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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.

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

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[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 (Ct. Cl. 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:

> (1) **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.

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[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).

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.