



Interoffice  
Memorandum

To: Ben Glisan  
From: AnnMarie Tiller and Brent Vasconcellos  
Subject: Talon I, LLC  
Department: Corporate Tax Department  
Date: August 19, 2000

*Confidential: Attorney-Client Privilege*

We understand that a proposed amendment to the Talon I, LLC Agreement would characterize LJM2-Talon LLC ("LJM2") as making an additional \$6M investment in Talon I, LLC ("Talon"). The proposal contemplates that LJM2 would not receive a return of its additional \$6M investment until the end of the transaction on or before April 18, 2005 and, even at that time, Talon would have to have sufficient retained earnings (as well as cash) to make the distribution. In the intervening period, Talon is supposed to receive a 12% return on its investment [although it is unclear to us whether that return would be paid currently in cash or would be capitalized and added to LJM2's investment].

Our earlier conclusion that we could treat LJM2's original investment in Talon as debt solely for tax purposes was in large measure based on Talon's capitalization or wherewithal to pay some few months after the closing. Talon's ability to pay was derived from the capitalization it received from Enron (via Harrier) in the form of Enron stock as well as a \$41M put option premium (later revalued on the option termination date to equal \$[36]M). Since Talon was restricted structurally from entering into any derivative transactions with Harrier until LJM2 received a payment of \$41M, we felt comfortable in characterizing this payment as a return of LJM2's investment for tax purposes and characterizing any subsequent return as a contingent return on LJM2's investment.

Since we have indicated the new changes put pressure on our tax characterization of the LJM2 interest in Talon as a financing, you have asked us to identify and quantify the risks of Talon becoming a partnership for federal income tax purposes. A quick-and-dirty analysis of the potential tax exposure follows below:

- Approx. \$305M capital gain. Taxable transfer of property by Enron to Talon (via Harrier). Contributions to a partnership are not tax-free if made to an entity that meets the definition of an "investment partnership." If over 80% of Talon's assets qualify as readily marketable securities and LJM2's transfer results in what is referred to as the diversification of its interest, then any unrealized appreciation in the Enron stock contributed by Enron will be triggered.  $[(\$175 - \$1) + [(\$68/\text{share} - \$20/\text{share}) \times 3,876,755 \text{ shares} \times 30\% \text{ discount}] = \$305\text{M}]$
- \$ [Unlimited gains]. Constructive sales of investments of various Enron affiliates. Under tax rules we have discussed verbally on numerous earlier occasions, the derivative contracts running between Harrier and Talon could cause a constructive sale and acceleration of any unrealized gains on the approximately \$1.4B in notional amount of investments that are the subject of both structures. Although there would be no earnings effect if deferred taxes have been recorded on the investments, the

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potential exposure here could only be estimated after conversations with those persons responsible for the underlying investments. Also, although cash taxes would be avoided to the extent that (a) the investments are held by entities that are part of the group of entities filing a consolidated tax return with Enron Corp. and assuming (b) Enron Corp's consolidated return reflects a net operating loss to offset the gains, it is our understanding that some investments will be held by entities outside the consolidated group (e.g., by partnerships, foreign, and less than 80% owned, entities).

- **[SUnknown]. Constructive sale of Enron stock.** If the portion of Enron's contribution to Talon of Enron stock under the Stock Purchase Agreement were characterized as a forward sale rather than a partnership contribution, then this stock could also be treated as constructively sold. Although any gain on this particular stock should receive non-recognition treatment to Enron, a related party provision in these rules might deem Enron stock held in other partnership structures to be constructively sold. The resulting gain triggered on stock held in those structures and allocable to persons who don't qualify for non-recognition treatment would cause tax liabilities that would be unexpected and may be the subject of indemnification agreements.

EC 000850969