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.

1994--Cumulative Preferred Shares

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 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 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 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.

ISSUE 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.

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.

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.

7/23/99

RICHARD L. HUNN
Special Trial Attorney

APPROVED:

Mark E. O'Leary JUL 26 1999

MARK E. O'LEARY
Assistant Regional Counsel (TL)
Acting Assistant Regional Counsel (LC)