinate in right of repayment to the Notes. [The Trust is also prohibited under the Indenture Agreement from creating, assuming, or incurring any further indebtedness.] As discussed further below, since the Trust has only one owner, the Trust is disregarded for federal income tax purposes and is treated as a branch of RBC.

The Notes issued by the Trust are debt for federal income tax purposes. Enron's obligation under the "Swap" and the Trust's obligation to repay the principal amount of the Notes, along with any accrued and unpaid interest, both come due on August 15, 2005 to the extent the Notes have not been redeemed, accelerated, or repaid prior to that date. The interest accruing on the principal amount of the Notes at a rate of 8.0% is payable semi-annually in arrears on February 15 and August 15 of each year starting on February 15, 2001.

The Notes were issued at a slight discount of 99.827% to their stated redemption price at maturity or face amount giving rise to proceeds of $499,135,000. The discount of $865,000 falls below the de minimis threshold of Section 1273(a)(3) ($6,250,000 computed as .0025 x $500,000,000 x 5 years) and, thus, can be treated as zero.

The Noteholders are part of a group called the "Secured Parties" who receive protection under a Collateral Security Agreement that provides them with a security interest in all of the assets of the Trust. Citibank is also a Secured Party although the bank's rights are superior to the rights of the Noteholders in all of the collateral except as to a credit swap running between Citibank and the Trust (the "Credit Swap") and any Enron Deliverable Obligations that may be delivered under the Credit Swap as described further below.

The Notes were sold to qualified institutional buyers ("QIBs") in the U.S. in reliance on Rule 144A of the Securities Act and to non-U.S. persons in reliance upon Regulation S of the Securities Act. Both sets of Notes were issued in fully registered form without interest coupons. [At least initially, approximately __% of the Notes were sold to domestic holders and approximately ___% of the Notes were sold to non-US holders.]

Trust Investments

The $550M in proceeds from the sale of the Notes and the Certificates must be used by the Trust to invest in a select group of investments (the "Trust Investments") defined to include (1) time deposits, promissory notes, and commercial paper of certain U.S. money center banks; (2) promissory notes of, or guaranteed investment contracts from, certain insurance companies; or (3) direct obligations of the United States government as long as the Trust Investments represent no more than nine separate obligors and each Trust Investment is scheduled to mature on or before the maturity date of the Notes. No Trust Investment may be purchased at a premium and no existing Trust Investment may be sold at a discount unless in default. At least initially, the Trust used the entire $550M in funds received from the issuance of the Notes and Certificates, and as discussed below, from a one-time payment under the Credit Swap, to acquire a certificate of deposit issued by Citibank and carrying an interest rate of 6%.

The Trust obtains the funds necessary to pay interest on the Notes and yield on the Certificates from periodic payments received by the Trust from Citibank under the Credit Swap as described below.

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Credit Swap.

The Trust and Citibank entered into the Credit Swap that provides for certain periodic payments and, upon an Enron Credit Event, calls for physical settlement of all or part of the Credit Swap. On a periodic basis as the Trust receives interest payments on the Trust Investments, the Trust delivers those funds to Citibank. On each February 15 and August 15, starting on February 15, 2001, Citibank is required to pay the Trust an amount equal to the interest accrued on the outstanding Notes and the yield on the Certificates.

In the absence of an Enron Credit Event, the Trust will repay the principal amount of the Notes and the Certificateholder's investment from the principal proceeds of the Trust Investments. If an Enron Credit Event should occur (defined to include an Enron failure to pay under the Credit Swap as well as the general condition of Enron being either insolvent or bankrupt), the Credit Swap permits Citibank to physically settle the Credit Swap by delivering to the Trust certain senior unsecured obligations of Enron called Enron Deliverable Obligations in exchange for a like amount of Trust Investments then held by the Trust. In this event, the principal amount of the Notes would be repaid from any proceeds recovered from any of the Enron Deliverable Obligations received by the Trust and any remaining Trust Investments then held by the Trust.

On the closing date of August 25, 2000, Citibank made a one-time payment under the Credit Swap to the Trust of $865,000, an amount representing the discount on the Notes. This additional amount when added to the $499,135,000 in proceeds received on the sale of the Notes and $50M received on the sale of the Certificates equaled the $550M amount required to be invested in Trust Investments on the Closing Date and serve as security for the Noteholders and Certificateholders during the 5-year tenor of the deal. Citibank received the $865,000 by reducing the proceeds delivered to Enron under the Debt Security from the $25M face amount to $24,135,000.

Trust Certificateholder
Certificateholders in the Trust are restricted to U.S. persons within the meaning of Section 7701(a)(3) or non-U.S. persons who can supply an executed Form W-8ECI or W-8BEN claiming the benefits of a treaty that provides for no withholding of U.S. tax with respect to payments to the Certificateholder. Certificateholders cannot exceed a number that directly or indirectly exceeds the 99-person threshold of the publicly traded partnership rules of Section 7704. Similarly, a Certificateholder must represent, warrant, and covenant that it has not and will not transfer any Certificate on or through an established securities market within the meaning of Section 7704(b)(1).

The Trust Agreement acknowledges that if there is more than one Certificateholder, then the Trust will be a partnership but as long as there is a single Certificateholder, the Trust will be disregarded within the meaning of Reg. 301.7701-3(b)(1)(ii). As the sole owner of the Trust, RBC will be treated as owning everything the Trust owns, including the $550M Citibank certificate of deposit and the Trust's rights and obligations in a notional principal contract with Citibank.

RBC will recognize ordinary income in each calendar year equal to the interest accrued on the Trust Investments and periodic payments received by Citibank under the Credit Swap. *See* Reg. Section 1.446-3(e). RBC will deduct the expenses of the Trust, the periodic payments made by the Trust to Citibank under the Credit Swap, and interest paid out to the Noteholders. [RBC will also recognize over the five year tenor of the deal the upfront $865,000 payment received from Citibank by amorting the amount .... Was the parenthetical in Section 10.9(a)(iv) stating "the Trust shall not be deemed to have paid any amount for the right to enter into the Credit Swap" intended to address this last minute change?]. *See* Reg. Section 1.446-3(f).

EC 000850724

Prepaid Swap and Direct Loan
References herein to the prepaid swap or the "Swap" are actually references to the combination of two contemporaneous cash-settled commodity swaps. The first such swap between Enron and Citibank is a cash-settled commodity swap on 22,238,748 barrels of crude oil. In return for an up-front payment of $439,677,103 from Citibank, Enron is obligated to make (1) floating payments to Citibank each January 14 and July 14 based on the NYMEX spot price for 568,024 barrels of crude at the closing price three commodity business days prior to the payment date; (2) one up-front floating payment to Citibank based on the NYMEX spot price for 533,312 barrels of crude at the closing price three commodity business days prior to the payment date; and (3) on the final floating payment date, a floating payment to Citibank equal to $475,000,000 or, if less, the NYMEX spot price for 23,238,748 barrels of crude at the closing price three commodity business days prior to the payment date.

The second cash-settled commodity swap runs between Enron and Delta Energy Corp., a Cayman Islands exempt LLC ("Delta") under which Enron will receive an up-front payment of $35,317,897 from Delta. Additionally, over the term of the swap, Delta is obligated to make (1) floating payments to Enron each January 14 and July 14 based on the NYMEX spot price for 568,024 barrels of crude at the closing price three commodity days prior to the payment date; and (2) one up-front floating payment to Enron based on the NYMEX spot price for 533,312 barrels of crude at the closing price three commodity business days prior to the payment date. In consideration for these payments under the second swap, Enron is obligated to make fixed payments of $17,750,750 with an initial fixed stub payment of $16,665,982.

Contemporaneously, Enron borrowed $25M from Citibank in return for a Debt Security calling for semi-annual interest payments payable in arrears with an interest rate of 24.83% from August 25, 2000 to January 14, 2001 and an interest rate of 23.994% thereafter. The Debt Security has a maturity date of July 14, 2005.

The result of the combination of the two swaps and the direct loan is that Enron will receive a net up-front payment of $499,995,000 and Enron must make fixed payments to Delta on January 14 and July 14 of $17,750,750. In five years, Enron must repay a total of $500M to Citibank under the terms of both the swap and the Debt Security.

Note: Commodity swaps generally settle on the fifth day of the month following the payment date. As a result, Enron's obligation to make payments under the Prepaid Swap on January 14 and July 14 are actually settled on February 5 and August 5, respectively. A lead time of 10 days was considered necessary for the obligations of Citibank and the Trust under the Credit Swap and the obligations of the Trust to make interest and yield payments to the Noteholders and Certificateholders all on February 15 and August 15.

U.S. Withholding Taxes

With respect to the Noteholders, the Indenture Agreement provides that the United States Trust Company of New York as Indenture Trustee is responsible for furnishing to the Noteholders and taxing authorities any forms of information required by applicable federal or state law, including, but not limited to appropriate Forms 1099 and/or 1042-S and provide any other such information requested by a Noteholder in order for the Noteholder to prepare its tax returns. The Indenture Agreement further provides that if the Indenture Trustee is required to make a deduction and pay over withholding taxes, no additional amounts will be payable by the Trust in respect of those taxes.

Since all of the Notes are registered bonds, interest payable to non-U.S. holders will qualify for the portfolio interest exemption [upon receipt of the proof of the holders' foreign status]. Section 881(c)(2)(B) and Section 871(h)(2)(B); Reg. Section 1.1441-1(b)(4)(i). Additionally, such payments are exempt from information reporting and backup withholding.....Reg. section 1.6049-5(b)(8); Reg. Section 1.6045-1(g)(1)(i).

If an Enron Credit Event should occur and Citibank physically settles the Credit Swap by delivering Enron Deliverable Obligations to the Trust in exchange for a like amount of Trust Investments then held by the Trust, interest on the Enron Deliverable Obligations will also qualify for the portfolio interest exemption. Section 871(h)(4)(C)(v)(I) and Section 881(c)(4).

With respect to the Certificateholder, no withholding forms should be necessary while the Trust is wholly owned by RBC and is thereby disregarded as a separate entity. If the Trust should become an independent entity for tax purposes, the Trust Agreement provides that the Trust will comply with any withholding requirements and that to the extent the Trust is required to withhold and pay over any amounts to any taxing authority with respect to distributions or allocations to any Certificateholder, any amount withheld will be treated as a distribution of cash and thereby reduce the amount of cash otherwise distributable to the Certificateholder.

Payments by Enron to Delta will qualify for exemption from withholding under Reg. Section 1.863-7(b)(1)....

Federal Tax Reporting.

The Trust Agreement provides that if Trust has more than one Certificateholder and becomes a partnership, Wilmington Trust Company ("Wilmington") as Trustee is responsible for maintaining the books of the partnership and filing such tax returns and making such elections as may from time to time be required as well as delivering Schedules K-1 to each partner. A side letter entered into contemporaneously between Enron Corp. and Wilminington provides that Wilmington will engage Enron Corp. to provide these servies on its behalf. Since the Trust is a disregarded entity for federal income tax purposes, no income tax or information return should be required.

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Enron's rights and obligations under the Swap and the Debt Security with Citibank are for tax purposes the equivalent of a borrowing of $500M with a five year tenor and a fixed rate of interest. In accordance with Reg. Section 1.446-3(g)(2)(iii)(A), the upfront payment together with the principal amount extended under the Debt Security should be amortized by assuming that $[500]M represents ...

For book purposes, Enron will record the upfront payment under the Prepaid Swap in income and record Enron's obligation under the Prepaid Swap as a price risk management expense and liability. For tax purposes, these income and expense entries will be reversed with an M-1 adjustment.

Approximately $[5]M in expenses have been paid to-dated by [Enron Corp.] in connection with the transaction. Enron paid up-front underwriting fees of $1.925M to Salomon Smith Barney and $825,000 to Lehman Brothers. Additionally, Enron is obligated to pay a "balance sheet" fee of 30 basis points per annum to [Salomon Smith Barney] calculated on the $500M principal of the Notes or $1.5M and a [$275,000 fee to RBC as additional compensation for their role as Certificateholder?] [Travis Winfrey is still checking on the annual fee equal to 36 basis points....] [Finally, Enron must also pay approximately $20,000 annually in fees to Wilmington Trust Company as Trustee of the Enron Credit Linked Notes Trust and $25,000 to United States Trust Company of New York as Indenture Trustee.]

These up-front expenses were deducted in calendar year 2000 for book purposes so Enron will make an M-1 adjustment to amortize the expenses for tax purposes over the five year tenor of the transaction. Purely to accomplish a book accounting objective that has no tax implications, the implicit rate of return that Citibank receives under the Swap was set at a rate lower than Enron's cost of funds. When Enron's obligation under the Swap is fair valued starting on the closing date of the transaction at Enron's higher cost of funds rate, Enron will recognize a book (but not a tax) gain that is expected to offset the fees expensed by Enron for book purposes. Enron will make another M-1 adjustment to reverse this and all other fair value or mark-to-market adjustments made for book purposes.

EC 000850726

Interoffice Memorandum

To: Dave Maxey

From: AnnMarie Tiller

Department: Corporate Tax Planning

Subject: Enron Credit Linked Notes Due August 2005

Date: January 12, 2001

On August 25, 2000, at the direction of the Enron Corp. Global Finance group, Enron North America ("ENA") borrowed $475M from Citibank N.A. in a transaction that took the form of a prepaid swap (the "Swap"). Since Citibank's internal credit policy did not allow the extension of any further credit to ENA, Enron Corp. (hereafter referred to in the aggregate along with ENA as "Enron") and Citibank simultaneously entered into a transaction in which the exposure to default by Enron under the prepaid swap will be ultimately borne by investors purchasing securities of a special purpose trust established on August 11, 2000 by Citibank as initial depositor called the Enron Credit Linked Notes Trust (the "Trust").

Trust Notes and Certificates.
At the same time that ENA and Citibank entered into the prepaid swap, the Trust issued $500M in notes (the "Notes") in a 144A offering and $50M in trust certificates (the "Certificates") to one entity, the Royal Bank of Canada ("RBC"). Since the Trust has only one owner, the Trust is disregarded for federal income tax purposes and is treated as a branch of RBC. See Reg. 301.7701-3(b)(1)(ii). The Notes issued by the Trust will be treated as debt for federal income tax purposes. (See tax opinion from Milbank, Tweed, Hadley & McCloy, LLP in the Offering Memorandum dated August 17, 2000.)

Enron's obligation under the "Swap" and the Trust's obligation to repay the principal amount of the Notes, along with any accrued and unpaid interest, both come due on August [15], 2005 to the extent the Notes have not been redeemed, accelerated, or repaid prior to that date. Interest accrues on the principal amount of the Notes at a rate of 8.0% and is payable semi-annually in arrears on February 15 and August 15 of each year starting on February 15, 2001.

The Notes were sold to qualified institutional buyers ("QIBs") in the U.S. in reliance on Rule 144A of the Securities Act and to non-U.S. persons in reliance upon Regulation S of the Securities Act. At least initially, approximately __% of the Notes were sold to domestic holders and approximately ___% of the Notes were sold to non-US holders. The Reg. S Notes bearer bonds meet the requirements of Reg. Section 1.163-5(c)(2)(i)(D), including legending, certification of non-U.S. status before interest can be paid or the delivery of definitive notes to holders.

The certificates in the Trust represent beneficial interests in the Trust and are subordinate in right of repayment to the Notes.

EC 000850727

Trust Investments.

The proceeds from the sale of the Notes and the Certificates may be used by the Trust to make any one or more investments from a list of permitted interest-paying obligations of domestic money center banks, insurance companies, or direct obligations of the United States government (the "Trust Investments") as long as the obligations mature on or before the maturity date of the Notes. At least initially, the Trust used the entire $550M in funds received from the issuance of the Notes and Certificates to acquire a [note/guaranteed investment contract] issued by Citibank carrying an interest rate of 6%.

The Trust granted a security interest to the

Credit Swap.
The Trust and Citibank entered into a credit swap (the "Credit Swap") that provides for certain periodic payments and, upon an Enron Credit Event, calls for physical settlement of all or part of the Credit Swap. Upon an Enron Credit Event (defined to include an Enron failure to pay under the Credit Swap as well as the general condition of Enron being either insolvent or bankrupt), the Credit Swap permits Citibank to physically settle the Credit Swap by delivering to the Trust certain senior unsecured obligations of Enron called Enron Deliverable Obligations in exchange for a like amount of Trust Investments then held by the Trust. The principal amount of the Notes would then be repaid from any proceeds recovered from any of these Enron Deliverable Obligations received by the Trust and any remaining Trust Investments then held by the Trust.

On a periodic basis in the absense of an Enron Credit Event, the Trust will obtain the funds necessary to pay interest on the Notes and yield on the Certificates from periodic payments received by the Trust from Citibank under the Credit Swap. In return, the Trust is obligated to pay Citibank all of the interest received by the Trust on the Trust Investments on dates concurrent with the interest payments dates on the Notes. To the extent the amount payable by Citibank under the Credit Swap exceeds the amount Citibank receives under the Credit Swap, Enron is contractually obligated to reimburse Citibank for this difference. [See the Enron-Citi Agreement.] In the absence of an Enron Credit Event, the principal amount of the Notes and the Certificate holder's investment will be repaid from the principal proceeds of the Trust Investments.

U.S. Withholding Taxes
The interest paid on the Notes to foreign holders

Tax Reporting and Filing Requirements.
Since it was critical that the Trust report the transaction for tax and accounting purposes in a correct and timely manner, Wilmington Trust Company ("WTC") as Trustee entered into agreement with Enron under which Enron agreed to perform

Discuss side letter

Transaction Expenses.

EC 000850728

State Tax Considerations.

Vasconcellos, Brent

From: Tiller, AnnMarie
Sent: Tuesday, March 27, 2001 8:55 PM
To: Siurek, Ryan
Cc: Vasconcellos, Brent; Bowes, Bill; Williams, David C.; Wilson, Danny; Sandt, Jim
Subject: Yosemite III prepay

Ryan,

Please let me know if we could meet for a short time around, say, 3:00 p.m. tomorrow to discuss the Yosemite prepay. I've included below the draft summary I have prepared to discuss this portion of the transaction in the deal memo I am preparing for our tax files, but I am confused about how the thing is supposed to work and how it accomplishes your book accounting objective. If 3:00 p.m. doesn't work for you, please don't hesitate to throw out another suggested time. Thanks.

AnnMarie

References herein to the prepaid swap or the "Swap" are actually references to the combination of two contemporaneous cash-settled commodity swaps. The first such swap between Enron and Citibank is a cash-settled commodity swap on 22,238,748 barrels of crude oil. In return for an up-front payment of $439,677,103 from Citibank, Enron is obligated to make (1) floating payments to Citibank each January 14 and July 14 based on the NYMEX spot price for 568,024 barrels of crude at the closing price three commodity business days prior to the payment date; (2) one up-front floating payment to Citibank based on the NYMEX spot price for 533,312 barrels of crude at the closing price three commodity business days prior to the payment date; and (3) on the final floating payment date, a floating payment to Citibank equal to $475,000,000 or, if less, the NYMEX spot price for 23,238,748 barrels of crude at the closing price three commodity business days prior to the payment date.

The second cash-settled commodity swap runs between Enron and Delta Energy Corp., a Cayman Islands exempt LLC ("Delta") under which Enron will receive an up-front payment of $35,317,897 from Delta. Additionally, over the term of the swap, Delta is obligated to make (1) floating payments to Enron each January 14 and July 14 based on the NYMEX spot price for 568,024 barrels of crude at the closing price three commodity days prior to the payment date; and (2) one up-front floating payment to Enron based on the NYMEX spot price for 533,312 barrels of crude at the closing price three commodity business days prior to the payment date.

In consideration for these payments under the second swap, Enron is obligated to make (1) an up-front payment to Delta of $16,665,982; (2) floating payments on each January 14 and July 14 based on the NYMEX spot price for 568,024 barrels of crude at the closing price three commodity business days prior to the payment date; and (3) on the final payment date, a payment in the amount of $17,750,750.

Contemporaneously, Enron borrowed $25M from Citibank in return for a Debt Security calling for semi-annual interest payments payable in arrears with an interest rate of 24.83% from August 25, 2000 to January 14, 2001 and an interest rate of 23.994% thereafter. The Debt Security has a maturity date of July 14, 2005.

[The result of the combination of the two swaps and the direct loan is that Enron will receive a net up-front payment under both swaps and the direct loan of $483,329,018; (2) Enron will have to make floating payments to Delta on January 14 and July 14 based on the NYMEX spot price for 568,024 barrels of crude oil at the closing price three commodity days prior to the payment date; and (3) Enron will be obligated to make a net payment of no less than [$492,750,750 + $25M] at the end of the transaction]

EC2 000033031

RMTC Liquids (Prepay)

Schedule of Product Prepayment Amortization
Event 142002 & 142015
1999

	142002 Current M-1	142015 NonCurrent M-1	Total M-1
Chase III - 4/95	(34,412,171)	(2,975,653)	(37,387,824)
Chase Mahonia III - 4/97	(45,290,580)	0	(45,290,580)
Chase IV - 12/98	28,970,135	(65,359,699)	(36,389,564)
Delta Energy (Roosevelt) - 12/98	C21 (17,101,882)	C21 (47,923,063)	(65,024,945)
TOTAL	**(67,834,498)**	**(116,258,415)**	**(184,092,913)**

EC2 000033554

1999 WORKPAPER

RMTC Liquids (Prepay) (69X)

Schedule of Financing Prepayment Amortization
Event 123014
1999

	Total M-1
Yosemite I - 12/99	800,000,000
Yosemite II - 12/99	324,000,000
TOTAL	**1,124,000,000**

EC2 000033529

RMTC Liquids (Prepay)
FEDERAL INCOME TAX RETURN WORKPAPERS
Advance Payments
CYE 12/31/00
Dr/(Cr)

				Tax Adjustment				
Prepay Description	Date Started	Completely Amortized	Total of Previous Year's M-1s	105100180 - Advance Payments - Current - NU	105100162 - Advance Payments - Noncurrent - NU	105100212 - Financial Prepayments - Current - NU	105100210 - Financial Prepayments - Noncurrent - NU	Tax Balance at End of Year
Chase III	Apr-95	Jan-00		(2,975,653)	0			(2,975,653)
Chase Mahonia III	Apr-97	Dec-99		0	0			0
Chase IV	Dec-98	Jan-03		3,697,239	(69,056,938)			(65,359,699)
Delta Energy (Roosevelt)	Dec-98	Feb-02		C2/ 17,670,420	C2/ (65,593,483)			(47,923,063)
Yosemite Securities Trust I	Dec-99	Repay 10/2004	800,000,000			0		800,000,000
Yosemite Securities Co. Ltd. (Bridge)	Dec-99	Repaid 4/2000	324,000,000			(324,000,000)		0
Yosemite Securities Co. Ltd.	Feb-00	Repay 2/2007					330,800,000	330,800,000
Enron Credit Linked Notes Trust I	Aug-00	Repay 8/2005					475,000,000	475,000,000
Toronto Dominion & CSFBI (WTI)	Dec-00	Repay 12/2001				315,000,000		315,000,000
Total			1,124,000,000	18,392,006	(134,650,421)	(9,000,000)	805,800,000	1,804,541,585
				A	B			

To reverse Commodity prepays, which are not deductible for federal tax purposes until the commodity is received, in order to return to the accrual basis of accounting.

Mcode: 105100180 - Advance Payments - Current - NU

A

Corptax Account	Description	Amount
6025082	Gas Services Trading/Swap Expense	18,392,006
1800070	Affiliates Receivable	(18,392,006)

To reverse Commodity prepays, which are not deductible for federal tax purposes until the commodity is received, in order to return to the accrual basis of accounting.

Mcode: 105100162 - Advance Payments - Noncurrent - NU

B

Corptax Account	Description	Amount
6025082	Gas Services Trading/Swap Expense	(134,650,421)
1800070	Affiliates Receivable	134,650,421

To reverse Financial prepays which are loans for Tax purposes.

Mcode: 105100212 - Financial Prepayments - Current - NU

Corptax Account	Description	Amount
6025082	Gas Services Trading/Swap Expense	(9,000,000)
1800070	Affiliates Receivable	9,000,000

To reverse Financial prepays which are loans for Tax purposes.

Mcode: 105100210 - Financial Prepayments - Noncurrent - NU

Corptax Account	Description	Amount
6025082	Gas Services Trading/Swap Expense	805,800,000
1800070	Affiliates Receivable	(805,800,000)

EC2 000033568

2000 WORKPAPER

Int office
Memorandum

To: Ann Marie Tiller

From: Brent Vasconcellos

Department: Tax Planning

Subject: Yosemite I Withholding

Date: January 14, 2000

Confidential: Attorney-Client Privilege

Pursuant to your request, I have prepared the following analysis of U.S. federal withholding tax considerations related to payments made by Enron North America ("ENA") to Delta Energy Corp. ("Delta"), a Cayman Islands exempt LLC, as part of the Yosemite structured finance transaction.

Background

On November 18, 1999, Yosemite Securities Trust I ("Yosemite"), a Delaware statutory business trust, issued $750 million in senior unsecured notes (the "Notes"). The beneficial ownership interests of Yosemite are evidenced by $75 million of certificates held by Enron Corp. ("Enron") and Long Lane Master Trust IV ("Long Lane"), a Delaware statutory business trust.[1] Yosemite is treated as a partnership for tax purposes, and the trust certificates held by Enron and Long Lane are treated as partnership interests for tax purposes. Currently, Yosemite's sole asset is an $800 million debt obligation of Delta (the "Delta Note").[2] The Delta Note originally bore interest at a rate of 6.3% payable semi-annually, although it was amended on December 22, 1999 (as discussed below) to, among other things, increase the rate to 7.25%.

Delta is checked open as a partnership and is capitalized with nominal equity held by a Cayman Islands charitable trust (the "Trust") and $800 million in proceeds, nominally in the form of a loan, from the issuance of the Delta Note to Yosemite.[3] Delta plans to take certain precautionary measures in order to assure itself of favorable tax treatment for withholding purposes by filing a Form 926 (Form 8865 which is not yet in final form) and has also included tax characterization language in the Delta Note[4]

The $800-million proceeds received by Delta were used as a prepayment of Delta's obligation under a cash-settled swap with ENA on the price of crude oil (the "Prepay").[5] As part of a pre-arranged integrated transaction, ENA entered into a cash-settled commodity swap with

[1] Enron and Long Lane each own $37.5 million of the certificates Long Lane is an accommodation party for Citibank through the total return swap in place between Long Lane and Salomon Smith Barney, a Citibank affiliate.

[2] Yosemite is also a swap counterparty to a credit default swap with Citibank, N.A. and has entered into a guarantee arrangement, nominally characterized as a loan, with Enron in which Enron effectively guarantees the interest payable on the Notes (although Enron's obligation is not in the nature of a traditional guarantee because it is not dependent on a payment default by Delta). Neither transaction is relevant for purposes of this discussion

[3] The use of Delta came at the insistence of Enron Global Finance due to accounting concerns over the Yosemite investing entity's status as a special purpose vehicle (SPV). Characterization of an alternative Delta-like entity as an SPV for financial accounting purposes would have jeopardized the accounting treatment of the debt issuance by Yosemite as an off-balance sheet financing. The decision to use Delta apparently reduced such concerns based, at least in part, on ENA's prior dealings with Delta in similar swap transactions

[4] These precautionary measures relate to withholding in calendar years 2001-2004. *See* discussion *infra*

[5] The use of a prepaid swap was not motivated by tax considerations but instead was necessary in order to report the transaction as part of ENA's price risk management activities rather than debt for financial accounting purposes.

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Citibank and Citibank entered to into a cash-settled commodity swap with Delta. Citibank and Delta hold floors and ENA holds a cap on the price of crude oil at the swap's maturity. All three swaps are based on an identical notional amount. Further, the caps and floors are identically priced and have the effect of creating a hedge to all three parties. After canceling all of the redundant terms to the three swaps, ENA receives $800 million and Delta receives 6.3% interest payable semi-annually. Delta uses the interest received from the Swaps to make identical semi-annual interest payments to Yosemite on the Delta Note. Yosemite uses the interest earned on the Delta Note to satisfy the semi-annual interest payments due on the Notes and the semi-annual yield payments due on the Certificates.[6]

Due to commercial uncertainty caused by a last-minute change to a provision in the Swaps, Enron decided to shorten the tenor of the Swaps to two and a half months with a maturity date of January 31, 2000. The tenor of the Delta Note was also shortened to reflect an identical maturity date. Enron terminated the original Swaps and executed new Swaps on December 22, 1999 that reflect the originally contemplated maturity date of October 26, 2004. The Delta Note was also amended to reflect a similar maturity date. The terms under the new Swaps and the Delta Note remained substantially unchanged with the exception of the maturity date and a new interest rate of 7.25%. In connection with the termination of the original Swaps and execution of the new Swaps, Yosemite will execute a consent to these changes in order avoid a mandatory repayment of the Delta Note as required under its terms.[7]

Issues

1. In calendar year 2000, what basis does ENA have for making payments to Delta under the Prepay without reduction for U.S. federal income tax withholding under I.R.C. § 1441 and the regulations thereunder?

2. In calendar years 2001 through 2004, what basis does ENA have for making payments to Delta under the Prepay without reduction for U.S. federal income tax withholding under I.R.C. § 1441 and the regulations thereunder?

Executive Summary

1. For calendar year 2000, ENA can forego withholding on payments made to Delta under the original Prepay by relying on the short-term OID exception contained in I.R.C. § 871. ENA can also forego withholding on payments made to Delta under the new Prepay in calendar year 2000 by relying on the "portfolio interest" exemption.

2. The regulations promulgated under I.R.C. § 1441, effective January 1, 2001, would not require ENA to withhold on any payments made to Delta under the new Prepay for calendar years 2001 through 2004 on the basis that the beneficial owner of the income received by Delta is a U.S. person.

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[6] These cash flows only partially satisfy the Notes and certificates. The "Magic Note" was put in place to make up the shortfall amount.

[7] For purposes of this discussion, the term "original Swaps" refers to the two-and-a-half-month Swaps that mature on January 31, 1999 and the "new" Swaps refers to the Swaps executed on December 22, 1999 that mature on October 26, 2004. Any reference to the "Prepay" or the "Swaps" also refers to the new Prepay/Swaps.

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Discussion

§ 1441 Withholding in Calendar Year 2000

Tax Characterization of the Prepay

The tax characterization of the Prepay is an integral part of the withholding analysis for calendar year 2000 because it allows ENA to identify alternative reporting positions based on the availability of withholding exemptions. Once the tax characterization of the underlying transaction is determined, the most advantageous reporting position for withholding purposes can be determined.

As noted above, the net result of the Swaps was that ENA received $800 million in exchange for interest payable semi-annually at 7.25%. Based on the economic substance of the Swaps, the Service could potentially view the Prepay as a 7.25%, $800 million loan by Delta to ENA and view the ENA/Citibank swap and the Citibank/Delta swap as swaps for tax purposes. Therefore, under this characterization, any payments made by ENA to Delta under the Prepay would be characterized as interest.[8]

Current § 1441 Regulations

The current version of the regulations promulgated under I.R.C. § 1441 are effective until December 31, 2000.[9] Those regulations generally provide that payments made by U.S. persons to foreign persons that constitute gross income from sources within the U.S. are subject to withholding tax at a rate of 30% unless an exemption applies.[10] Here, ENA is expected to make semi-annual payments to Delta under the Prepay that are likely characterized as interest. Therefore, in order for ENA to avoid the withholding obligation under § 1441, it must show either that:

- The payments constitute non-U.S. source income as:
    - Interest paid to by an 80/20 company[11]; or
    - Income from a notional principal contract

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- OR -

- The payments are U.S. source income, but an exemption from withholding applies:

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[8] ENA intends to report the payments under the Swaps according to their form but acknowledges that the economic substance of the Swaps for withholding purposes is a loan by Delta to ENA. ENA will obtain the appropriate withholding certificates from Delta in accordance with its acknowledgement that the Prepay is a loan for tax purposes. *See* § 1441 Documentation discussion *infra*.

[9] *See* I.R.S. Notice 99-25, 1999-20 I.R.B. 75. This notice was the second postponement of the effective date for the new withholding regulations. *See* I.R.S. Notice 98-16, 1998-15 I.R.B. 12 (moving the effective date from 1/1/99 to 1/1/2000)

[10] *See* Treas. Reg. § 1.1441-1

[11] Under Treas. Reg. § 1441-3(a), payments that represent income from sources without the U.S. are not subject to tax and withholding. I.R.C. § 861(a)(1)(A) excludes from the definition of income from sources within the U.S., interest received by a foreign taxpayer from an "80/20 company." Thus, if the provision applies, any interest paid to a foreign taxpayer would be deemed non-U.S. source income and thus not subject to withholding. An "80/20 company" is a domestic corporation that, for the three-year period ending on the close of the taxable year preceding the interest payment, derived at least 80% of its income from all sources as "active foreign business income." "Active foreign business income" is income derived from outside of the U.S. and is attributable to the active conduct of a trade of business in a foreign country. Here, ENA does not derive 80% of its income from all sources as "active foreign business income" and thus would not qualify as an "80/20 company" under § 861

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- Income tax treaty[12]; or
- Short-term OID exception; or
- The portfolio interest exemption

Non-U.S. Source Income

Income from a Notional Principal Contract

Under § 1441, a payer is only required to withhold on payments to foreign persons that constitute income from sources within the U.S.[13] Payments that constitute income from sources outside of the U.S. are not subject to § 1441 withholding. Under Treas. Reg. § 1.863-7(b)(1), the source of notional principal contract income is determined by reference to the residence of the taxpayer. Here, Delta is a Cayman Islands resident and thus under § 1.863-7, any income earned by it from a notional principal contract would be foreign source income. Therefore, if the payments made by ENA to Delta under the Prepay are characterized as payments made under a notional principal contract pursuant to § 1.446-3, no withholding would be required under § 1441 because the payments would not constitute U.S. source income to Delta.

Here, however the Service would likely take the position that the economic substance of the Prepay supports a loan characterization rather than a notional principal contract characterization. The $800 million prepayment by Delta would be treated as the advanced principal and the semi-annual barrel payments by ENA would be treated as interest payable to Delta on that principal. However, the payments under ENA/Citibank swap and the Citibank/Delta swap would be treated as payments under a notional principal contract. Another position the Service could take is that § 1.446-3(g)(4) applies to the Prepay. This provision generally provides that a swap that contains significant non-periodic payments is treated as two separate transactions consisting of a loan and a swap.[14] As such, all of the payments made by ENA to Delta under the Prepay would be characterized as interest rather than periodic swap payments under § 1.446-3, thus requiring ENA to identify another withholding exemption.

Exemptions from Withholding[15]

(i) Short-term OID Exception

The § 1441 regulations generally impose a withholding obligation on payments representing original issue discount under I.R.C. § 871(a)(1)(C). However, an amount representing original issue discount that is payable less than 183 days from an obligation's date of issuance is not subject to the tax imposed under § 871(a)(1)(C) and thus is not subject to withholding under § 1441.[16] Here, the original Swaps executed on November 18, 1999 provided for a maturity of January 31, 2000 and did not provide for any payments to be made during this

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[12] Under Treas. Reg. § 1.1441-6(a), a foreign taxpayer may claim a reduced rate of withholding or complete exemption from withholding pursuant to an income tax treaty between the U.S. and the taxpayer's home country. The U.S. and Cayman Islands do not currently have a negotiated tax treaty in place and therefore this withholding exemption would not be available to Delta for the payments it receives from ENA.
[13] *See* Treas. Reg. § 1.1441-1. For purposes of this discussion, the term "payer" is synonymous with the term "withholding agent" under § 1441 and the regulations thereunder.
[14] *See also* Treas. Reg. § 1.446-3(g)(6) example 3. It is not entirely clear how this provision would apply to the Prepay. However, the potential does exist that the Service could apply this provision in an attempt to recharacterize the transaction.
[15] The exemptions discussed below are dependent on a characterization of the Swaps as a loan for § 1441 withholding purposes.
[16] *See* I.R.C. § 871(g)(1)(B)(i).

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period.[17] Therefore, any interest component of the termination payment made by ENA to Delta is not subject to withholding since the payment contains OID payable less than 183 days from the Swaps' execution date.

(ii) The Portfolio Interest Exemption

Payments to foreign persons that constitute "portfolio interest" are generally not subject to withholding.[18] "Portfolio interest" includes interest paid on certain registered debt issued to unrelated non-bank persons. In order to be unrelated for purposes of the "portfolio interest" exemption, the foreign person may not own, either directly or indirectly, through application of the § 318 stock attribution rules, 10 percent or more of a corporate debt issuer's total combined voting power of all classes of stock entitled to vote. I.R.C. § 871(h)(3)(C) modifies the § 318 stock attribution rules by eliminating the 50-percent limitation.[19]

It is not entirely clear whether a withholding agent is required to look beyond the form of a transaction to reasonably rely on a foreign payee's claim of exemption from withholding. Here, the Service could potentially argue that ENA is required to acknowledge the economic substance of the transactions in the Yosemite structure for purposes of determining its withholding obligations under § 1441: This argument would effectively require that ENA, as a "withholding agent" under § 1441, determine the tax characterization of any transaction that ultimately determines whether it has an obligation to withhold on payments to foreign persons. In the context of payments made by ENA to Delta that constitute "portfolio interest", the Service's argument would require that ENA determine the tax character of the Delta Note held by Yosemite in order to determine whether Delta is a 10% or more shareholder in ENA under § 871(h)(3). Thus, the potential exists that the Service would disallow use of the "portfolio interest" exemption by asserting that Delta is a 10% or more shareholder in ENA.

If the Service were to attack ENA's reliance on the "portfolio interest" exemption, ENA should argue that Delta is merely an accommodation party used solely for accounting purposes and that the ultimate recipient and beneficiary of all payments made by ENA is Yosemite, who is a U.S. person. This argument should be at least somewhat persuasive because it serves as the foundation for the new but not yet effective § 1441 regulations. The new § 1441 regulations recognize that the status of the ultimate beneficiary of income should determine (as discussed further below) whether withholding is appropriate.

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[17] The Swaps, as drafted, retained provisions that provided for interest payments beyond the maturity date of the Swaps, effectively creating OID. This was done in anticipation of the early termination and issuance of new Swaps with similar terms and a maturity of October 26, 2004.
[18] *See* I.R.C. § 1441(c)(9).
[19] The § 318 stock attribution rules, as modified by § 871(h)(3)(C), could potentially apply to Delta as follows:

1. Yosemite's constructive ownership of the ENA stock owned by Enron
   - § 318(a)(3)(A), as modified by § 871(h)(3)(C), provides that stock (the ENA stock) owned by a partner (Enron) shall be considered as owned by the partnership (Yosemite).
   - Thus, through application of this provision, Yosemite is deemed to constructively own the ENA stock.
2. Reattribution of the constructively owned ENA stock by Yosemite to Delta
   - § 318(a)(5)(A) provides that the entity (Yosemite) deemed to "constructively" own stock (the ENA stock) from the first application of § 318 is deemed to "actually" own the stock (ENA stock) for purposes of applying the attribution rules a second time (i.e., continuing ENA stock attribution down the chain of ownership to Delta).
3. Delta's constructive ownership of the ENA stock "actually" owned by Yosemite for the purposes of § 318
   § 318(a)(3)(A), as modified by § 871(h)(3)(C), provides that stock (the ENA stock) owned by a partner (Yosemite) shall be considered as owned by the partnership (Delta).

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Reporting Position for Year 2000 Payments to Delta

Loan Characterization

Given the economic substance underlying the Swaps, the most advantageous position for ENA to take is that the Prepay is a loan for tax purposes but that § 1441 withholding should not apply based on the following arguments:

1. The Swaps possess a five-year tenor that straddles the effective date of the new § 1441 regulations. The transaction should be treated consistently over its outstanding life and since four of five years' payments under the Prepay will not be subject to withholding under the new § 1441 regulations, the first year payments under the Prepay should be treated similarly.

2. By promulgating the new § 1441 regulations, Treasury recognized that the aggregate theory of partnerships was appropriate for § 1441 withholding purposes in contrast to the entity theory utilized by the current § 1441 regulations. Since Yosemite is a U.S. partner in Delta for tax purposes and is allocated all of the income of Delta, payments made by ENA to Delta should not be subject to withholding by virtue of Yosemite's status as a U.S. person under the approach embodied by the new § 1441 regulations.

3. By giving effect to the new withholding certificates, the Service implicitly authorized the use of the new regulations since the new withholding certificates were created for use under the new withholding regulations.

4. The new regulations were originally expected to take effect on January 1, 1999, but were delayed for two years and therefore ENA should be allowed to informally adopt the new § 1441 regulations.

Even if the Service were to ignore all of the preceding arguments regarding the inapplicability of § 1441 withholding to payments made by ENA to Delta in calendar year 2000, ENA should argue that once the tax is paid it is abated and therefore ENA is only potentially liable for interest and penalties.[20]

§ 1441 Withholding in Calendar Years 2001-2004

New § 1441 Regulations

As discussed above, effective January 1, 2001, the withholding rules promulgated under § 1441 will change.[21] One of the major changes under the new regulations is the addition of the partnership look-through rules which recognize that payments made to partnerships generally flow through the partnership to its partners whom are the beneficial owners of income.[22] Thus, if a payment is made to a foreign partnership in which only U.S. persons are partners, the payment would not be subject to withholding because it would be considered a payment by a U.S. person to a U.S. person under the new regulations.

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[20] *See* I.R.C. § 1463.

[21] *See* note 5, *supra*.

[22] *See generally* Treas. Reg. § 1.1441-5

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The new § 1441 regulations also contemplate payments to partnerships where another partnership is a partner.[23] In such a case, the regulations require that the payer look through only the partnerships that are foreign until it can identify a U.S. person, if any.[24] For purposes of the new § 1441 regulations, language was included in the Delta Note that acknowledges its treatment as a partnership for tax purposes. Therefore, Yosemite and the Trust would be treated as partners in Delta. Yosemite is a U.S. person and the Trust is a foreign person for tax purposes. Since Yosemite is allocated all of the income of Delta under the terms of the Delta Note, any payments made by ENA to Delta after the year 2000 would not be subject to withholding under the new § 1441 regulations since they would be considered made between ENA and Yosemite rather than between ENA and Delta.

§ 1441 Documentation

In 1998, the Service announced that it would be implementing the use of new withholding certificates in connection with the new § 1441 regulations that were finalized in 1997.[25] However, the Service announced that the new certificates would be valid under the current withholding regime.[26] Generally, a U.S. taxpayer must request the appropriate withholding certificate from a foreign payee in order to meet the reliance standard under § 1441 and the regulations thereunder. (*See* **Attachment A** for a summary of the required withholding certificates and other tax forms discussed below).

Portfolio Interest Exemption

A foreign payee claiming the "portfolio interest" exemption from withholding under § 1441 should provide the payer with Form W-8BEN. The purpose of the form is to establish that the payee is a foreign person and that it is the beneficial owner of the income. The payer reports the payment to a foreign person on Form 1042-S and claims an exemption from withholding as portfolio interest. If ENA relies upon the "portfolio interest" exemption Delta should provide ENA with Form W-8BEN to claim its status as a foreign person and beneficial owner of the income it receives.

The Look-through Rules under the New § 1441 Regulations

Under the look-through rules of the new § 1441 regulations, a foreign partnership that claims it is not subject to withholding must provide the payer with Form W-8IMY that indicates its status as a foreign partnership. In order for the payer to rely on the foreign partnership's claim of exemption from withholding, the partnership must also provide the payer with the withholding certificates of its beneficial owners evidencing each owner's distributive share and the owner's status for withholding purposes (e.g., U.S. person, foreign person, income effectively connected with a U.S. trade or business). For purposes of the new § 1441 withholding regulations, Delta is a foreign partnership and Delta's partners are Yosemite, a Delaware statutory business trust, and the Trust, a Cayman Islands exempt LLC. Yosemite should provide Delta with Form W-9 to

[23] *See* Treas. Reg. § 1.1441-5(c).
[24] *See* parenthetical in Treas. Reg. § 1.1441-5(c)(1)(i). The documentation requirements for a withholding agent's reliance on a partner's U.S. or foreign status is discussed *infra*.
[25] *See* Announcement 98-15, 1998-10 I.R.B. 36, T.D. 8734, 1997-44 I.R.B. 5.
[26] *See* Notice 98-16, 1998-15 I.R.B. 12. The withholding certificates discussed herein refer to the new certificates.

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claim its status as a U.S. person. Delta should provide ENA with its Form W-8IMY and attach Yosemite's Form W-9 in order to satisfy the requirements under Treas. Reg. § 1.1441-5(c).[27]

CC: Jim Ginty
Dave Maxey
Morris Clark
Janine Juggins
Mathew Landy
Ed Osterberg

[27] As a precautionary measure, ENA should obtain these forms during calendar year 2000 based on the discussion, *supra*, regarding year 2000 reporting. The Trust need not provide a withholding certificate since none of the money paid by ENA under the Swaps will be allocated to the Trust. The Trust's "accommodation fee" will be deducted from the initial prepayment made by Delta to ENA under the Prepay.

A.M. Tiller
10/28/99

Yosemite Financing
Confidential

1.) Two overall characterizations currently under consideration.

a.) "Option #1." Each owner of a certificate of beneficial interest in the trust. treated as a partnership interest, is treated as owning directly its proportionate share of the assets of the trust and and having written its proportionate share of the default swap. The owners of the Certificates are Enron and the U.S. branch of a foreign bank. (Another alternative (referred to as Option #2) would have recognized Citibank as a partner as well, but Citibank is unwilling to report its participation in the transaction for any purpose, including tax, as anything other than as a swap counterparty.) As discussed below, Option #1 currently looks like the more likely characterization, but this characterization has the potential for creating [timing and/or character] mismatches.

b.) "Option #4." The collateral asset and the default swap would be collapsed together and treated as though the trust held the debt of Enron. The Danielson language that would be necessary to treat the transaction contrary to its form has caused the accountants some discomfort and it is currently not clear that AA would agree. Based on research regarding the availability of the portfolio interest exemption (or the lack thereof), it appears that this option may not be the preferred approach. (Another alternative, referred to as Option #3, would have treated the trust as holding the debt of Citibank, but Citibank would not accept such a characterization and this characterization could potentially cause the debt to be treated as a contingent payment debt obligation.)

2.) Yosemite's characterization as a partnership and the accompanying tax consequences. Milbank is issuing a "will" level opinion in the Offering Memorandum for the Yosemite Notes, that

a. The Notes will be treated as debt for U.S. federal income tax purposes, and

b. The Trust will not be treated as a corporation or as a publicly traded partnership taxable as a corporation.

3.) Potential for OID on the Linked Enron Obligations ("LEOs") through an allocation of basis to the credit default swap.

a. General rule for "investment units." If a debt obligation is issued to noteholders along with a separate property right, the combination of rights can be treated as an "investment unit" that has the potential for giving rise to original issue discount ("OID").

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b. The portion of the purchase price paid by the holder which represents the FMV of the separate right must be allocated to the right, and the result of that allocation will cause the issue price of the debt obligation to be less than the price at which the debt was actually sold. Reg. section 1.1273-2(h).

c. Example: The Exchangeable Notes or ACES issued by Enron in 1995 were issued as an investment unit consisting of a debt obligation and a forward purchase contract although in the case of the ACES, the full purchase price of the notes was allocated to the debt obligation since the stated interest on the notes (6.25%) represented a yield higher than Enron's Mid-Term Borrowing Rate at the time of 5.90% thus indicating that the notes' full purchase price was attributable to the debt obligation.

d. In this case, the LEOs issued by the Yosemite Trust don't provide the noteholders with any separate property rights. Under the Indenture Agreement, the Noteholders acknowledge that Citibank is the Directing Party with respect to the Collateral for the notes under Collateral Security Agreement and the Indenture Trustee doesn't even have the right to elect to become the Directing Party with respect to an Enron Investment unless and until (1) an Indenture Event of Default has occurred, and (2) with the approval of 100% of the Noteholders of the related Series at which time the Citibank Swap immediately terminates. As a result, it doesn't appear appropriate to characterize the LEO's as being anything other than a debt instrument as opposed to an investment unit.

4.) Characterization and treatment of the credit default swap and the Enron-Citibank makewhole agreement. The swap between Yosemite and Citibank is probably best viewed as actually being two swaps: a cash flow swap and a credit default swap [although ... discuss the potential for the credit default swap to be better characterized as an option].

a.) A cash flow swap under which the Trust exchanges with Citibank the variable actual periodic receipts or yield it receives on the Enron and AAA Investments it holds and, in return, Citibank exchanges with the Trust the variable weighted average yield payable on the Notes and Certificates adjusted for .

1.) This cash flow swap doesn't qualify as a notional principal contract because not based on objective financial information. Reg. section 1.446-3(c).

2.) Query whether Enron's make-whole can be integrated with Yosemite's obligation under this cash-flow swap as a guarantee? If so, would we want to include a Danielson statement in the Enron Agreement to this effect?

5.) Citibank Swap.

a.) Tax uncertainty. In a 1997 article in The Tax Lawyer, Milbank Tweed partner, Bruce Kayle (who just happens to also be tax counsel for Citibank in this transaction) describes in some detail the uncertain tax treatment of a variety of transactions which Bruce describes generically as credit derivatives. 50 The Tax Lawyer, Will the Real Lender Please Stand Up? The Federal Income Tax

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Treatment of Credit Derivative Transactions, 569-615 (Spring 1997). It is Bruce's premise that the tax uncertainly for these transactions doesn't pose a substantial risk for market participants who are banks or dealers but that these tax risks should be a serious consideration for other market participants.

b.) Three characterizations. Bruce's article indicates that the Citibank swap which is nominally documented as a swap (with an ISDA Master, a Schedule, and Confirmation) could actually be treated as one of three things for tax purposes, a credit default swap, an option, or a guarantee, each with distinct tax consequences.

c.) Characterization as a credit default swap.

1.) Notional principal contract. Although a credit default swap could generally be expected to qualify as a notional principal contract ("NPC"), this swap would not so qualify because it is not based on objective financial information. Because of the absence of guidance for swaps that don't qualify as NPCs, this discussion continues to focus on the factors, pro and con. for NPC treatment.

A.) Enron is expected to pay Citi's fee over the term of the swap at an annualized rate of 12.5 basis points per year for a total annual fee of $10M. Multiple payments support support swap treatment at least at a cosmetic level.

B.) There are technical questions about whether payments under a credit default swap really fit the definition of an NPC as set out in Reg. section 1.446-3(c).

C.) Bruce asks if a swap has provisions that make it sufficiently close to other arrangements such as an option or a guarantee, whether it should be allowed to be treated as an NPC to the extent that there are substantively different tax results to the counterparties.

2.) Timing. The discussion below is based on the premise that the credit default swap were treated as an NPC which it is not.

A. If Citibank's payment [in the event of a Enron Investment default] were characterized as a periodic payment, Citi would have a deduction and Yosemite would have income in the period in which the payment was made.

B. If Citibank's payment were treated as a non-periodic payment, the timing would probably be the same. Non-periodic payments are supposed to be spread out and taken into account over the periods to which they relate. Where a default is not imminent or threatened, Bruce concludes that an effort to quantify and allocate the Yosemite entity's payment would be an arbitrary exercise and recognition of this fact would cause one to conclude that the period the payment is made is the period to which it relates.

C. If Citibank chooses cash settlement, Yosemite would have to sell the underlying obligation and recognize the corresponding loss to avoid accelerating income.

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D. If Citibank chooses physical settlement, Yosemite should recognize the loss on the receipt of the substituted investment.

E. If Yosemite sold an Enron Investment prior to default and if the reference obligation were actively traded personal property, the loss on the Enron Investment could be deferred under the straddle rules. As a result, we should guard against Enron Investments that would qualify as actively traded personal property or ensure that they are not sold by Yosemite.

3.) Character.

A. Since the Trust can be expected to recognize a capital loss on the default of the Enron Investment, Yosemite will want to say that Section 1234A applies to make Citi's payment under the swap capital in character.

1.) The NPCs rules that are believed to accord ordinary character to periodic payments generally are inapplicable here.

2.) There is a concern about finding a satisfactory distinction for purposes of saying that a Citi payment under the swap is capital, but Enron's payment of Citi's fee is ordinary.

3.) Exposure. The biggest risk of this characterization appears to be the potential for the payment of Citi's fee to be treated as capital rather than ordinary. [If Yosemite is treated as having made this payment, capital losses will be allocated to the Certificateholders over the term of the deal that will not offset the ordinary certificate yield allocated to them. As a result, they will recognize capital gain on the conclusion of the transaction when their interests in Yosemite are redeemed.] Although there are also concerns about timing as well since the swap won't qualify as an NPC, it would seem the Service would have more difficulty making the case that another timing methodology would be more appropriate.

c.) Characterization as an option. Bruce's article notes that the absence of multiple payments being required of either party under a swap might put NPC characterization in jeopardy and justify a position that the contract is better characterized as an option. Bruce notes, however, that there is no reason why an option could not call for its premium to be paid in installments.

1.) Bruce observes that there is suprisingly little guidance regarding the essential elements that cause an economic relationship to be treated as an option for tax purposes.

2.) Timing. Yosemite's would neither deduct or amortize the payments to Citibank of its fee. Instead, Yosemite would offset these payments against any payment it actually received from Citibank under the credit default swap or it would recognize a loss

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at the expiration of the swap if Citibank were never required to make a payment.

3.) Character.

A.) Since the underlying obligation is a capital assets to Yosemite, Yosemite would have a capital loss equal to the aggregate payments it makes to Citi if the swap expires without any default. Section 1234.

B.) Citi's payment to Yosemite should be capital under Section 1234A.

4.) Exposure. As in the case of characterization of the swap as an NPC, it appears that the biggest risk is treatment of Yosemite's payment of Citi's fee as capital.

d.) Characterization as a guarantee.

1.) Bruce observes that just as there is no real guidance about what are the fundamental elements of an option for tax purposes, there is no real guidance about the fundamental elements of a guarantee.

A.) First fundamental element - is the requirement of a payment on the nonperformance by the primary obligor which is present in the credit default swap.

B.) A second fundamental element is that the payment by the "guarantor" must bear some relationship to the nonperformance by the primary obligor.

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5.)Characterization of the Make-Whole Agreement and "Magic Note."

a.) The "Magic Note" or other contractual agreement that is intended to make the Yosemite trust whole for any differential between the amount received by the Trust and ded to serve the function previously served by the Periodic Payments under the latest draft of the Enron Agreement or make-whole agreement. In other words, if the Scheduled Interest Receipts received by the Trust and transferred to Citi under the Citibank Swap are insufficient to pay interest on the Yosemite Notes and yield on the Certificates (Citi's obligation under the Citibank Swap), then Enron makes up the difference. Mark Spradling says that the Magic Note will have a $25M principal amount and a maturity date of four days prior to the maturity of the Notes [open issue – which tranche or will there be a separate Magic Note for each tranche?]

b.) The Enron Magic Note resembles a

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6.) Withholding on payments from Yosemite to U.S. branch of foreign bank.

a.) Any payments by Yosemite to the U.S. branch of a foreign bank will be subject to withholding.

1.) Non-ECI. If Yosemite income is non-effectively connected FDAP income or other income subject to withholding that is included in the foreign partner's distributive share of partnership income, the payments will be subject to withholding under Section 1442.

2.) ECI. Alternatively, if Yosemite income is effectively connected to a U.S. trade or business, any income allocable to the U.S. branch of the foreign bank will be subject to withholding under Section 1446. Withholding under either provision applies regardless of whether the distributive share of the foreign partner's income is actually distributed or not.

b.) Withholding on Non-ECI. With respect to the timing of withholding on non-ECI, Rev. Rul. 89-17, 1989-1 C.B. 289 provides that since a partner's undistributed distributive share of partnership FDAP income is deemed distributed on the last day of the partnership's taxable year, a partnership must withhold and pay the tax by the date on which the Schedule K or K-1 is sent to the foreign partners.

c.) Withholding on ECI. Yosemite must withhold at a rate of 35% in the case of its corporate partner, the foreign bank. The tax must be paid in quarterly estimated tax payments based on a computation of the foreign partner's allocable share of ECI and reported on Form 8813, Partnership Withholding Tax Payments (Section 1446). In addition, Yosemite must file an annual return on Form 8804, Annual Return for Partnership Withholding Tax (Section 1446) and a copy of Form 8805, Foreign Partner's Information Statement of Section 1446 Withholding, must be attached to the Form 8804 and also supplied to the foreign bank. The amount of the withholding tax paid by Yosemite on behalf of the foreign bank is allowed as a credit to the bank toward its U.S. income tax liability. In order to claim the credit, the bank must attach the Form 8805 furnished by Yosemite to its U.S. income tax return.

d.) Indemnities for timing mismatches. Counsel for Citibank implied that he thought at least some of Yosemite's income would be ECI and that a timing mismatch could occur between the quarterly estimated tax withholding dates and the date on which the bank would otherwise owe the tax, thus presumably justifying an indemnity for this timing difference. [Does this make sense? If the foreign bank is already a U.S. taxpayer (and presumably it will be), it will be obligated to make estimated tax payments anyway. Why should an estimated tax payment be a justification for an indemnity based on timing?]

e.) Potential for Yosemite to Generate ECI. [Open]

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6.) The tax treatment of Delta and Enron North America ("ENA") under the lower-tier swaps.

a.) Delta's treatment under its two swaps with ENA and Citibank.

1.) The notional principal contract ("NPC") periodic payments received by Delta from Citibank and paid by Delta to ENA based on the spot price of oil should offset one another or wash. It is generally understood that such periodic payments are ordinary in character.

2.) Delta's receipt of 8% quarterly [interest] payment annually should constitute ordinary income to Delta. This income should be offset by a similarly sized will be offset with a deduction for "interest" paid on the Delta Notes, but the Cayman Islands doesn't assess any tax on income anyway.

3.) Receives $800M at 10/2006.

4.) Embedded option contracts

A.) If both option contracts are treated as embedded, the prepaid premiums paid for each will be amortized using the "level payment mehtod" of Reg. section 1.446-3(f)(2)(iii)(A). Reg. section 1.446-3(f)(2)(v)(A).

B.) If the the option contract Delta sells is treated as embedded but the option contract it purchases is treated as a separate contract ... [plus describe basis for such a position...]

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b.) ENA's treatment under its two swaps with Delta and Citibank.

1.) Offsetting floating rate periodic payments

2.) Payment of 8% periodic payments annually.

3.) Receipt of $800M in prepaid amount either recognized in income over the life of the contract under Reg. section 1.446-3(f) OR entirely treated as receipt of a loan under Reg. section 1.446-3(g).

4.) Repayment of $800M at 10/2006 treated as a deduction.

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7.) Whether Delta is a CFC and the tax effects of such a characterization

a. Initially, Delta is deemed to be owned 50/50 by U.S. (Enron) and foreign entities (U.S. branch of a foreign bank) after applying the constructive ownership rules of Section 318(a)(2)(A) which look through Yosemite to its partners for purposes of applying the stock ownership rules of Section 957. Enron and the U.S. branch are expected to each contribute 50% ($37.5 M of the total capitalization of the trust). With this equilibrium, Delta might not be a CFC. If, however, Enron pays the various fees and expenses associated with the transaction (which is expected), Enron will probably be deemed to make a partnership contribution for those amounts and, as a result, Delta could potentially become a CFC EXCEPT for the fact that Enron should not be a

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U.S. shareholder because the Delta Notes are intended to be non-voting. Section 951(b).

b. If Delta is or were to become a CFC AND if the Delta Notes were treated as voting stock,
   1.) Delta's income from the notional principal contracts to which it is a counterparty would constitute foreign personal holding company income under Section 954(c)(1)(F), and
   2.) The stock of Delta is used as security for the and thus would constitute a pledge for the obligation of a U.S. person for purposes of Section 956(d) and Reg. section 1.956-2(c).

c. The business team has confirmed that the Delta Notes are intended to be non-voting.

8.) Whether Delta is a PFIC and the tax effects of such a characterization.
   a.) Delta can be expected to meet either or both of the income and asset tests for qualification as a passive foreign investment company or "PFIC" since all of its assets and income, at least initially, are expected to be foreign personal holding company income under Section 956(c)(1)(F).
   b.) For purposes of determining if the stock of a PFIC is owned by a U.S. person, the attribution rules of Section 1298(a)(3) provide that stock owned directly or indirectly by a partnership is treated as owned by its partners. As a result, Enron will be a U.S. person with respect to Delta. Although one would think a similar look-through concept would apply to the foreign bank which holds its interest through a U.S. branch. Section 1298(a)(1)(B) indicates otherwise since it appears that one is expected to stop the attribution process once one reaches a U.S. person (except to the extent otherwise provided in regulations of which there currently appear to be none).
   c.) [Discuss need to make a QEF election ...]
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9.) Withholding on payments from ENA (a U.S. entity) to Delta (a foreign entity). *See separate memorandum by Brent Vasconcellos dated 10/27/99.*

10.) The overall effect of the Citibank/foreign bank total return swap on the characterization of the transaction.
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11.) Tax treatment and structuring of transaction fees and expenses
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12.) Texas franchise tax
   a.) Per discussion with V&E partner, Jim Penny, on 10/27/99, the Texas Comptroller has issued a ruling stating that derivative financial products,

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regardless of the index on which they are based, are treated as intangibles. As such, the payments exchanged under such contracts should be sourced under the location of the payor rule.

1. Corporations and LLCs. For corporations and LLC payors, their location for purposes of this rule is determined by the state of their formation.
2. National banks. For a national bank like Citibank, N.A., its location for purposes of this rule is determined by the location of its principal office (which in this case is probably New York).
3. Trusts. For a trust like Yosemite, its location for purposes of this rule is determined by its principal place of business. In this case, we will want to take the appropriate steps to ensure that Yosemite's principal place of business is in Delaware by, for example, having Wilmington Trust Company handle its day-to-day operations and the hiring the services of a non-Texas office of a public accounting firm to handle the preparation of the Yosemite's tax return and other tax filings as well as any required financial reports.

b.) Trusts are non-taxable entities for Texas franchise tax purposes.

1. Grantor trusts. Jim indicates that the Comptroller is somewhat perplexed about how to treat grantor trusts, but we had already concluded that we probably couldn't treat Yosemite as a grantor trust anyway.
2. Qualification as a foreign LLC. Jim Penny said that he understands that Texas does not provide limitation of liability protection to foreign trusts like Yosemite and so people will sometimes qualify a foreign trust as a foreign LLC to provide it with that protection. The quid pro quo is that LLC status makes the entity a taxable entity for Texas franchise tax purposes and requires the filing of a Texas franchise tax report.

c.) Based on the formalistic approach adopted by the Comptroller in analyzing transactions, Jim indicated that even if we adopted a substance-over-form analysis for federal tax purposes (i.e., collapsing the structure and taking the position that Yosemite holds the debt of Enron), he thought there was a good chance that the Comptroller would still treat the various swaps as swaps and apply the beneficial location of the payor rule. Although we did not discuss the issue with Jim, a characterization of what Yosemite holds as debt of Enron would seem to still allow the application of the location of the payor rule for the sourcing of interest payments as well.

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Yosemite Financing Structure
Open Questions

- Financing Amounts
  - Economics of deal presumably require the amounts raised from sale of Notes and Certificates to all be invested in the Delta Notes and become a part of the notional on the underlying prepaid swaps
  - What is the size of the Yosemite Notes offering – the latest OM still contained blanks?
  - What is the size of the certificates offering – is it still an Enron/non-Enron split of 49%/50%, at least before the payment of expenses?

- Delta Energy Corp.
  - Who holds the beneficial interest in the Cayman Islands charitable trust that apparently holds the only equity in Delta?
  - Has Delta been checked open or closed?
  - Will AA get its representation and warranty that Delta holds "other assets" or will Delta require additional equity to avoid SPV status for accounting purposes?
- Enron Agreement
  - Do we have a more recent iteration than the version dated 9/15/99?

- Citibank Swap
  - Confirm that it is intended that Citibank receive periodic payments for its role as counterparty under this swap.
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