KING & SPALDING

1730 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20006-4706
TELEPHONE: 202/737-0500
FACSIMILE: 202/626-3737

DIRECT DIAL:
(202) 626-2908

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AND WORK-PRODUCT DOCTRINE

MEMORANDUM

TO: R. Davis Maxey
Director, Tax Research
Enron Corp

FROM: William S. McKee
Susan Jewett

DATE: February 20, 1997

RE: Deferred Tax Liability Accounting Transaction

This memorandum is prepared in our capacity as counsel to Enron Corp. ("Enron") and its Affiliates[1] in connection with a proposed transaction. You have requested that we provide you with our analysis to date of the potential federal income tax consequences of the hypothetical transactions described in the assumed facts set forth below.

EC2 000033661

I. Assumed Facts

Enron and its Affiliates, and BT and its Affiliates, will at all times act in accordance with the form of the transactions as described below. The predominant purpose of Enron and its Affiliates for participating in the transactions described below is to generate income for financial accounting purposes. Additional purposes include risk shifting and raising minority equity capital for the Enron group. These effects of the transactions provide Enron and its Affiliates with significant and material benefits. The transactions were structured to achieve the above purposes

[1] For purposes of this memorandum, the "Affiliates" of a person are those persons directly or indirectly controlling, controlled by, or under common control with such person.

without either increasing or decreasing, on a present value basis (using a discount rate that is less than or equal to the weighted average cost of capital of the Enron consolidated group[2] during the relevant period), the aggregate federal income tax liability of the Enron consolidated group and those Affiliates of members of the Enron consolidated group that are included on Enron's consolidated financial statements.

Enron directly owns all of the outstanding stock of a regulated oil and gas distribution company ("Regulated") and of an unregulated oil and gas exploration and production company ("Enron Sub II"). Each of Regulated and Enron Sub II have only common stock outstanding. Enron has a basis of at least $5 billion in the stock of Enron Sub II. Enron's holding period with respect to stock of each of Regulated and Enron Sub II is greater than two years and is not at any time subject to reduction under section 246(c)(4). Each of Regulated and Enron Sub II has at least $2 billion of accumulated earnings and profits as of the end of 1996. Enron is the parent, and Regulated and Enron Sub II are members, of an affiliated group within the meaning of section 1504(a)(1). Enron files a consolidated return that includes Regulated and Enron Sub II. Enron directly owns all of the stock of a foreign corporation ("Forco"). Forco forms a new wholly-owned U.S. corporation, Enron GP.

Enron contributes a building (the "Building") with a fair market value of $320 million and a tax basis of $210 million, subject to nonrecourse debt of $284.5 million (the "Building Debt"), and $1.03 billion of cash to a newly-formed corporation ("SPVCo") for all of the common stock of SPVCo. No liabilities are assumed by SPVCo and, except for the Building Debt, SPVCo does not take any assets subject to liabilities. BT Sub, a subsidiary of Bankers Trust Company ("BT"), contributes $21,744,898 of cash to SPVCo for all of the preferred stock of SPVCo. The cash contributed by BT Sub qualifies as minority equity capital for purposes of Enron's consolidated financial statements.

Distributions by SPVCo go first to pay a Y percent dividend on the preferred stock, second to pay a Y percent dividend on the common stock, and then 98 percent to the common stock and 2 percent to the preferred stock. The preferred stock of SPVCo is redeemable at the

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[2] As used in this memorandum, the term "consolidated group" has the same meaning as in the consolidated return regulations. Treas. Reg. § 1.1502-1(h) (a consolidated group is an affiliated group of corporations filing consolidated returns for the tax year). References to the "Enron consolidated group" are to the consolidated group of which Enron is a member. All references to sections are to the Internal Revenue Code of 1986 (the "Code"), as amended and in effect as of the date of this memorandum, unless otherwise noted. All references to regulations are to U.S. Treasury Department regulations, as most recently adopted, amended, or proposed, as the case may be, as of the date of this memorandum, unless otherwise noted.

option of either SPVCo or BT Sub beginning approximately seven years after the formation of SPVCo. All stock of SPVCo is freely transferable.

The common stock of SPVCo has the right to elect 75 percent of the board of directors and the preferred stock of SPVCo has the right to elect 25 percent of the board of directors. Enron will exercise its voting rights in SPVCo independently of BT Sub, and will not exercise any control or influence over BT Sub in the exercise of its voting rights in SPVCo. BT Sub will exercise its voting rights in SPVCo for the benefit of itself and its Affiliates, and not on behalf of or for the benefit of Enron and its Affiliates. No fee received by BT Sub or any of its Affiliates in connection with the transactions described herein is contingent upon the manner in which BT Sub exercises its voting rights in SPVCo.

SPVCo, Enron GP, and BT Sub intend to join together as partners in a partnership ("Partnership") and to share the profits and losses from the operations of Partnership. SPVCo contributes the Building, subject to the Building Debt, and $951,744,898 of cash to Partnership for a 98 percent interest as a limited partner. BT Sub contributes $10,073,928 of cash to Partnership for a 1 percent interest as a limited partner. Enron GP contributes $10,073,928 cash to Partnership for a 1 percent interest as a general partner. The cash contributed by BT Sub qualifies as minority equity capital for purposes of Enron's consolidated financial statements. Income and losses on the Building are allocated on a disproportionate basis, shifting a significant amount of risk and a corresponding potential for profit on the Building to BT Sub. All other items are allocated in proportion to the contributions made by the partners. No transfers other than distributions of reasonable preferred returns and guaranteed payments made pursuant to the terms of the partnership agreement are made from Partnership to any partner within two years of a contribution to Partnership by that partner. The terms of the partnership agreement of Partnership are commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree.

None of the interests in Partnership are traded on an established securities market. All of the interests in Partnership were offered and sold within the United States and were issued in transactions that were not required to be registered under the Securities Act of 1933. Less than 100 persons own, directly or indirectly through partnerships, grantor trusts, or S corporations, an interest in Partnership.

The terms of any transactions, including any loan, lease, license, or fee for services, between any of SPVCo, Enron GP, Partnership and members of the Enron consolidated group will be commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree.

Partnership contributes $930 million of cash to a newly formed for profit Delaware corporation, Enron Sub III, in exchange for 100 percent of the only class of preferred stock of Enron Sub III. SPVCo contributes $100 million to Enron Sub III in exchange for 20 percent of the only class of common stock of Enron Sub III. Enron contributes X percent of the common stock of Regulated with a value of $400 million to Enron Sub III in exchange for 80 percent of the only class of common stock of Enron Sub III. No other stock of Enron Sub III and no warrants for stock, obligations convertible into stock, other similar interests in stock, or options to acquire stock of Enron Sub III are issued, created, or outstanding. Enron Sub III will not be an insurance company subject to taxation under section 801, a regulated investment company or a real estate investment trust subject to tax under subchapter M of chapter 1 of the Code, or a DISC (as defined in section 992(a)(1)). No election under section 936 will be made with respect to Enron Sub III.

Partnership will not acquire any stock of Enron Sub III other than as described above. Neither SPVCo's nor Partnership's holding period with respect to the stock of Enron Sub III will at any time be subject to reduction under section 246(c)(4). The dividend rate on the Enron Sub III preferred stock is a floating rate based on LIBOR. The spread over LIBOR is fixed and does not decline over time. The Enron Sub III preferred stock is nonvoting and is not convertible into any other class of stock. On the date the Enron Sub III preferred stock is issued, (i) the annual dividend rate for the stock is no less than the rate that would be required by an investor that owns no common stock of Enron Sub III and that is unrelated to Enron Sub III, (ii) the annual dividend rate for the stock is not materially in excess of the then prevailing market rate for preferred stock having similar terms and issued by a corporation having a credit rating similar to that which Enron Sub III would have on the date of issuance if it were rated, (iii) all terms of the stock are consistent with commercial practices generally prevailing at that time and are terms that could reasonably be expected to be agreed upon in negotiations between unrelated parties having adverse interests, and (iv) the stock has a fair market value, to an investor that owns no common stock of Enron Sub III and that is unrelated to Enron Sub III, equal to its issue price. The issue price of the Enron Sub III preferred stock is not greater than its redemption price and its liquidation value and is not less than its redemption price and its liquidation value (except for a reasonable redemption or liquidation premium). The fair market value of the assets of Enron Sub III will at all times exceed the face amount of all outstanding debt plus any accrued but unpaid interest plus the liquidation value (including accrued but unpaid dividends) of its preferred stock. All dividends on the Enron Sub III preferred stock will be paid currently. The current earnings and profits and net cash flow of Enron Sub III for each year will each exceed the annual dividend on the preferred stock. Enron will exercise its voting rights in Enron Sub III for the benefit of itself and the Enron consolidated group, and not on behalf of or for the benefit of SPVCo, Enron GP, Partnership, or BT Sub and its Affiliates. The Enron Sub III preferred stock will be treated by all parties as stock for tax, financial accounting, regulatory, and all other purposes.

Enron contributes the remainder of the common stock of Regulated to a newly formed for profit Delaware corporation, Holdco, in exchange for all of the common stock of Holdco. Enron Sub III contributes the common stock of Regulated that it holds plus $1.03 billion of cash to Holdco in exchange for all ($1.43 billion) of the voting preferred stock of Holdco. The voting rights of the Holdco preferred stock represent 20 percent or less of the total voting rights of all Holdco stock. Holdco purchases $1.43 billion of investment grade securities, some (but not all) of which are issued by Enron or Affiliates of Enron.

Each of Enron, Regulated, Holdco, Enron Sub II, SPVCo, Enron GP, and Enron Sub III represents itself to third parties as a separate entity in all transactions, observes all corporate and bookkeeping formalities, maintains separate bank accounts, has employees and/or pays fees for services that would otherwise be rendered by employees, and executes contracts in a manner consistent with its status as a separate entity. Partnership represents itself to third parties as a separate entity in all transactions, observes all partnership and bookkeeping formalities, maintains separate bank accounts, has employees and/or pays fees for services that would otherwise be rendered by employees, and executes contracts in a manner consistent with its status as a separate entity. Each of the entities listed in the preceding two sentences holds significant assets. Partnership enters into financial transactions with respect to the Building with unrelated persons. In addition, each of Enron, Regulated, and Enron Sub II has been in existence for a substantial period of time and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons. Enron Sub III will engage in financial or business transactions with unrelated persons during each of its taxable years.

The transactions described above provide the potential for economic profit or loss to the various parties, including BT Sub. It is anticipated that the structure created by these transactions will remain in place for at least seven years. While some stock of Enron Sub III may be sold or redeemed over time, it is anticipated that a substantial portion of the preferred stock of Enron Sub III will be retained by Partnership for at least two years.

At one or more times in the future, not less than 45 days after the Enron Sub III preferred stock is issued, Enron Sub II may purchase a portion of the Enron Sub III preferred stock from Partnership (a "Purchase"). The terms of the purchase agreement are commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree. The purchase price ("Purchase Price") is a value to which adverse parties dealing at arm's length could reasonably agree as being the value of the purchased shares of Enron Sub III preferred stock on the date of the Purchase. Partnership invests the proceeds in additional real estate assets or high quality securities. Enron Sub II's current and accumulated earnings and profits for the taxable year in which a Purchase occurs will exceed the aggregate amount of the Purchase Price plus any distributions made or deemed made by Enron Sub II to its shareholders during such year.

Enron Sub II will not, during any 85 day period that begins within two years of the formation of Partnership, purchase Enron Sub III preferred stock in amounts such that, if all dividends resulting from Purchases ("Section 304 Dividends") were treated as made pro rata with respect to all stock of Enron Sub II, the sum for any share of stock of Enron Sub II of all Section 304 Dividends that are treated as made with respect to such share of Enron Sub II stock during such 85 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 85 day period is greater than 10 percent of the shareholder's basis in such share. Enron Sub II will not, during any 365 day period that begins within two years of the formation of Partnership, purchase Enron Sub III preferred stock in amounts such that, if all Section 304 Dividends were treated as made pro rata with respect to all stock of Enron Sub II, the sum for any share of stock of Enron Sub II of all Section 304 Dividends that are treated as made with respect to such share of Enron Sub II stock during such 365 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 365 day period is greater than 20 percent of the shareholder's basis in such share. While it is anticipated that a substantial portion of the preferred stock of Enron Sub III may be sold over time, the timing and amount of Purchases will be contingent on a variety of factors, including the continued availability of the anticipated accounting treatment of such transactions and the financial position of Enron and its Affiliates that are included in its consolidated financial statements. With respect to any Purchase that may occur more than two years after the formation of Partnership (the "304 Start Date"), there is currently no fixed plan as to the date or amount of any such Purchase and there will not be, within two years of the 304 Start Date, any announcement, action by Enron Sub II's board of directors, formal or informal agreement or fixed plan, commitment, or other action relating to the amount or the time of such Purchase.

At one or more times in the future, not less than 45 days after the Enron Sub III preferred stock is issued, Holdco may redeem a portion of its preferred stock held by Enron Sub III (a "Holdco Redemption"). Enron Sub III may use some or all of the proceeds of a Holdco Redemption to redeem a percentage of its common stock and an identical percentage of its preferred stock (a "Enron Sub III Redemption"). Partnership will invest the proceeds in additional real estate assets or high quality securities. Holdco's current earnings and profits for each taxable year will exceed the aggregate amount of any distributions, other than a Holdco Redemption, made or deemed made bv Holdco to its shareholders during such year. None of Regulated's accumulated earnings and profits will have been taken into account, directly or indirectly, in determining the federal income tax consequences of any transaction to any taxpayer. Current and accumulated earnings and profits of Enron Sub III, determined without regard to any Holdco Redemptions and without regard to any Enron Sub III Redemptions, for the taxable year in which an Enron Sub III Redemption occurs will exceed the aggregate amount of any distributions, other than an Enron Sub III Redemption, made or deemed made by Enron Sub III to its shareholders during such year.

Enron Sub III will not, during any 85 day period that begins within two years of Partnership's acquisition of Enron Sub III preferred stock, redeem from Partnership Enron Sub III preferred stock having, in the aggregate, a value greater than the excess of 5 percent of Partnership's basis in its Enron Sub III preferred stock over the sum of all dividends on such stock that are received by Partnership or have an ex-dividend date during such 85 day period. Enron Sub III will not, during any 365 day period that begins within two years of Partnership's acquisition of Enron Sub III preferred stock, redeem from Partnership Enron Sub III preferred stock having, in the aggregate, a value greater than the excess of 20 percent of Partnership's basis in its Enron Sub III preferred stock over the sum of all dividends on such stock that are received by Partnership or have an ex-dividend date during such 365 day period. While it is anticipated that a substantial portion of the preferred stock of Enron Sub III may be redeemed over time, the timing and amount of Enron Sub III Redemptions will be contingent on a variety of factors, including the continued availability of the anticipated accounting treatment of such transactions and the financial position of Enron and its Affiliates that are included in its consolidated financial statements. With respect to any Enron Sub III Redemption that may occur more than two years after the date on which Partnership acquires stock of Enron Sub III (the "302 Start Date"), there is currently no fixed plan as to the date or amount of any such Enron Sub III Redemption and there will not be, within two years of the 302 Start Date, any announcement, action by Enron Sub III's board of directors, formal or informal agreement or fixed plan, commitment, or other action relating to the amount or the time of such Enron Sub III Redemption.

Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the partners of Partnership (in the aggregate), to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a Purchase, a Holdco Redemption, or an Enron Sub III Redemption. A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using a discount rate that is less than or equal to the weighted average cost of capital of the Enron consolidated group during the relevant period) on the date of the Purchase, the Holdco Redemption, or the Enron Sub III Redemption of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer will equal or exceed the present value (computed using a discount rate that is less than or equal to the weighted average cost of capital of the Enron consolidated group during the relevant period) on the date of the Purchase, the Holdco Redemption, or the Enron Sub III Redemption of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Purchase, the Holdco Redemption, or the Enron Sub III Redemption.

Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group, SPVCo, Enron GP, BT Sub, and their Affiliates, in the aggregate, from the transactions described above. The transactions are considered to produce a net tax benefit, in the aggregate, if the sum of the present values (computed using a discount rate that is less than or equal to the weighted average cost of capital of the Enron consolidated group during the relevant period), on the date on which the first transaction occurs, of the hypothetical federal income tax liabilities of the Enron consolidated group, SPVCo, Enron GP, BT Sub, and their Affiliates, determined as if none of the transactions described above had occurred, exceeds the sum of the present values (computed using a discount rate that is less than or equal to the weighted average cost of capital of the Enron consolidated group during the relevant period), on the date on which the first transaction occurs, of the actual federal income tax liabilities of the Enron consolidated group, SPVCo, Enron GP, BT Sub, and their Affiliates.

A Purchase or an Enron Sub III Redemption will not (i) alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Purchase or the Enron Sub III Redemption) by members of the Enron consolidated group to nonmembers of the Enron consolidated group that are treated as made out of earnings and profits or (ii) result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Purchase or the Enron Sub III Redemption on the earnings and profits of members of the Enron consolidated group.

A Purchase, a Holdco Redemption, or an Enron Sub III Redemption will not have any direct or indirect federal income tax effect on members of the Enron consolidated group other than the section 312 earnings and profits effects and any investment and earnings and profits adjustments attributable to the Purchase, Holdco Redemption, or Enron Sub III Redemption. There is no current plan or intention, and there will be no plan or intention at the time of any Purchase, Holdco Redemption, or Enron Sub III Redemption, that any member of the Enron consolidated group dispose of any stock of Holdco, Enron Sub II, or Enron Sub III except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to a Purchase, Holdco Redemption, or Enron Sub III Redemption.

Partnership and each of its partners will have taxable income from nondividend sources that exceeds its deductible expenses.

II. Tax Consequences Summary

Our beliefs as to the federal income tax consequences of the above transactions are summarized here. These beliefs are based on the analysis below, which is limited to the assumed facts set forth above. Many of the issues considered are highly fact sensitive and our conclusions as to the tax consequences of the transactions could be altered substantially by facts that may develop during the negotiation or execution of an actual transaction.

A. Affiliation

We believe that SPVCo should not be a member of the affiliated group, within the meaning of section 1504(a), of which Enron is the parent. We believe that Enron Sub III will be a member of the affiliated group, within the meaning of section 1504(a)(1), of which Enron is the parent.

B. Purchase

We believe that, under section 304, the payment by Enron Sub II to Partnership for a Purchase of the Enron Sub III stock should be treated as a distribution (the "Deemed Distribution") in redemption of the stock of Enron Sub II for purposes of sections 302 and 303, and that the Deemed Distribution should be treated as a distribution subject to section 301 and as a dividend under section 301(c)(1). We believe that the adjusted basis of the Enron Sub III stock retained by Partnership should be increased by an amount equal to Partnership's adjusted basis in the Enron Sub III stock sold to Enron Sub II. We believe the adjusted basis of SPVCo's interest in Partnership should be increased by its distributive share of the Deemed Distribution. We believe that section 1059 should not be applicable to reduce Partnership's basis in the retained Enron Sub III stock, to reduce SPVCo's basis in its interest in Partnership, or to trigger gain on the Deemed Distribution. Legislation proposed by the President, if enacted, would alter one or more of these conclusions with respect a Purchase that occurs after the date of first committee action on the provision.

We believe that SPVCo should be treated, for purposes of section 243, as having received its distributive share of the Deemed Distribution from Enron Sub II and should be treated as having satisfied the holding period requirement of section 246(c). We believe SPVCo's dividends received deduction with respect to its distributive share of the Deemed Distribution from Enron Sub II should not be subject to reduction under section 246A. We believe that it is more likely than not that SPVCo will be treated as owning 20 percent or more of the stock of Enron Sub II for purposes of section 243(c)(2).

C. Formation of Holdco and Enron Sub III

We believe that the contribution of X percent of the common stock of Regulated to Enron Sub III should cause Enron Sub III to have accumulated earnings and profits equal to X percent of those of Regulated at the time of the contribution. We believe that the contribution of 100 percent of the stock of Regulated to Holdco by Enron and Enron Sub III should cause Holdco to have accumulated earnings and profits equal to those of Regulated at the time of the contribution.

D. Holdco Redemption

We believe that a Holdco Redemption of preferred stock from Enron Sub III should be treated as a distribution subject to section 301 and as a dividend under section 301(c)(1). We believe that the dividend should be eliminated in the consolidated return, that the redemption should result in an adjustment to the basis of the Holdco preferred stock retained by Enron Sub III equal to the amount of Enron Sub III's adjusted basis in the Holdco stock redeemed by Holdco minus the aggregate amount of prior investment adjustments allocable to the Holdco preferred stock (including investment adjustments allocable to the Regulated common stock that Enron Sub III contributed to Holdco) that reflect the amount paid in the redemption, that the dividend should result in a decrease in the earnings and profits of Holdco in an amount equal to the amount paid to Enron Sub III in the redemption, and that the dividend should result in an increase in the earnings and profits of Enron Sub III in an amount equal to the excess of (i) the sum of the amount paid to Enron Sub III in the redemption plus all other distributions by Holdco with respect to the Holdco preferred stock over (ii) the aggregate amount of earnings and profits of Holdco that have previously been allocated to the Holdco preferred stock (including an amount equal to the earnings and profits of Regulated that were allocated to the common stock of Regulated that was contributed to Holdco by Enron Sub III and that were duplicated in Holdco at the time of that contribution).

E. Enron Sub III Redemption

We believe that the payments by Enron Sub III in redemption of the Enron Sub III common and preferred stock should be treated as distributions subject to section 301 and as dividends under section 301(c)(1). We believe that the adjusted basis of the Enron Sub III preferred stock retained by Partnership should be increased by an amount equal to Partnership's adjusted basis in the Enron Sub III preferred stock redeemed by Enron Sub III and that the adjusted basis of SPVCo's interest in Partnership should be increased by its distributive share of the dividend attributable to the redemption of Enron Sub III preferred stock from Partnership. We believe that section 1059 should not be applicable to reduce Partnership's basis in the retained Enron Sub III preferred stock, to reduce SPVCo's basis in its interest in Partnership, or to trigger gain on the redemption. We believe that SPVCo should be treated, for purposes of section 243, as having received from Enron Sub III its distributive share of the dividend attributable to the redemption of preferred stock from Partnership and should be treated as having satisfied the holding period requirement of section 246(c). We believe that SPVCo's dividends received deduction with respect to any dividends on stock of Enron Sub III should not be subject to reduction under section 246A. We believe that the adjusted basis of the Enron Sub III common stock retained by SPVCo should be increased by an amount equal to SPVCo's adjusted basis in the Enron Sub III common stock redeemed by Enron Sub III and that section 1059 should not be applicable to reduce the basis of the Enron Sub III common stock in the hands of SPVCo or to trigger gain on the redemption. Legislation proposed by the President, if enacted, would deny any dividends received deduction with respect to dividends on the Enron Sub III preferred stock if such stock were issued more than 30 days after the date of enactment of the provision.

III. Analysis

A. Deconsolidated Status of SPVCo

In order for SPVCo to be an affiliate of Enron under section 1504 of the consolidated return rules, members of the Enron affiliated group (within the meaning of section 1504) must own stock possessing at least 80 percent of the total voting power and 80 percent of the total value of the stock of SPVCo. Section 1504(a). Enron owns 98 percent of the value, but only 75 percent of the voting power, of the SPVCo shares, and BT Sub owns 2 percent of the value and 25 percent of the voting power of the SPVCo shares. Accordingly, if BT Sub's ownership of 25 percent of the voting power of SPVCo is respected, SPVCo will not be an affiliate of Enron.

We do not believe the disproportionality between the voting rights and the value of the shares held by BT Sub should prevent the voting power of such shares from being taken into account in determining whether SPVCo is an affiliate of Enron. Prior to 1984, section 1504 required that a corporation own 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock of another corporation in order to file a consolidated return with such corporation. Concern about the potential for abuse of the consolidated return privilege by creating an affiliated group using stock that had disproportionately high voting rights as compared to value led to amendments of section 1504 in 1984. See H.R. Rep. No. 98-432, pt. 2, at 1205-06 (1984). The 1984 amendments changed the test for consolidation to require ownership of 80 percent of the voting power and 80 percent of the total value of the stock of a corporation and gave Treasury the authority to prescribe regulations which disregard changes in voting power to the extent such changes are disproportionate to related changes in value. Sections 1504(a)(2), 1504(a)(5)(F). To date, this regulatory authority has not been exercised.

Pre-1984 authority indicates that the Internal Revenue Service (the "Service") did not consider disproportionality between the voting rights and the value of shares of stock, by itself, to be a reason to disregard the voting power of such shares in determining affiliated status. The Service has repeatedly respected the use of heavy voting shares to create affiliated status. In Technical Advice Memorandum 8030007 (Apr. 14, 1980), the taxpayer wanted to create affiliated status through its ownership of a class of common stock that initially represented approximately 80 percent of the number of, 73.5 percent of the consideration paid for, and 96 percent of the vote of all outstanding shares of the corporation, and later represented approximately 40 percent of the number of, approximately 20 percent of the consideration paid for, and slightly in excess of 80 percent of the voting power of all outstanding shares of the corporation. Finding that the voting power accorded the stock existed for a substantial period of time and, during such period, actually reflected the relative rights of the shareholders, the Technical Advice Memorandum concludes that the disproportionate allocation of voting rights was not a sham and that ownership of the stock was sufficient to establish affiliation, despite the facts that the disproportionate voting rights were given to the stock for the purpose of establishing affiliation and were intended to be eliminated after 6 years. See also Priv. Ltr. Rul. 8139089 (June 30, 1981) (affiliated status respected based on ownership of common stock representing 100 percent of the voting power and 60 percent of the equity value of a corporation); Priv. Ltr. Rul. 7401231710B (Jan. 23, 1974) (affiliated status respected based on ownership of common stock representing 80 percent of the voting power and 50 percent of the value of a corporation).

In contrast to the above rulings, in Private Letter Ruling 8022017 (Feb. 22, 1980), the Service refused to permit consolidation based on the ownership of preferred stock representing 80 percent of the voting power of, and 50 percent of the capital contributions to, a corporation. The basis for refusing to allow consolidation was not the disproportionate voting rights, however, but the inconsistency between a literal application of the then applicable investment adjustment rules (which potentially allowed a double deduction of losses where the consolidated group owned only preferred stock) and the Congressional intent that consolidated returns clearly reflect the income tax liability of the affiliated group and prevent the avoidance of such liability. See also Priv. Ltr. Rul. 8339020 (June 28, 1983) (revoking Private Letter Ruling 8146071 (Aug. 21, 1981), in which affiliation was recognized based on ownership of heavy voting preferred stock, because on reconsideration it was concluded that the basis on which the earlier letter ruling was issued was not compatible with the requirements for determining affiliation).

The Service has also respected the use of heavy voting stock to break affiliation. In Private Letter Ruling 6710242620B (Oct. 24, 1967), the taxpayer wanted to deconsolidate a subsidiary using a class of common stock having the power to elect 1/3 of the board of directors of the corporation but representing less than 3.5 percent of the consideration paid for all of the corporation's outstanding stock. The letter ruling concludes, without mentioning the disproportionality between the voting power and value of the stock, that ownership of the entire class of stock outside the group would be sufficient to terminate affiliated status.[3]

Similarly, the Tax Court does not appear to consider a disproportionality between overall capital contributions and voting power to be significant in determining affiliated status. In Merlite Industries, Inc. v. Commissioner, 34 T.C.M. 1361 (1975), the common stock of a corporation was issued 100 shares to Merlite in exchange for $1,000 and 100 shares to an individual who apparently never paid in the $1,000 par value of his shares. Merlite and a subsidiary also made advances in the form of loans to the corporation totaling, over time, in excess of $200,000, of which in excess of $150,000 remained outstanding during the years at issue. The court held that these advances clearly constituted additional contributions to capital. Id. at 1365. In order to obtain a deduction for the substantial losses of the corporation, either under section 165(g)(3)(A) or through consolidation, Merlite argued that the individual's stock ownership should be disregarded because he never paid for his stock. While acknowledging that Merlite's contributions to capital far exceeded those of the individual, the court pointed out that the individual considered himself to be a stockholder (acting as chairman of the board, president and subsequently vice president), the books of the corporation reflected his stock ownership, the corporate income tax returns listed him as having 50 percent of the stock, he signed the stockholders' election of dissolution as a stockholder, no action was ever taken to void his shares, and he was treated as a stockholder from the creation to the dissolution of the corporation. Accordingly, the court concluded there was no basis for finding that he was not a shareholder, and therefore Merlite was not the 80 percent owner of, and was not entitled to file a consolidated return with, the corporation. Id. at 1366.

Consistent with the above authorities, we believe that the determination of whether the purported ownership of voting shares of a corporation should be respected for purposes of

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3 Private Letter Ruling 6710242620B refers to an earlier ruling letter to the same taxpayer which held that the ownership by a nonmember of stock representing 21% of the nonvoting stock of the corporation and 0.62% of the total consideration paid for all of the issued and outstanding stock of the corporation should be disregarded. Accordingly, the technical lack of ownership by the group of 80% of the nonvoting class of stock, as required by the statute at that time, did not prevent the corporation from being included as a member of the affiliated group. There is no indication in Private Letter Ruling 6710242620B whether it was the addition of voting rights to the stock held by nonmembers, the increase in the value of the stock held by nonmembers, or a combination of these factors that caused the stock held by nonmembers to be respected for disaffiliation purposes. Cf. Priv. Ltr. Rul. 8331015 (Apr. 26, 1983) (corporation issued 100% of nonvoting class of common stock to individuals for valid business purpose; assuming the individuals did not hold the nonvoting stock as nominees of the owner of the voting stock and that the nonvoting stock had "sufficient substance" to be recognized for purposes of section 1504, the letter ruling concluded that the issuance of the stock would break affiliation with the owner of the voting stock).

establishing or preventing affiliation should be based on an analysis of all facts and circumstances as they bear on the reality of the ownership and voting power of each shareholder. We believe that neither a disproportionality between voting power and value, nor a purpose to avoid affiliation, should prevent the actual (as opposed to sham) ownership outside the group of more than 20 percent of the effective voting power of a corporation from breaking affiliation. See Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956) (court held sales and gifts by parent corporation of shares of a subsidiary to friendly buyers for the purpose of reducing ownership of the subsidiary to below 80 percent, allowing parent to take loss on liquidation of subsidiary, were effective; the court concluded that the substance of the transfers matched the form, noting the absence of any evidence of an understanding by the parties that any interest in the transferred stock was retained by the parent). Rather, we believe the analysis should focus on whether the purported ownership and voting rights are real or illusory. While disproportionality between vote and value and a purpose to deconsolidate may suggest that the substance of the transaction (i.e., the reality of the ownership and voting rights) deserves careful scrutiny, we believe that these factors by themselves should not cause stock to be disregarded for purposes of determining whether two corporations are affiliates. Cf. Higgins v. Smith, 308 U.S. 473 (1940) (related party transactions subject to greater scrutiny than transactions between unrelated parties because they may not be on arm's-length terms); Sun Properties, Inc. v. United States, 220 F.2d 171, 174 (5th Cir. 1955) (transaction not disregarded simply because not at arm's length).

Authorities dealing with the voting power test contained in the definition of a controlled foreign corporation ("CFC") provide some indication of the factors that the Service and the courts might consider relevant in determining the reality of a shareholder's purported ownership and voting power. While the purposes of the CFC rules and the consolidation rules are quite different, we believe the CFC authorities can be useful in analyzing fact situations in which the taxpayer is attempting to avoid consolidation. The antiabuse considerations underlying enactment of the CFC rules are quite different from the considerations underlying enactment of the consolidated return rules, which are generally considered to create a taxpayer-favorable privilege. Consistent with these differing purposes, the authorities tend to interpret the voting control requirement in the CFC rules in favor of finding control, thereby imposing the limitations of CFC status on the tax avoidance opportunities available to a taxpayer, but tend to interpret the voting control requirement in the consolidated return rules against finding control, thereby denying the privilege of filing a consolidated return. Accordingly, we believe that voting rights that would be recognized as sufficient to avoid control for purposes of determining CFC status should be sufficient to avoid control for purposes of determining affiliation.

Section 957(a) provides that a foreign corporation is a CFC if more than 50 percent of the total combined voting power of the corporation is owned by United States shareholders. (Section 957(a) was amended in 1986 to add, as an alternative basis for classification as a CFC, ownership of more than 50 percent of the total value of the stock of the corporation by United States shareholders.) The regulations under section 957 provide that, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person on whose behalf it is exercised, or, if not exercised, will be disregarded if the percentage of voting power of such class is substantially greater than its proportionate share of the corporate earnings, if the facts show that the shareholders of such class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification as a CFC. Treas. Reg. § 1.957-1(b)(2). Accordingly, disproportionality between vote and value or between vote and profit share does not appear to be a sufficient reason by itself to disregard the voting power of a class of stock. Rather, the facts and circumstances surrounding the manner in which the vote is exercised are critical to a determination to disregard such voting rights.

Application of this regulation by the courts confirms that a disproportionately high vote compared to value or profit share does not, by itself, prevent the purported voting power of shares from being respected. See CCA, Inc. v. Commissioner, 64 T.C. 137 (1975) (nonacq.); Koehring Co. v. United States, 583 F.2d 313 (7th Cir. 1978); Kraus v. Commissioner, 490 F.2d 898 (2nd Cir. 1974); Garlock, Inc. v. Commissioner, 489 F.2d 197 (2nd Cir. 1973); Estate of Weiskopf v. Commissioner, 64 T.C. 78 (1975), aff'd, 538 F.2d 317 (2nd Cir. 1976).

In CCA, the court found that a Swiss corporation was not a CFC where preferred stock carrying 50 percent of the voting rights in the corporation was sold to foreign persons. The fact that the preferred shareholders paid less for their stock than 50 percent of the net worth of the corporation[4] was not considered by the court to be sufficient, in light of other factors present in the case, to disregard the voting power of the preferred stock. 64 T.C. at 153. The other factors considered by the court were that there were no substantial restrictions placed on the preferred stock other than a requirement for approval of transfers that was equally applicable to the common stock, no provision was made for the U.S. shareholders to acquire the preferred stock, the board of directors was equally divided between representatives of the common shareholders and the preferred shareholders, there were no provisions for breaking deadlocks, the board of directors had significant powers, any two members of the board of directors could act jointly to represent the corporation vis-a-vis the outside world, the preferred shareholders were not related to the U.S. shareholders, representatives of the preferred shareholders took an active part in shareholder and director meetings, and the U.S. shareholder retained no "significant strings"

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[4] Based on the facts set forth in the case, it appears that the preferred stock was purchased for an amount equal to not more than 12 percent of the net worth of the corporation.

which could have been used to require the preferred shareholders to vote with it. The court found the facts in CCA to be in sharp contrast to those in Kraus, Garlock, and Weiskopf in which U.S. shareholders were found to have retained dominion and control, despite the ownership by foreign persons of shares representing 50 percent of the voting power of the corporation.

In Kraus, a foreign corporation owned by U.S. persons was recapitalized, just before the CFC rules became effective, by the issuance of preferred stock representing 50 percent of the voting power in the corporation to foreign persons in exchange for a capital contribution that constituted less than 10 percent of the net worth of the corporation. The court disregarded the foreign shareholders' voting power, stating that it "defies credulity" that the owners of a corporation with a net worth in excess of $250,000 and annual profits in excess of $225,000 would surrender 50 percent of the control of their corporation to new shareholders who were making a capital contribution of less than $25,000. Kraus, 490 F.2d at 902. The court went on, however, to review other factors. The court noted that a foreign shareholder was present in person at only one meeting, that the foreign shareholders, while represented at all meetings, had never shown any dissent or disapproval, that the U.S. shareholder had sought out foreign shareholders who were related to, close personal friends of, or business associates of the U.S. shareholder, that the stock issued to the foreign shareholders was registered, could be transferred only upon approval of the board of directors and could be redeemed at any time, and that when the U.S. shareholders decided to sell their shares, they agreed to and did in fact cause the preferred shareholders to sell their stock to certain parties at a specified price. Based on the totality of the facts, and not on any one factor, the court concluded that the corporation was a CFC. Id. at 903.

Garlock is similar to Kraus in that preferred stock possessing 50 percent of the voting power of a foreign corporation was issued to a foreign person just before the effective date of the CFC rules. The preferred stock received a maximum of 16 percent of corporate profits in the years at issue. The court sustained the Service's application of the regulation under section 957, finding that the preferred shareholders voting power was illusory. Garlock, 489 F.2d at 202. The court identified as significant the facts that the U.S. shareholder sought out parties who understood both its motives and its situation, that the terms of the arrangement were such that the preferred shareholders would have no interest in disturbing the U.S. shareholder's continued control, the stock was made attractive by paying a rate in excess of market, the stake of the preferred shareholders was limited since they could put their stock to the corporation after one year or if the working capital of the corporation fell below 200 percent of the aggregate par value of the preferred, and the arbitration provision for resolving disputes was unrealistic. Id. at 201-02.

In Weiskopf, a newly formed UK corporation (Ininco) issued preferred ordinary shares in exchange for £25,000 to another UK corporation (Romney), and issued to a U.S. corporation deferred ordinary shares in exchange for £2,500 and second preferred shares in exchange for £17,500. The preferred ordinary shares elected 50 percent of the board of directors and received a dividend of 12.5 percent per year. The deferred ordinary shares elected the remaining 50 percent of the board of directors and shared the profits of the corporation, after the payment of the dividend on the preferred ordinary shares, with the second preferred shares. While the facts are not entirely clear, it appears that the UK tax exemption of Ininco resulted in Ininco having very substantial net earnings, with the result that the 12.5 percent return on the preferred ordinary shares represented much less than 50 percent of the annual earnings of Ininco. Weiskopf, 64 T.C. at 96. Two and one-half years after its formation, the preferred ordinary shares of Ininco were sold for par value (25,000 pounds) and the remaining shares were sold for approximately 810,000 pounds. Again, the opinion focuses on a factual analysis to determine the reality of the control exercised by Romney. The court concluded that, as in Garlock, the arrangement was such that the preferred shareholder would have no interest in disturbing the U.S. shareholders' control and that the U.S. shareholders retained complete dominion and control of Ininco. The factors mentioned by the court in reaching its conclusion were the above market rate of return being paid on the preferred shares, the limitation of the preferred shareholder to a return of its investment upon disposing of its stock, the dependence of Ininco on the U.S. shareholder as its source of supply for Ininco's product line, the unrealistic provision for resolving a deadlock, the disproportionality between vote and profit share, and the control the U.S. shareholder demonstrated at the time of the sale of the stock of Ininco.

In Koehring, preferred stock entitled to 55 percent of the vote and less than 10 percent of the annual earnings of a Panamanian corporation was issued to a UK corporation that had a longstanding business relationship with the U.S. shareholder of the Panamanian corporation, followed shortly by a cross-investment of the identical amount of cash by the U.S. shareholder of the Panamanian corporation in the UK corporation. The opinion turns on the factual issue of whether the foreign preferred shareholder exercised its 55 percent voting rights independently, with the court focusing on the cross-investment, the dependence of the preferred shareholder on the U.S. shareholder under a license agreement, the actual actions taken by the preferred shareholder's directors and the understanding that the UK corporation could withdraw its investment after a year. The factual statement in the opinion also refers to the preferred directors not being authorized to draw checks on behalf of the corporation and a reference in the minutes of a board of directors meeting of the UK corporation to its control over the Panamanian corporation being "nominal." The court affirmed the district court's decision to disregard the voting power of the UK corporation, distinguishing CCA (without conceding that CCA was correctly decided) based on the tax court's finding of the absence of an agreement in CCA regarding the voting of the foreign shareholders' shares. Koehring, 583 F.2d at 324.

We believe that BT Sub's voting power in SPVCo should be respected because we believe the relevant facts and circumstances indicate that BT Sub's ownership of its shares and its voting rights under the documents should be considered to be real. First and foremost are the facts that Enron will not exercise any control or influence over BT Sub in the exercise of its voting rights in SPVCo and BT Sub will exercise its voting rights in SPVCo for the benefit of itself and its Affiliates, and not on behalf of or for the benefit of Enron and its Affiliates. BT Sub has an economic interest in 2 percent of the profits of SPVCo above the base return provided to the shareholders, which it appears reasonable to believe they would want to protect through the exercise of their voting rights. In addition, BT Sub and Enron are not related, and no fee received by BT Sub or any of its Affiliates in connection with the transactions described herein is contingent upon the manner in which BT Sub exercises its voting rights in SPVCo. Finally, all classes of shares in SPVCo are freely transferable. While SPVCo has a right to redeem the shares held by BT Sub, and BT Sub has a right to require redemption of its shares, these rights do not arise for seven years after the formation of SPVCo. We believe these redemption rights should not affect the reality of BT Sub's voting power during the seven year period that begins on the date SPVCo is formed. Accordingly, we believe the voting power held by BT Sub should be respected and that SPVCo should not be an affiliate of Enron under section 1504.

B. <u>Affiliation of Enron Sub III</u>

The term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if the common parent owns directly stock meeting the 80-percent voting and value test in at least one of the other includible corporations and stock meeting the 80-percent voting and value test in each of the includible corporations (other than the common parent) is owned directly by one or more of the other includible corporations. Section 1504(a)(1). Enron is the parent, and Enron Sub II is a member of, an affiliated group within the meaning of section 1504(a)(1). The 80-percent voting and value test requires ownership of stock of a corporation that possesses at least 80 percent of the total voting power of the stock of such corporation and that has a value equal to at least 80 percent of the total value of the stock of such corporation. Section 1504(a)(2).

The term "includible corporation" means any corporation except (1) corporations exempt from tax under section 501, (2) insurance companies subject to taxation under section 801, (3) foreign corporations, (4) corporations with respect to which an election under section 936 is in effect for the taxable year, (5) regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1 of the Internal Revenue Code of 1986, and (6) a DISC (as defined in section 992(a)(1)). Section 1504(b). Enron Sub III is a for profit Delaware corporation that will not be an insurance company subject to taxation under section 801, a regulated investment company or a real estate investment trust subject to tax under subchapter M of chapter 1 of the Code, or a DISC (as defined in section 992(a)(1)). No election under section 936 will be made with respect to Enron Sub III. Accordingly, we believe Enron Sub III is an includible corporation.

For purposes of section 1504(a), the term "stock" does not include stock that (A) is not entitled to vote; (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; (C) has redemption and liquidation rights which do not exceed the issue price (except for a reasonable redemption or liquidation premium); and (D) is not convertible into another class of stock. Section 1504(a)(4). The Enron Sub III preferred stock is, by its terms, not entitled to vote, limited and preferred as to dividends, and not convertible into any other class of stock. Moreover, the facts do not indicate that the preferred stock of either corporation has any beneficial interest in or control over the voting power of the corporation. The issue price of Enron Sub III preferred stock is not less than its redemption price and its liquidation value (except for a reasonable redemption or liquidation premium).

The last requirement of section 1504(a)(4) is that the stock not participate in corporate growth to any significant extent. No regulatory guidance exists as to the meaning of this section 1504(a)(4) "participation" test. A similar test is contained in the regulations under section 382. An ownership interest that would not otherwise be treated as "stock" for purposes of section 382 is treated as stock if such interest "offers a potential significant participation in the growth of the corporation" and certain other facts are present. Treas. Reg. § 1.382-2T(f)(18)(iii)(A). Section 1504(a)(4) stock is not stock for purposes of section 382 unless the provisions of Treasury Regulation § 1.382-2T(f)(18)(iii) apply. Treas. Reg. § 1.382-2T(f)(18)(i). It appears that stock that satisfies the section 1504(a)(4)(B) requirement that it "not participate in corporate growth to any significant extent" could nevertheless be found to offer a "potential significant participation in the growth of the corporation." Cf. Priv. Ltr. Rul. 8945055 (Aug. 16, 1989). Thus, the participation standard in the section 382 regulation appears to be stricter than that in section 1504(a)(4)(B), and stock that does not offer a "potential significant participation in the growth of the corporation" for purposes of Treasury Regulation § 1.382-2T(f)(18)(iii) should not be considered to "participate in corporate growth to any significant extent" for purposes of section 1504(a)(4)(B).

The yield on the preferred stock of Enron Sub III does not vary with either the profitability of the issuing corporation or the appreciation of its assets. Terms that do not vary the return on the preferred stock with the profits of the issuing corporation may not be sufficient to establish an absence of participation in corporate growth, however, if the facts and circumstances indicate that the preferred stock in effect participates in corporate growth. See H.R. Rep. No. 98-861, at 817 (1984) ("preferred stock carrying a dividend rate materially in excess of a market rate when issued would not be ignored"). An argument might be made that the preferred stock nevertheless participates in corporate growth if the capitalization or operations of the corporation were such that corporate growth would be required in order for the issuing corporation to satisfy its obligations with respect to the preferred stock.[5]

In the section 382 context, the Service has ruled that preferred stock does not offer a potential significant participation in the growth of a corporation solely because of its dividend rate where the current earnings of the corporation are sufficient to permit the corporation to pay dividends at the highest rate with respect to the stock. Priv. Ltr. Rul. 8945055 (Aug. 16, 1989). The Service has also ruled that ownership interests (notes and debentures) in an insolvent corporation did not constitute stock where the issue was whether the notes and debentures offered a potential significant participation in the growth of the corporation within the meaning of Treasury Regulation § 1.382-2T(f)(18)(iii)(A) and the corporation represented that it would have sufficient assets (not taking into account future growth of assets), in conjunction with the cash flow from its projected future earnings and proceeds of anticipated additional debt financing, to meet all required payments of principal and interest on the notes and debentures. Priv. Ltr. Rul. 9441036 (July 14, 1994); see also Priv. Ltr. Rul. 8940006 (Apr. 20, 1989) (preferred stock issued in bankruptcy reorganization was not stock for purposes of section 382; issuing corporation represented that (i) it would have sufficient assets (not taking into account future growth of assets), in conjunction with the cash flow from its projected future earnings, to meet all required payments on the preferred stock, including required payments on preferred stock issued in lieu of cash dividends, and (ii) the fair market value of the assets of the issuing corporation would exceed the face amount of the outstanding debt plus the par value of the preferred stock).

On the date of issue, the annual dividend rate for the preferred stock of Enron Sub III is not materially in excess of the prevailing market rate for preferred stock having similar terms and issued by a corporation having a credit rating similar to that which the issuing corporation would have on the date of issuance if it were rated. The preferred stock of Enron Sub III represents approximately 65 percent of the initial equity capital of Enron Sub III. The fair market value of the assets of Enron Sub III will at all times exceed the face amount of such corporation's outstanding debt plus any accrued but unpaid interest plus the liquidation value (including accrued but unpaid dividends) of its preferred stock. All dividends on the Enron Sub III preferred stock will be paid currently. The current earnings and profits and net cash flow of Enron Sub III for each year will each exceed the annual dividend on its preferred stock.

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5 See Michael L. Schler, Money Market Preferred Stock: Making the Punishment Fit the Crime, 46 Tax Notes 935, 939 (1990) (insubstantial common stock capitalization might mean that the preferred stock bears the downside risk of the corporate assets and thus may not constitute section 1504(a)(4) stock).

We have found no authority addressing the effect, if any, under section 1504(a)(4) of having a substantial portion of a corporation's capital represented by preferred stock. We understand that the Service has refused to rule on this issue, suggesting that the Service might challenge the treatment of such preferred stock.[6] We believe that any such challenge would be based on the participation test, and we further believe that the facts described do not provide any basis for a court to conclude that the preferred stock of Enron Sub III participates in corporate growth to any significant extent. Accordingly, we believe the preferred stock of Enron Sub III is described in section 1504(a)(4).

Enron owns 80 percent of the only class of common stock of Enron Sub III. No stock other than this single class of common stock and the section 1504(a)(4) stock discussed above, and no warrants for stock, obligations convertible into stock, other similar interests with respect to stock, or options to acquire or sell stock of Enron Sub III are issued, created, or outstanding. Accordingly, we believe the 80-percent voting and value test is satisfied with respect to Enron Sub III, and that Enron Sub III will be a member of the affiliated group of which Enron is the parent.

C. Purchase

1. Section 304

Under section 304, if one person controls each of two corporations and, in return for property, one of the corporations (the acquiring corporation) acquires stock of the other corporation from the person so in control, then such property is treated for purposes of sections 302 and 303 as a distribution in redemption of the stock of the acquiring corporation. Section 304(a)(1). Control for these purposes is defined as ownership of 50 percent of the vote or value of all classes of stock. Section 304(c)(1). A modified version of the constructive ownership rules of section 318 is applied to determine ownership. Section 304(c)(3)

Enron owns directly all of the outstanding stock of Enron Sub II. Enron owns in excess of 50 percent of the value of all shares of SPVCo. SPVCo is a partner in Partnership. Under the constructive ownership rules of section 304(c)(3), in general Partnership constructively owns all stock that is directly owned by Enron, Enron Sub II, or SPVCo. Sections 318(a)(2)(C),

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[6] See Priv. Ltr. Rul. 8937022 (June 19, 1989) (par value of nonparticipating preferred stock represented 72 percent of the par value of the entire corporation, no indication given as to fair market value of respective classes; Service did not rule on the section 1504(a) issue); see also Richard B. Engel, The Section 1504(a) Affiliation Test, 20 Tax Adviser 615 (1989) (identifying the refusal by the Service to rule whether preferred stock was section 1504(a)(4) stock when it constituted a substantial percentage of the corporate structure).

318(a)(3)(A), 318(a)(3)(C). Accordingly, Partnership directly owns preferred stock of Enron Sub III and constructively owns all of the remaining outstanding stock of Enron Sub III (i.e., preferred stock, if any, directly owned by Enron Sub II and common stock directly owned by Enron and SPVCo) and all of the outstanding stock of Enron Sub II (because such stock is directly owned by Enron). Accordingly, both before and after the Purchase, Partnership controls both Enron Sub II and Enron Sub III for purposes of section 304. Accordingly, we believe that the acquisition of stock of Enron Sub III by Enron Sub II from Partnership should be subject to section 304(a)(1) and the property transferred from Enron Sub II to Partnership should be treated as a distribution (the "Deemed Distribution") in redemption of stock of Enron Sub II.[7]

The determination of whether the Deemed Distribution in redemption of stock of Enron Sub II is treated as a capital transaction under section 302(b) or as a distribution subject to section 301 is made by reference to the stock of Enron Sub III. Section 304(b)(1). For these purposes, the constructive ownership rules of section 318 are applied without regard to the 50 percent limitation contained in sections 318(a)(2)(C) and 318(a)(3)(C). Applying these constructive ownership rules, Partnership should be treated as owning all shares of Enron Sub III owned by Enron, Enron Sub II, and SPVCo, with the result that Partnership should be treated as owning all of the stock of Enron Sub III for purposes of applying section 302(b). Sections 318(a)(2)(C), 318(a)(3)(A), 318(a)(3)(C). Because Partnership's ownership of Enron Sub III is not diminished by the Purchase, we believe the transaction should be treated as subject to section 301. See sections 302(b), 302(d); United States v. Davis, 397 U.S. 301 (1970).

Under section 301(c)(1) and section 316, a distribution is treated as a dividend to the extent of the earnings and profits of the distributing corporation. Under section 304, the determination of whether the Deemed Distribution is a dividend is made as if the Deemed

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7 If a subsidiary acquires stock of its parent from a shareholder of the parent, section 304(a)(2) treats the property transferred to the shareholder of the parent as a distribution in redemption of the stock of the parent. Prior to Enron Sub II's acquisition of any stock of Enron Sub III, the constructive ownership rules of section 304(c) could be applied to treat Enron Sub II as a subsidiary of Enron Sub III. Literally read, the parent/subsidiary rules of section 304(a)(2) take precedence over the brother/sister rules of section 304(a)(1). We believe that section 304(a)(1) rather than section 304(a)(2) should apply where a parent/subsidiary relationship exists only by reason of constructive ownership. See Treas. Reg. § 1.304-2(c) Example 1 (applying section 304(a)(1) to a brother/sister sale); Rev. Rul. 92-86, 1992-2 C.B. 199 (applying section 304(a)(1) to a brother/sister sale); Broadview Lumber Co. v. United States, 561 F.2d 698, 709 (7th Cir. 1977) (stating, in dicta, that section 304(a)(2) should only apply when the parent corporation controls the subsidiary without relying on constructive ownership). If the statute were construed so as to allow for the application of section 304(a)(2) in brother/sister sales, section 304(a)(1) would become extremely narrow in scope. We do not believe that Congress intended such a result. S. Rep. No. 83-1622, at 239 (1954) (stating section 304(a)(1) applies to brother/sister sales).

Distribution were made by Enron Sub II to the extent of its earnings and profits, and then by Enron Sub III to the extent of its earnings and profits. Section 304(b)(2). Given current and accumulated earnings and profits of Enron Sub II for the year in which the Purchase occurs in excess of the aggregate amount of the Purchase Price plus all other actual or deemed distributions by Enron Sub II in such year, the full amount of the Purchase Price should be treated as a dividend from Enron Sub II.

2. Consequences of Dividend Treatment

Enron Sub II should reduce its earnings and profits under section 312 by the amount of the section 304 dividend. H.R. Rep. No. 98-861, at 1223 (1984).

Under section 304(a)(1), Partnership should be treated as making a capital contribution of the purchased Enron Sub III stock to Enron Sub II. For purposes of determining the tax consequences to Enron Sub II of this deemed contribution to capital, the Service appears to take the position that Partnership should be treated as having made the contribution as a shareholder of Enron Sub II, without regard to the fact that it does not actually own any stock in Enron Sub II. See Treas. Reg. § 1.304-2(a) (referring to section 362(a) for the determination of the basis of the stock that is deemed contributed to the acquiring corporation); Rev. Rul. 71-563, 1971-2 C.B. 175 (applying Treas. Reg. § 1.304-2(a) and section 362(a) to determine the basis of stock in the hands of the acquiring corporation; selling corporation did not directly own any stock of the acquiring corporation); Rev. Rul. 70-496, 1970-2 C.B. 74 (same); compare section 362(a) (general rule providing carryover basis for contributions to capital) with section 362(c)(1) (special rule providing for zero basis in property other than money received as a contribution to capital that is not contributed by a shareholder as such). Accordingly, we believe that Enron Sub II should take a carryover basis in the Enron Sub III stock.[8]

If Partnership were an actual shareholder of Enron Sub II, Partnership's basis in its Enron Sub II stock should be increased by an amount equal to its basis in the Enron Sub III stock deemed contributed to Enron Sub II. Treas. Reg. § 1.304-2(a). In the absence of any direct ownership of Enron Sub II stock, it is not entirely clear what happens to the basis of the transferred Enron Sub III stock. See Coyle v. United States, 415 F.2d 488, 493 (4th Cir. 1968) (in dicta, the court noted that increasing the basis of the constructively held stock of the acquiring

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[8] We note that, in the case of a Purchase (the "Second Purchase") that occurs after an earlier Purchase (the "First Purchase"), the high basis of the Enron Sub III stock in the hands of Partnership attributable to the First Purchase would carry over to Enron Sub II. We have not analyzed the collateral effects under the consolidated return regulations (e.g., the investment adjustment rules, the earnings and profits rules, the loss disallowance rule) of the acquisition of this high basis asset by a member of the Enron consolidated group.

corporation or increasing the basis of the directly held stock of the issuing corporation would be reasonable solutions to the potential basis allocation problem created by the taxpayer's lack of any direct ownership of the acquiring corporation in a section 304 transaction). Where the transferor retains shares of the transferred corporation, the Service has adopted the position that the basis of the transferred shares attaches to the basis of the retained shares. Rev. Rul. 71-563, 1971-2 C.B. 175. But cf. Priv. Ltr. Rul. 8710035 (Dec. 9, 1986), revoked, Priv. Ltr. Rul. 9437004 (June 10, 1994) (basis of transferred issuing corporation stock disappears where seller had only constructive ownership of stock of purchaser; no mention of potential for adding basis to the single share of issuing corporation stock retained by the seller). Given the rejection of alternative approaches by either the Service or the courts,[9] we believe that Partnership should increase its basis in the retained shares of Enron Sub III stock by the amount of its basis in the Enron Sub III stock deemed contributed to Enron Sub II in the section 304 transaction.[10]

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[9] One alternative approach would be to increase the basis of the Enron Sub II stock in the hands of Enron. See Coyle, 415 F.2d at 493; see also Treas. Reg. § 1.302-2(c) *Example (2)* (redemption from husband of all stock held by husband treated as a dividend because of constructive ownership of shares held by wife; basis in the redeemed shares is added to the basis of the shares held by wife); Levin v. Commissioner, 385 F.2d 521, 528 n.29 (2d Cir. 1967) (citing Treas. Reg. § 1.302-2(c) for the proposition that taxpayer's basis in redeemed shares would attach to constructively held shares). The Service, however, has consistently taken the position that no basis adjustments attributable to deemed distributions and contributions resulting from a section 304 transaction are made with respect to constructively held stock. Rev. Rul. 70-496, 1970-2 C.B. 74 (no adjustments to parent's basis in stock of its wholly-owned subsidiary for deemed distribution by the subsidiary in excess of earnings and profits or for the deemed contribution to capital of the subsidiary in connection with subsidiary's purchase of stock from another subsidiary that was 70 percent-owned by parent; basis on transferred stock disappears where transferor does not own any stock of the acquiring corporation or of the acquired corporation after the transfer); Priv. Ltr. Rul. 8710035 (Dec. 9, 1986), revoked, Priv. Ltr. Rul. 9437004 (June 10, 1994) (section 304 transaction has no effect on parent's basis in stock of consolidated wholly-owned subsidiary that acquired stock from another consolidated subsidiary); cf. Rev. Rul. 71-563, 1971-2 C.B. 175 (basis of transferred shares of issuing corporation added to basis of retained shares of issuing corporation where transferor did not directly own any shares of the acquiring corporation).

Another approach would be to allow the basis in the transferred shares to disappear. The Service has adopted this approach where the transferor does not directly own any stock of either the acquiring corporation or the issuing corporation. Rev. Rul. 70-496. The courts, however, have rejected the proposition that basis simply disappears in a transaction. See Coyle, 415 F.2d at 493 ("In any event, it is clear that taxpayer's basis [in the shares transferred in a section 304 transaction] will not disappear.")(dicta); Levin v. Commissioner, 385 F.2d at 521, 528 n.29 (2d Cir. 1967) (in rejecting as without merit taxpayer's argument that dividend treatment of a redemption imposed a tax on gross receipts, court stated that "[h]er basis does not disappear; it simply is transferred to her son").

[10] The revenue proposals in the President's proposed fiscal year 1998 budget include a proposed amendment that would treat Enron Sub II's purchase of Enron Sub III stock as if Partnership had transferred the Enron Sub III stock to Enron Sub II in exchange for stock of Enron Sub II in a section 351(a) transaction and Enron Sub II

Finally, we believe that SPVCo's, Enron GP's, and BT Sub's distributive shares of Partnership's dividend income from the Purchase should increase the basis of their respective interests in Partnership, and that there should not be any reduction in such basis for any dividends received deduction that may be allowable to the partner. Section 705(a)(1)(A) and (B); Treas. Reg. § 1.705-1(a)(2)(ii) (a partner's basis is increased by tax-exempt receipts of the partnership).

3. Consolidated Return Regulations

a. Inapplicability of Section 304 Within a Consolidated Group

Treasury Regulation § 1.1502-80(b) ("-80(b)") provides that section 304 does not apply to the acquisition of a corporation's stock in an intercompany transaction occurring on or after July 24, 1991. A sale between Partnership and Enron Sub II is not an intercompany transaction because Partnership is not a member of the Enron consolidated group.[11] We do not believe the principles underlying -80(b) have any application to transactions that actually occur between persons who are not members of the same consolidated group.

The rule of -80(b) was adopted as "the simplest way to implement the purposes of section 304(b)(4) for a consolidated group. . . ." T.D. 8402, 1992-1 C.B. 302, 303 (preamble). Section 304(b)(4) requires that "proper adjustments" be made to the adjusted basis of stock of a member of an affiliated group that is held by the group, and to the earnings and profits of members of the group, to the extent necessary to carry out the purposes of the section. Section 304(b)(4) was adopted to prevent the use of section 304 transactions within an affiliated group to shift built-in gain within the group, allowing the disposition of appreciated stock of a subsidiary outside the

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had then redeemed the stock issued in the exchange. The effective date of this amendment would be for transactions after the date of first committee action. The fictional issuance of stock created by this amendment may be inconsistent with the positions taken by the Service in Revenue Ruling 70-496 and Revenue Ruling 71-563. While the Treasury Department explanation of the proposal states that the amendment would "clarify" the treatment of a section 304 transaction, the characterization of the change as a clarification is conspicuously absent in the description of the provision by the staff of the Joint Committee on Taxation. We do not believe that the reference to clarification in the Treasury Department explanation is effective to revoke outstanding revenue rulings. Accordingly, we do not believe that current law, including the published positions of the Service, has been changed by the mere proposal of this amendment. In the event this proposal were enacted, however, our conclusion as to the basis consequences of a Purchase occurring after the effective date of the amendment could be substantially different.

11 Even if Partnership was treated, under Treasury Regulation § 1.701-2(e), as an aggregate rather than an entity for purposes of applying -80(b), -80(b) should not be applicable because none of SPVCo, Enron GP, and BT Sub should be a member of the Enron consolidated group.

group without the payment of the corporate level tax on the appreciation. See H.R. Conf. Rep. No. 100-495, at 969-70 (1987); H.R. Rep. No 100-391, pt. 2, at 1084 (1987). Where stock is never owned within the consolidated group, the concerns addressed by section 304(b)(4) would not appear to be present. Accordingly, we do not believe that application of section 304 to a Purchase of Enron Sub III preferred stock that was originally issued to Partnership should be considered inconsistent with the principles underlying -80(b).

b. Intercompany Transaction Rules

In general, Treasury Regulation § 1.1502-13, which contains the intercompany transaction rules of the consolidated return regulations (the "intercompany transaction rules"), applies to transactions between corporations that are members of the same consolidated group immediately after the transaction. Treas. Reg. §§ 1.1502-13(a)(1), -13(b)(1). Partnership is not a member of the same consolidated group as Enron Sub II at any time. Therefore, the Purchase is not an intercompany transaction and, absent the application of the anti-avoidance rule of Treasury Regulation § 1.1502-13(h), the intercompany transaction rules should not be applicable.

The intercompany transaction anti-avoidance rule of Treasury Regulation § 1.1502-13(h) provides as follows:

> If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section.

The purpose of the intercompany transaction rules is "to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)." Treas. Reg. § 1.1502-13(a)(1). The examples under the intercompany transaction anti-avoidance rule provide the only available guidance on what type of transaction has a principal purpose to avoid the purposes of the intercompany transaction rules. Treas. Reg. § 1.1502-13(h)(2). These examples suggest that a transaction may be considered to avoid the purposes of the intercompany transaction rules if it (i) invokes or avoids the effects of those rules, either by interposing an unnecessary intercompany transaction or by avoiding an equivalent and more direct intercompany transaction, for the purpose of altering the consolidated taxable income or consolidated tax liability of the group as compared to an equivalent alternative transaction (Examples 1, 3, 4) or (ii) is structured to affirmatively use the intercompany transaction rules for the purpose of altering the taxable income of a nonmember and the relationship between the transaction and consolidated taxable income or consolidated tax liability is artificially created

(Example 2). See also Prop. Treas. Reg. § 1.1502-13(h)(2) Example 2 (1994) (proposed example deleted in final regulations; would have applied anti-avoidance rule to transaction that did not involve an intercompany transaction and that did not avoid a more direct intercompany transaction).

The Service might argue that the cash contribution from Enron to SPVCo to Partnership, the investment by Partnership in the Enron Sub III preferred stock, the sale of a portion of the Enron Sub III stock to Enron Sub II, and the loan of the proceeds of the sale to Enron should be viewed as an indirect route adopted to avoid intercompany transactions in which Enron invests in Enron Sub III preferred stock and then Enron Sub II purchases the Enron Sub III preferred stock from Enron. The economic consequences of the actual transactions are different from those of such hypothetical intercompany transactions in that BT Sub bears the benefits and burdens of the Enron Sub III preferred stock and the loans to Enron while each is held by Partnership. Moreover, the fact that the investment in the Enron Sub III preferred stock and the Purchase are not intercompany transactions does not alter the consolidated taxable income or consolidated tax liability of the Enron consolidated group as compared to an intercompany investment by Enron and an intercompany sale from Enron to Enron Sub II. Taxable income and tax liability of the consolidated group will not be affected by the investment in the Enron Sub III preferred stock and the Purchase of the Enron Sub III preferred stock by Enron Sub II, without regard to whether Enron or Partnership is the seller, where the Enron Sub III preferred stock and the Enron Sub II stock are retained within the group and no action is taken to utilize any high basis in Enron Sub III stock that carries over to Enron Sub II.

The issuance of Enron Sub III preferred stock in exchange for a capital contribution is not a taxable event, whether the investment is made by Enron or by Partnership. Under the transactions as structured, the section 304 dividend by Enron Sub II does not affect the group's taxable income or tax liability, and Enron Sub II takes the Enron Sub III preferred stock with a carryover basis equal to Partnership's basis in the stock. Under the intercompany transaction alternative, Enron's gain or loss, if any, on the sale of Enron Sub III preferred stock directly to Enron Sub II would be deferred under the intercompany transaction rules. There is no current plan or intention, and there will be no plan or intention at the time of a Purchase, to dispose of the Enron Sub II stock or the high basis Enron Sub III stock acquired by Enron Sub II outside the Enron consolidated group, and Enron and its Affiliates will not take any action to utilize any high basis in Enron Sub III stock that carries over to Enron Sub II. Under these facts, there should be no difference in the tax liability or taxable income of the Enron consolidated group following a Purchase and following a hypothetical intercompany transaction in which Enron invests directly in Enron Sub III and then sells stock of Enron Sub III to Enron Sub II.

In the absence of any alteration in the consolidated taxable income or the consolidated tax liability of the Enron consolidated group, we believe any application of the intercompany transaction anti-avoidance rule to a Purchase would have to be based on the effects of the Purchase on the separate taxable income or tax liability of a nonmember. In Example 2 under the intercompany transaction anti-avoidance rule, a nonmember holds an obligation of a member with an unrealized loss. The holder becomes a member of the group temporarily, triggering the loss in the obligation under the rules of Treasury Regulation § 1.1502-13(g) when the obligation becomes an intercompany obligation. While the transaction also results in the inclusion of discharge of indebtedness income on the consolidated return, this effect appears to be ignored in determining the applicability of the anti-avoidance rule. Rather, it is a principal purpose to accelerate the loss, which is carried to the holder's separate return years, that is cited as the reason for applying the anti-avoidance rule to treat the obligation as not becoming an intercompany obligation. This example suggests that, under some circumstances, the affirmative use of the intercompany transaction rules to alter the separate taxable income of a nonmember may be inconsistent with the purposes of the intercompany transaction rules (i.e., to provide rules to clearly reflect consolidated taxable income). We believe that Example 2 should be strictly limited to factual situations in which (i) a transaction is structured to affirmatively use the intercompany transaction rules for the purpose of altering the taxable income of a nonmember and (ii) the relationship between the transaction and consolidated taxable income or consolidated tax liability is artificially created (e.g., because the status of a participant as a member of the group is transitory).

In the case of the Purchase, there is no affirmative application of the intercompany transaction rules to affect the income of a nonmember. Rather, the tax consequences of the Purchase to nonmembers are determined without the application of any consolidated return rules because Partnership is not a member of the Enron consolidated group. Based on the absence of either an alteration of consolidated taxable income or consolidated tax liability or a positive use of the intercompany transaction rules to alter a nonmember's separate taxable income or tax liability, we believe the intercompany transaction anti-avoidance rule should not be applicable to the Purchase.

c. Earnings and Profits Rules

The section 304 dividend from Enron Sub II should result in a reduction under section 312 in Enron Sub II's earnings and profits. H.R. Rep. No. 98-861, at 1223 (1984). Additional adjustments to the earnings and profits of members of the Enron consolidated group may be required in connection with the Purchase under Treasury Regulation § 1.1502-33, which contains rules (the "earnings and profits rules") for adjusting the earnings and profits of members of the group where one member owns stock of another member.[12]

Treasury Regulation § 1.1502-33(g) provides as follows:

> If any person acts with a principal purpose contrary to the purpose of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

The purpose for the modifications made by the earnings and profits rules is to treat a parent and a subsidiary as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent. Treas. Reg. § 1.1502-33(a)(1). The preamble to the regulations describes the earnings and profits system as "fundamentally concerned with measuring dividend paying capacity. . . ." T.D. 8560, 1994-2 C.B. 200, 201.

The primary earnings and profits effect of the Purchase on members of the Enron consolidated group is the reduction under section 312 in the earnings and profits Enron Sub II attributable to the section 304 dividend by Enron Sub II. The potential for distortions of earnings and profits from a section 304 transaction has been specifically considered and addressed by Congress. In the case of a section 304 transaction between members of an affiliated group, section 304(b)(4) requires that "proper adjustments" be made to the earnings and profits of members of the group to the extent necessary to carry out the purposes of section 304. The consolidated return regulations implement this directive in the context of members of a consolidated group by denying the application of section 304 to intercompany transactions. Treas. Reg. § 1.1502-80(b). Since Enron Sub II and Partnership are not affiliates, section 304(b)(4) and Treasury Regulation § 1.1502-80(b) should not be applicable. Given provisions which specifically deal with potential earnings and profits distortions produced within an affiliated group by section 304 transactions, we believe a court would be reluctant to create further exceptions under a more general anti-avoidance provision.

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12 We have not analyzed the specific earnings and profits adjustments that would be required under the consolidated return regulations in connection with a Purchase. Our analysis of the application of the anti-avoidance rule in the earnings and profits rules is based on the fact that the effects of a Purchase on the earnings and profits of members of the Enron consolidated group will not alter the amount of distributions by members of the Enron consolidated group to nonmembers that are treated as made out of earnings and profits and will not result in any tax benefit to the Enron consolidated group or its shareholders.

The earnings and profits effects of a Purchase will not (i) alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Purchase) by members of the Enron consolidated group to nonmembers that are treated as made out of earnings and profits or (ii) result in any tax benefit to the Enron consolidated group or its shareholders attributable to the reduction of the earnings and profits of members of the Enron consolidated group arising from the deemed distribution created by the application of section 304 to the Purchase. Accordingly, we believe the earnings and profits effects of a Purchase should not be considered to produce a result that is contrary to the purpose of the earnings and profits rules or that avoids the effect of the earnings and profits rules or any other provision of the consolidated return regulations.

d. Investment Adjustment Rules

Treasury Regulation § 1.1502-32 contains rules (the "investment adjustment rules") for adjusting the basis of stock of a subsidiary member of the group that is owned by another member. These rules modify the otherwise applicable basis rules by adjusting the shareholder/member's basis in the subsidiary's stock to reflect the subsidiary's distributions and items of income, gain, deduction and loss taken into account for the period that the subsidiary is a member of the consolidated group. Treas. Reg. § 1.1502-32(a)(1). The amount of adjustments is the net amount of the subsidiary's taxable income or loss, tax-exempt income, noncapital, nondeductible expenses, and distributions with respect to the subsidiary's stock. Treas. Reg. §§ 1.1502-32(b)(2). The portion of the adjustment attributable to a distribution with respect to the subsidiary's stock is allocated to the shares of the subsidiary's stock to which the distribution relates. Treas. Reg. § 1.1502-32(c)(1).

As discussed above, the Service has consistently taken the position that basis adjustments attributable to the deemed distributions and contributions resulting from a section 304 transaction are made with respect to stock held directly by the taxpayer receiving the deemed distribution or making the deemed contribution, but not with respect to stock that is held constructively by such taxpayer. Rev. Rul. 71-563; Rev. Rul. 70-496. Based on this authority, we believe that distributions and contributions that are deemed to occur under section 304 with respect to stock that is constructively held by a taxpayer should not be treated as being made through the shareholder from whom ownership is attributed (the "direct" shareholder) for purposes of determining the federal tax effects of such deemed transactions on the direct shareholder. Accordingly, we believe Enron should not be treated as having either received a distribution from or made a contribution to Enron Sub II in connection with the Purchase for purposes of applying the investment adjustment rules (or other applicable basis rules of the Code).[13]

The investment adjustment rules contain an anti-avoidance rule which calls for adjustments to be made to carry out the purpose of the investment adjustment rules if a person acts "with a principal purpose which is contrary to the purpose of [the investment adjustment rules], to avoid the effect of [the investment adjustment rules], or to apply [the investment adjustment rules] to avoid the effect of any other provision of the consolidated return regulations." Treas. Reg. § 1.1502-32(e)(1). The purpose of the investment adjustment rules is to treat the shareholder/member and the subsidiary as a single entity so that consolidated taxable income reflects the group's income. Treas. Reg. § 1.1502-32(a)(1).

The examples under the investment adjustment anti-avoidance rule suggest that it is applicable where stock ownership or affiliated status is manipulated in order either to obtain the benefits of positive investment adjustments without bearing the burden of corresponding negative investment adjustments (Examples 1, 4, 5) or to shift basis among group members or among classes of stock, thereby reducing gain recognition on an anticipated sale (Examples 2, 3). Treas. Reg. § 1.1502-32(e)(2) *Examples 1-5*. A Purchase will not have any direct or indirect federal income tax effect on members of the Enron consolidated group other than the section 312 earnings and profits effects and any investment and earnings and profits adjustments attributable to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a Purchase. There is no current plan or intention, and there will be no plan or intention at the time of any Purchase, that any member of the Enron consolidated group dispose of any stock of Holdco, Enron Sub II, or Enron Sub III except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to a Purchase. Based on these facts, we believe that neither Enron nor any of its Affiliates should be considered to have a principal purpose which is contrary to the purposes of the investment adjustment rules, to avoid the effect of the investment adjustment rules, or to apply the investment adjustment rules to avoid the effect of any other provision of the consolidated return regulations.

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13 We have not analyzed the specific investment adjustments that would be required under the consolidated return regulations in connection with a Purchase. Our analysis of the application of the investment adjustment anti-avoidance rule is based on the fact that no action will be taken to obtain any tax benefit from investment adjustments attributable, directly or indirectly, to a Purchase.

4. Dividends Received Deduction

Subject to certain limitations, a corporation is allowed a deduction for a percentage of the amount "received as dividends" from a domestic corporation which is subject to taxation under Chapter 1 of Subtitle A of the Code. Section 243.[14]

a. Receipt of a Dividend from a Domestic Corporation

In determining its income tax, each partner must take into account separately, as part of the dividends received by it from domestic corporations, its distributive share of dividends received by the partnership with respect to which the partner is entitled to a deduction under part VIII of subchapter B (currently sections 241-250). Section 705(a)(2); Treas. Reg. § 1.701-1(a)(5). The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of section 701(a) is determined as if such item were realized directly from the source from which realized by the partnership. Section 702(b); Treas. Reg. § 1.702-1(b). Based on this authority we believe that each partner in a partnership should be treated, for purposes of section 243, as having received its distributive share of a partnership's dividend income directly from the source from which the partnership received the dividend.

Section 304 was amended in 1984 to clarify, among other things, the source of deemed distributions. Pursuant to those amendments, section 304(b)(2) provides that the determination of the amount which is a dividend and the source thereof is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. The effect of this amendment was described in the legislative history as follows:

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[14] The revenue proposals in the President's proposed fiscal year 1998 budget include a proposed amendment that would deny the dividends received deduction for dividends on "limited term preferred stock" of a corporation that is not an affiliate of the taxpayer. Limited term preferred stock is stock that is limited and preferred as to dividends, that does not participate (through a conversion privilege or otherwise) in corporate growth to any significant extent, and with respect to which (i) the holder has the right to put the stock to the issuer or a related person, (ii) the issuer or a related person is required to purchase the stock, (iii) it is more likely than not that the issuer or a related person will exercise a right to redeem or purchase the stock, or (iv) the dividend rate on the stock varies in whole or in part with reference to interest rates, commodity prices, or similar indices. See 1998 Revenue Proposals Explanation. This amendment would apply to dividends on stock issued more than 30 days after the date of enactment. If enacted, this proposal would deny the dividends received deduction with respect to dividends received by Partnership on any preferred stock of Enron Sub III that is issued more than 30 days after the date of enactment.

> [I]n all cases . . . the characterization of a distribution as a dividend, and the source of the dividend will be determined by treating the distribution as made by the acquiring corporation directly to the selling shareholder to the extent of the earnings and profits of the acquiring corporation and then as made by the issuing corporation directly to the selling shareholder to the extent of its earnings and profits. Thus, any dividend received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the corporation which is treated as having made the distribution.

H.R. Rep. No. 98-861, at 1223 (1984). The fiction of a dividend made directly to the seller by the acquiring corporation to the extent of the acquiring corporation's earnings and profits has been respected by the Service for purposes of section 243 where the seller has only constructive ownership of stock of the acquiring corporation. Priv. Ltr. Rul. 8609054 (Dec. 3, 1985), modified on another issue, Priv. Ltr. Rul. 8737027 (June 12, 1987) (dividends received deduction allowed to seller that had only constructive ownership of stock of acquiring corporation). Accordingly, we believe that, for purposes of section 243, Partnership should be treated as having received the Deemed Distribution directly from Enron Sub II and SPVCo should be treated as having received its distributive share of the Deemed Distribution directly from Enron Sub II.

b. Section 246(c)

No deduction is allowed in respect of any dividend on any share of stock which is held by the taxpayer for 45 days or less. Section 246(c)(1)(A). For purposes of determining the period for which the taxpayer has held any share of stock, any day which is more than 45 days after the date on which such share becomes ex-dividend is not taken into account. Section 246(c)(3)(B). The holding period is reduced for periods where the taxpayer's risk of loss is diminished. Section 246(c)(4).

Implicit in the provisions of section 702, which contemplate that a partner may be entitled to a dividends received deduction with respect to dividends received by a partnership, is that the holding period requirements of section 246(c) can be satisfied with respect to stock that a corporation owns indirectly through a partnership. Accordingly, we believe that a partner should be considered to have satisfied the holding period requirement of section 246(c) to the same extent that the partnership that receives the dividend would be considered to have satisfied the holding period requirement of section 246(c) if the partnership itself were otherwise entitled to the dividends received deduction.[15]

In order to determine whether Partnership could satisfy the holding period requirement of section 246(c), it is first necessary to identify the share of stock on which a dividend is paid. In the context of a section 304 transaction involving constructive ownership, the identity of the stock on which the dividend is paid is not clear. In the instant case, prior to any Purchase, Enron has a holding period in the common stock of Enron Sub III and Enron Sub II, SPVCo has a holding period in the common stock of Enron Sub III, and Partnership has a holding period in the preferred stock of Enron Sub III in excess of the 45 days required by section 246(c)(1). Accordingly, whether one looks to the holding period of the stock of the acquiring corporation (Enron Sub II) or to the holding period of the stock of the issuing corporation (Enron Sub III), and whether one considers directly held stock or constructively held stock, we believe the holding period requirement of section 246(c)(1) should be satisfied.

In the case of stock having a preference in dividends, the required holding period is extended to 90 days if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days. Section 246(c)(2). If the section 304 dividend were treated as paid on the Enron Sub III preferred stock, the Service might argue that the 90 day holding period is applicable if the earnings and profits that support the dividend were accrued over a period of more than 366 days. The Service might further argue that the disposition in the Purchase of some of the Enron Sub III preferred shares prevented those shares from satisfying the 90 day holding period requirement, triggering the application of section 246(c) to deny the dividends received deduction. Such an argument requires that the section 304 dividend be treated as paid on the transferred Enron Sub III preferred stock, which is inconsistent with the directive of section 304(b)(2) and its legislative history that the section 304 distribution be treated as made first by Enron Sub II to the extent of its earnings and profits. Moreover,

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15 If complete aggregate treatment of a partnership were applied for purposes of section 246(c), it might be argued that the holding period of the partner with respect to its interest in the partnership should be taken into account in applying section 246(c). Cf. Treas. Reg. § 1.856-3(g) (real estate investment trust deemed to own its proportionate share of assets of partnership in which it is a partner; holding period with respect to sale of property by partnership is shorter of partnership's holding period in asset or partner's holding period in partnership interest); Priv. Ltr. Rul. 9615004 (Apr. 12, 1996) (extending aggregate treatment prescribed by statute for purposes of section 851(b)(2) to determine satisfaction by regulated investment company of section 854 requirements relating to sections 243, 246, and 246A; holds regulated investment company will be deemed to hold its proportionate share of assets of a partnership for the period that the partnership held the assets or for the period the regulated investment company has held its interest in the partnership, whichever is shorter). Under the facts, each partner will have a holding period in its interest in Partnership that should satisfy the requirements of section 246(c)(1).

where the basis of the redeemed shares is added to the basis of the retained shares, and assuming the 90 day holding period will be satisfied with respect to the retained shares prior to any disposition of those shares, we believe the case for applying section 246(c)(2) to deny the dividends received deduction would be weak.

c. Section 246(b)

Section 246(b) imposes limits on the aggregate amount of section 243 deductions, based on the taxable income of the taxpayer, computed with certain adjustments. Section 246(b)(2). In essence, section 246(b) denies a taxpayer the benefit of the dividends received deduction to the extent the dividend is offset by other deductions. Partnership and each of its partners will have taxable income from nondividend sources that exceeds its deductible expenses. Accordingly, we believe section 246(b) should not apply.

d. Section 246A

Section 246A reduces the percentage used in computing the dividends received deduction "in the case of any dividend on debt-financed portfolio stock." Section 246A(a). Portfolio stock means any stock of a corporation unless, as of the beginning of the ex-dividend date, (A) the taxpayer owns stock of the corporation that represents 50 percent of the vote and 50 percent of the value of all stock of the corporation (the "50 percent test"), or (B) the taxpayer owns stock of the corporation that represents 20 percent of the vote and 20 percent of the value of all stock of the corporation (the "20 percent test") and five or fewer corporate shareholders own stock that satisfies the 50 percent test. Section 246A(c)(2). For purposes of satisfying the 50 percent test and the 20 percent test, stock described in section 1504(a)(4) is not taken into account. Section 246A(c)(4).

In order to determine whether a section 304 dividend is paid on portfolio stock, it is necessary to determine the identity of the corporation on whose stock the section 304 dividend is paid. Section 304(a)(1) treats the purchase by Enron Sub II as a distribution in redemption of stock of Enron Sub II and section 304(b)(2) determines the amount of the deemed distribution which is treated as a dividend (and the source thereof) as if the property were distributed by Enron Sub II. The Service has characterized a section 304 dividend as a dividend to the selling corporation from the acquiring corporation where the selling corporation had only constructive ownership of stock of the acquiring corporation. Priv. Ltr. Rul. 8609054 (Dec. 3, 1985). In addition, the Service has applied the ownership test of section 902(a), which applies to a domestic corporation that owns 10 percent or more of the voting stock of a foreign corporation from which it receives a dividend, by reference to the constructive ownership of the stock of the acquiring corporation in a section 304 transaction. Rev. Rul. 92-86, 1992-2 C.B. 199. Accordingly, we believe that the section 304 dividend should be treated as paid to Partnership by Enron Sub II.

While we have found no explicit authority on the identity of the stock on which a redemption dividend is paid, we believe that a dividend that is treated as paid by Enron Sub II should be treated as paid on stock of Enron Sub II. See H.R. Conf. Rep. No. 98-861, at 817 (1984) (statement in legislative history of section 1059 that a redemption dividend is treated as being made pro rata with respect to the stock of the shareholder which is not redeemed).[16]

Applying the requirements of section 246A at the partner level, stock of Enron Sub II will not be portfolio stock with respect to SPVCo if Partnership's constructive ownership of stock of Enron Sub II is taken into account. Section 246A does not specifically provide for the general application of constructive ownership rules. Nevertheless, in the context of a transaction which is subject to section 304 based on ownership of the stock of Enron Sub II that is constructive only, we believe that the constructive ownership of the stock of Enron Sub II should be taken into account in applying section 246A with respect to a section 304 dividend from Enron Sub II. See Rev. Rul. 92-86, 1992-2 C.B. 199. Accordingly, we believe that the stock of Enron Sub II should not be treated as portfolio stock with respect to SPVCo and that SPVCo's dividends received deduction with respect to its distributive share of the Deemed Distribution should not be subject to reduction under section 246A.

e. Percentage

Section 243(a)(1) provides for a deduction equal to 70 percent of the dividend amount, with certain exceptions that are not applicable to the instant case. Section 243(c) increases this percentage to 80 percent in the case of any dividend received from a 20-percent owned corporation. A 20-percent owned corporation is defined as any corporation if 20 percent or more of the stock of such corporation (by vote and value) is "owned" by the taxpayer. Section 243(c)(2). This definition raises the issues of whether a partner is treated as "owning" stock owned by a partnership and whether constructive ownership under section 304 is taken into account in determining "ownership."

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[16] The Service might argue that the dividend should be treated as paid on the only stock that Partnership owns directly (i.e., stock of Enron Sub III). If the section 304 dividend were treated as a dividend on the preferred stock of Enron Sub III retained by Partnership, we believe SPVCo's dividends received deduction with respect to the section 304 dividend should not be subject to reduction under section 246A because SPVCo owns 20 percent of the common stock of Enron Sub III.

With respect to the issue of whether a partner should be treated as owning stock owned by a partnership, the Service has taken the position that ownership through a partnership is ownership for purposes of the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation. See Rev. Rul. 71-141, 1971-1 C.B. 211 (allowing section 902 credit to partners who hold 20 percent interests, indirectly through a partnership, in foreign corporation). Based on this authority, we believe that it is more likely than not that, for purposes of section 243(c), SPVCo will be treated as owning 98 percent (its share of profits and capital) of any stock of Enron Sub II that Partnership is treated as owning.

With respect to the issue of whether constructively held stock will be taken into account in determining ownership of the payor corporation in a section 304 transaction, we again look to the statement in the legislative history of the 1984 amendment to section 304 that any dividends received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the acquiring corporation (to the extent of its earnings and profits). The Service has cited this legislative history in ruling that a section 304(a)(1) dividend qualifies for the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation, even though the transferor corporation did not own directly any stock in the acquiring corporation. Rev. Rul. 92-86, 1992-2 C.B. 199. Of particular importance is the fact that section 902, like section 243(c), does not invoke the constructive ownership provisions of section 318. See First Chicago Corp. v. Commissioner, 96 T.C. 421 (1991) (corporation not allowed to aggregate its ownership with that of its affiliates so as to meet the requisite ownership of section 902); Rev. Rul. 85-3, 1985-1 C.B. 222 (section 902 does not allow indirect ownership through subsidiaries to satisfy the section 902 ownership requirement). Nevertheless, Revenue Ruling 92-86, 1992-2 C.B. 199, explicitly holds that the transferor corporation's constructive ownership as determined under section 304(c) is counted for purposes of determining the existence and amount of direct ownership under section 902. Based on the legislative history of section 304 and the Service's position in Revenue Ruling 92-86, we believe that it is more likely than not that Partnership will be treated, for purposes of section 243(c)(2), as "owning" the stock of Enron Sub II that it constructively owns for purposes of section 304.

5. Section 1059

Section 1059 provides for the reduction (but not below zero) of a corporation's basis in stock by the amount of the dividends received deduction allowable with respect to certain "extraordinary" dividends received with respect to such stock. Extraordinary dividends that trigger the application of section 1059 include (i) a dividend received by a corporation with respect to a share of stock that equals or exceeds a threshold percentage of the corporation's adjusted basis in such share of stock, if the corporation has not held such share of stock for more than two years before the dividend announcement date or (ii) any amount treated as a dividend in the case of any redemption of stock which is non pro rata as to all shareholders. Sections 1059(a)(1), 1059(e)(1). The reduction occurs immediately before any sale or disposition of the stock. Section 1059(d)(1). Any excess of the dividends received deduction over the basis of the stock is treated as gain upon disposition of the stock. Section 1059(a)(2). The Service takes the position, and we assume for purposes of this discussion, that a partnership is treated as an aggregate for purposes of applying section 1059, with each partner treated as owning its share of the stock owned by the partnership. Treas. Reg. § 1.701-2(f) *Example 2*. The discussion refers to Partnership and the application of section 1059 to Partnership, with the understanding that the dividends received deduction that causes a portion of the dividend to be nontaxable is that of one or more partners of Partnership.

While Treasury has been given broad regulatory authority by section 1059(g), to date there have been no regulations or other administrative authorities addressing the application of section 1059 to a section 304 transaction.[17] The difficulties in determining how or whether section 1059 should be applied in the instant case arise from the fact that Partnership does not own directly any stock of Enron Sub II. Section 1059 assumes that the recipient of a dividend owns the stock with respect to which a dividend is paid and has a basis in such stock that could be reduced. Despite these uncertainties, we believe that the Purchase should not be treated as meeting the threshold requirements of section 1059 under current law.

a. Pro Rata Redemption

A threshold question in the case of a redemption of stock is whether the redemption is pro rata as to all shareholders. No guidance has been issued on the meaning of "pro rata" for these purposes. The application of section 304, and the resulting deemed redemption of stock of Enron Sub II from Partnership, is based on Partnership's constructive ownership of all of the stock of Enron Sub II. Where the only ownership by a taxpayer of stock of the redeeming corporation is

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[17] The President's fiscal year 1998 revenue proposals include a proposed amendment that addresses the interaction of sections 1059 and 304. See Treasury Explanation of Clinton Administration's Fiscal Year 1998 Revenue Proposals (Feb. 6, 1997) ("1998 Revenue Proposals Explanation"). Under this amendment, section 1059 would be applicable to the Deemed Distribution without regard to either the holding period of any stock or the amount of the Deemed Distribution. The effective date of this amendment would be for transactions after the date of first committee action. If this amendment were enacted, we believe that section 1059 would be applicable to a Purchase that occurs after the effective date to reduce Partnership's basis attributable to the transferred shares of Enron Sub III preferred stock by the amount of the dividends received deduction allowable with respect to the Deemed Distribution.

constructive, we believe the "non pro rata" test of section 1059(e) should be applied by reference to this same constructive ownership. In other contexts, a redemption from a shareholder that owns 100 percent of the stock of a corporation by attribution is treated as being pro rata. See United States v. Davis, 397 U.S. 301 (1970) (application of attribution rules make 25 percent shareholder a 100 percent shareholder; treated as "sole shareholder" for purposes of section 302; Congress clearly mandated that pro rata distributions be treated under rules of section 301 rather than under section 302; redemption was essentially equivalent to a dividend); Rev. Rul. 81-289, 1981-2 C.B. 82 (describing the distribution in Davis as "precisely pro rata"). Since Partnership constructively owns 100 percent of all classes of stock of Enron Sub II, we believe Partnership should be viewed as the sole shareholder of Enron Sub II for purposes of testing whether a deemed redemption from Partnership of stock of Enron Sub II is "pro rata as to all shareholders." In the case of a redemption from a sole shareholder, we do not believe it is necessary to determine the class of stock that is deemed to have been redeemed in order to determine whether the redemption is pro rata as to all shareholders. Accordingly, we believe the deemed redemption of Enron Sub II stock from Partnership should be treated as pro rata as to all shareholders for purposes of section 1059(e).[18]

b. Two-Year Holding Period

Where a redemption is pro rata, a second threshold question for application of section 1059 is whether the stock with respect to which the dividend is received has been held by the corporation for more than two years. For this purpose, the holding period of stock is determined under rules similar to the rules of sections 246(c)(3) and 246(c)(4). Section 1059(d)(3). For the reasons discussed below, we believe it is the holding period in the Enron Sub II stock that should be relevant in applying section 1059. Accordingly, we believe that a two-year holding period with respect to the stock of Enron Sub II should preclude application of section 1059.

Enron Sub II is the corporation that is treated as redeeming its stock under section 304(a)(1) and as the payor of the section 304 dividend under section 304(b)(2)(A). The legislative history of section 1059 states that "if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to stock of the shareholder

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[18] If the determination of whether a redemption is pro rata were made at the partner, rather than the partnership level, we believe the redemption should be treated as pro rata provided that each partner's distributive share of the dividend is proportional to each partner's proportionate share of stock held, directly, indirectly, or constructively, by the partnership. We believe this should be the result if allocations of substantially all Partnership items, and allocations of all items relating to any stock, are made in proportion to the capital contributions of each partner.

which is not redeemed." H.R. Conf. Rep. No. 98-861, at 817 (1984). Accordingly, we believe the stock with respect to which the Deemed Distribution is made should be stock of Enron Sub II that is owned by Partnership and that is not redeemed (i.e., that remains outstanding after the transaction). Where a taxpayer does not directly own any stock of the redeeming corporation, we believe that the holding period test of section 1059 should be applied by looking to the holding period of stock that is constructively held by the taxpayer.

We believe looking to the holding period of the Enron Sub II stock is consistent with the purpose of section 304 to ensure that Code provisions relating to dividend treatment of direct redemptions are not circumvented through the use of indirect redemptions. It is the common ownership by Enron of Enron Sub II and Enron Sub III that results in the application of section 304, and it is the earnings and profits of Enron Sub II that support the dividend characterization of the deemed redemption. Under these facts, we believe that the direct redemption, the tax consequences of which section 304 is intended to mimic, should be considered to be a redemption of Enron Sub II stock from Enron. If Enron Sub II had redeemed a portion of its stock directly from Enron, section 1059 would not have been applicable, given that Enron's holding period with respect to the Enron Sub II stock exceeds two years. Similarly, if Enron owned Enron Sub III preferred stock directly, then in a purchase by Enron Sub II of Enron Sub III preferred stock directly from Enron, we believe it would be the holding period in the stock of the redeeming company (i.e., Enron Sub II) that would be considered relevant for purposes of determining whether section 1059 would be applicable to such a transaction.

Section 1059 was enacted to address tax arbitrage opportunities presented by the effective rate of tax on dividend income as compared to the effective rate of tax on income that could be offset by a capital loss. H.R. Rep. No. 98-432, pt. 2, at 1186 (1984). Section 1059 is concerned with the creation of a noneconomic tax loss where a corporation purchases stock in anticipation of an extraordinary dividend, receives the dividend, and then sells the stock for a loss (resulting from the decline in value of the stock attributable to the payment of the dividend). See H.R. Rep. No. 98-432, pt. 2, at 1184 (1984); S. Prt. 98-169, vol. I, at 170 (1984). The Service may argue that, despite the technical satisfaction of the two-year holding period requirement with respect to the stock of Enron Sub II, application of section 1059 is necessary to effectuate the intent of Congress to prevent tax arbitrage because the recipient of the extraordinary dividend (Partnership) holds an asset (the retained Enron Sub III stock) with respect to which a potential noneconomic tax loss (i.e., an excess of basis over value) has been created in connection with the section 304 transaction. The Service might argue further that, to the extent Partnership has a holding period of less than two years in the Enron Sub III stock, the literal language of section 1059 should yield to the underlying purpose of the statute to prevent tax arbitrage and section 1059 should be applicable.

While this argument has some initial appeal, an examination of the facts indicates that the distortion between basis and economics in the instant case is created by the combined fictions of sections 304 and 318, which treat a sale of stock as if it were a dividend from, and a contribution to the capital of, a corporation in which the taxpayer has no direct ownership of stock, rather than by the effects of an extraordinary dividend addressed by section 1059. The excess of basis over value in the stock of Enron Sub III retained by Partnership is not attributable to a reduction in the value of Enron Sub III due to a dividend distribution, but rather to an increase in the basis of the retained Enron Sub III stock with respect to a deemed contribution to capital to another corporation (Enron Sub II). Moreover, where it is the earnings and profits of Enron Sub II that support the dividend characterization of the section 304 deemed redemption, we believe the holding period with respect to the Enron Sub III stock should be considered irrelevant in the context of the objectives of section 1059.

The lack of any distortion caused by the dividend portion of a section 304 transaction (as opposed to the basis adjustment relating to the deemed capital contribution) can be demonstrated by comparing the economic and tax consequences of a direct dividend, a direct redemption, and a section 304 transaction in which the stock of the acquiring corporation and the stock of the issuing corporation are held directly by a common parent. Assume the following facts:

> Initially X, a corporation unrelated to Parent, owns all 100 outstanding shares of Acquiring;
>
> At the beginning of Year 1, Parent purchases 75 shares of the stock of Acquiring from X for their fair market value of $75;[19]
>
> During Years 1 through 3, Acquiring accumulates $20 of earnings and profits and the fair market value of Parent's 75 shares of Acquiring's stock increases to $90;
>
> At the end of Year 3, Parent purchases 75 shares of the 100 outstanding shares of Issuing from an unrelated party for their fair market value of $75.
>
> At the beginning of Year 4, Acquiring does one of the following three things: (i) pays a dividend of $20 pro rata to Parent and X; (ii) redeems $20 worth of its stock pro rata from Parent and X; or (iii) purchases 15 shares of Issuing stock from Parent for their fair

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[19] The example assumes 75 percent ownership because special rules alter the effects of sections 304 and 1059 in the case of transactions between affiliates. See sections 304(b)(4), 1059(e)(2).

market value of $15 (i.e., the value of the Issuing stock has not changed since the purchase by Parent).

Economically, each of the first two transactions (the direct dividend and the direct redemptions) would result in a $20 reduction in the overall value of Acquiring and no change in the relative ownership of Acquiring by Parent and X. The value and basis of Parent's stock in Acquiring is $75 after the distribution. The distribution does not create any potential tax loss for Parent, because the value of the earnings and profits on which the dividend characterization of those distributions is based is not reflected in Parent's basis before the distribution. Consistent with the absence of any potential for tax arbitrage at which section 1059 is directed, section 1059 is not applicable, based on Parent's two-year holding period in its 75 shares of Acquiring stock.

The economics of the third transaction above (the paradigm section 304 transaction) are different from those of the direct dividend and the direct redemptions. In the paradigm section 304 transaction, the overall value of Acquiring and the relative interests of Parent and X in Acquiring are unchanged. There is no net reduction in the value of Parent's 75 shares of Acquiring, but the basis of those shares is increased by the deemed capital contribution of the Issuing shares with a $15 basis. As a result, Parent holds 75 shares of Acquiring with a value and basis of $90. As with the direct dividend and the direct redemption transactions discussed above, the paradigm section 304 transaction does not create any potential tax loss for Parent where the value of the earnings and profits on which the dividend characterization of the section 304 deemed redemption is based is not reflected in Parent's basis before the transaction. Consistent with the absence of any potential for tax arbitrage at which section 1059 is directed, the threshold requirement of section 1059 of a holding period of two years or less would not be met based on Parent's two-year holding period in its 75 shares of Acquiring stock.[20]

Given that none of what might be considered economically equivalent transactions (a direct dividend distribution from Enron Sub II to Enron, a direct redemption of Enron Sub II stock from Enron, and the dividend portion of a section 304 transaction in which Enron Sub II purchases stock of Enron Sub III from Enron (with no affiliation among the parties)) would be subject to section 1059 based on a two year holding period of the Enron Sub II stock, and that none of those transactions appears to violate the spirit of section 1059, we believe a court should not consider the holding period of the retained Enron Sub III stock to be relevant to the application of section 1059 to the Purchase. Rather, we believe a court should recognize that the

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[20] Some redemption from X might be required to avoid section 1059(e)(1)(B), which overrides the two year threshold requirement in the case of non pro rata redemptions. It is unclear how one would determine whether a section 304 deemed redemption is pro rata where a shareholder directly owns some, but less than 100 percent, of the stock of the redeeming corporation.

distortions between basis and value created in the retained Enron Sub III stock are attributable to the fictions created by sections 304 and 318 in which there is a deemed capital contribution to a corporation in which the contributor has no direct ownership.

Congress viewed acquisitions of stock in anticipation of the payment of an extraordinary dividend as the acquisition of two assets: the right to distributions to be made with respect to the stock and the underlying stock itself. In such cases, Congress concluded that it was appropriate to reduce the basis of the underlying stock to reflect the value of the distribution that was not taxed to a corporate distributee. See H.R. Rep. No. 98-432, pt. 2, at 1186 (1984); S. Prt. No. 98-169, vol. I, at 172 (1984). Congress used objective rather than subjective criteria to identify transactions that were appropriately treated as "two asset" acquisitions (i.e., those acquisitions in which a portion of the basis of the shareholder is attributable to the value of an anticipated distribution). The statute provides a dual test for its application, requiring both a holding period of two years or less as of the dividend announcement date (presumably as an indication that the dividend might have been anticipated at the time of the acquisition and thus reflected as a separate asset in the acquisition transaction) and a dividend in excess of a specified percentage of the basis in the stock (presumably to exclude regular dividends, the tax arbitrage potential of which is addressed by section 246(c)). Subject to certain express statutory exceptions, the statute does not apply where the taxpayer's holding period exceeds the objective two year holding period standard, regardless of whether the shareholder in fact anticipated an extraordinary dividend or whether the value of an extraordinary dividend is in fact reflected in the shareholder's basis in the stock. In effect, there is an irrebuttable presumption that the distortion between basis and economics created by a dividend distribution and addressed by section 1059 is not present where a shareholder has a holding period in excess of two years as of the dividend announcement date. We believe the holding period threshold in section 1059 serves as an objective substitute for an inquiry into whether an extraordinary dividend distribution is made with respect to stock having a basis that reflects the value of the earnings and profits that fund the extraordinary dividend. We believe that it is consistent with the purposes of section 1059 to look to the holding period in the stock of the corporation having the earnings and profits that fund a dividend to determine whether the two-year threshold of section 1059 is satisfied. Accordingly, we believe that section 1059 should not be applicable to a Purchase that occurs at a time when the holding period of each share of stock of Enron Sub II is greater than two years.

c. Threshold Percentage

The Service might argue that the relevant holding period for Partnership is the shorter of the period for which it has constructively owned Enron Sub II stock and Enron's holding period in the Enron Sub II stock. We believe that the period of constructive ownership has no relevance to the purposes of section 304 and 1059. Accordingly, we believe such an argument should be rejected by a court. If such an argument were, nevertheless, accepted, then in the case of a Purchase that occurs within two years of the formation of Partnership, the characterization of a dividend as extraordinary would become significant.[21]

In general, the term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds 10 percent (5 percent in the case of stock which is preferred as to dividends) of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends received within an 85-day period, or exceeds 20 percent of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends having ex-dividend dates within an 365-day period. Section 1059(c).

Enron Sub II will not, during any 85 day period that begins within two years of the formation of Partnership, purchase Enron Sub III preferred stock in amounts such that, if the dividends resulting from all Purchases ("Section 304 Dividends") were treated as made pro rata with respect to all stock of Enron Sub II, the sum for any share of stock of Enron Sub II of all Section 304 Dividends that are treated as made with respect to such share of Enron Sub II stock during such 85 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 85 day period is greater than 10 percent of the shareholder's basis in such share. Enron Sub II will not, during any 365 day period that begins within two years of the formation of Partnership, purchase Enron Sub III preferred stock in amounts such that, if the Section 304 Dividends resulting from all Purchases were treated as made pro rata with respect to all stock of Enron Sub II, the sum for any share of stock of Enron Sub II of all Section 304 Dividends that are treated as made with respect to such share of Enron Sub II stock during such 365 day period plus all other dividends on such share that are received or that have an ex-dividend

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21 The two-year holding period requirement of section 1059 must be satisfied on the dividend announcement date. The term "dividend announcement date" means the date on which the corporation declares, announces, or agrees to the amount or payment of such dividend, whichever is the earliest. Section 1059(d)(5). The legislative history of this provision states that "[i]f there is a formal or informal agreement to pay the particular dividend prior to the declaration date, the date of such agreement shall be treated as the dividend announcement date for purposes of applying the two-year holding period requirement." H.R. Conf. Rep. No. 99-841, vol. II, at II-164 (1986). While it is anticipated that a substantial portion of the preferred stock of Enron Sub III may be sold over time, the timing and amount of Purchases will be contingent on a variety of factors, including the continued availability of the anticipated accounting treatment of such transactions and the financial position of Enron and its Affiliates that are included in its consolidated financial statements. With respect to any Purchase that may occur more than two years after the 304 Start Date, there is currently no fixed plan as to the date or amount of any such Purchase and there will be no announcement, action by Enron Sub II's board of directors, formal or informal agreement or fixed plan, commitment, or other action relating to the amount or the time of such Purchase within two years of the 304 Start Date. Based on these facts, we believe that, with respect to a Purchase that occurs after the date that is two years after the 304 Start Date, the dividend announcement date also should be considered to be more than two years after the 304 Start Date.

date during such 365 day period is greater than 20 percent of the shareholder's basis in such share. Based on these facts, we believe a dividend attributable to a Purchase and deemed made with respect to stock of Enron Sub II that has been constructively held by Partnership for less than two years should not be treated as exceeding the threshold percentage.[22]

D. Formation of Holdco and Enron Sub III

1. Application of Section 351

The transfer by Enron of X percent of the common stock of Regulated to Enron Sub III in exchange for 80 percent of the common stock of Enron Sub III is a transfer to a controlled corporation as described in section 351(a), whether viewed separately or in combination with the transfers of cash by Partnership and SPVCo to Enron Sub III. Accordingly, no gain or loss should be recognized by Enron on the exchange. Enron's basis in its Enron Sub III stock should be the same as its basis in the contributed Regulated stock. Section 358.

The transfer by Enron to Holdco of common stock of Regulated in exchange for all of the common stock of Holdco, and the transfer by Enron Sub III to Holdco of common stock of Regulated and cash in exchange for all of the preferred stock of Holdco, are transfers to a controlled corporation as described in section 351 (a), upon which no gain or loss should be recognized. See Treas. Reg. § 1.1502-34.

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22 The Service might argue that the threshold tests of section 1059 should be applied by reference to the retained stock of the issuing corporation (Enron Sub III) where that is the only stock that the dividend recipient (Partnership) owns directly. In support of such a position, the Service might point to the fact that the determination of whether the redemption is a sale or exchange is made by reference to the ownership of stock of the issuing corporation, without regard to the identity of the corporation that is deemed to have made the redemption or to have paid the dividend, and that the basis attributable to the deemed capital contribution of the redeemed shares to the acquiring corporation attaches to the retained shares of the issuing corporation, in the absence of any direct ownership of stock of the acquiring corporation. As discussed in the text, we believe that the threshold test of section 1059 should be applied by reference to the stock of the acquiring corporation (Enron Sub II), where such corporation is treated as making the redemption under section 304(a)(1) and as having made the section 301 distribution under section 304(b)(2)(A). In the event that, contrary to our views, a court were to apply the threshold tests of section 1059 by reference to the stock of the issuing corporation (Enron Sub III), the application of section 1059 could be avoided if the amount of Purchases and Enron Sub III Redemptions satisfied the threshold percentage requirements described above, as applied to the Enron Sub III preferred stock held by Partnership. Under such circumstances, the percentage threshold tests would be 5 percent per 85 day period (instead of 10 percent) and 20 percent per 365 day period of the basis of Partnership in the Enron Sub III preferred stock.

Enron Sub III's basis in its Holdco preferred stock should equal the amount of cash contributed plus the basis of the Regulated stock at the time of the contribution. Section 362(a). Holdco's basis in its Regulated stock should be equal to the sum of Enron's and Enron Sub III's basis in the transferred stock immediately prior to its contribution to Holdco. Section 362(a).

2. Earnings and Profits Rules

The consolidated return regulations modify the determination of the earnings and profits of a member of a consolidated group ("P") by adjusting the earnings and profits of P to reflect a subsidiary's ("S") earnings and profits for the period that S is a member of the consolidated group. Treas. Reg. § 1.1502-33(a)(1). The purpose for these modifications (the "earnings and profits rules") is to treat P and S as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent. Id. Adjustments to the earnings and profits of P under these rules are in addition to adjustments under other rules of law (e.g., section 312), subject to the limitation that P's earnings and profits must not be adjusted in a manner that has the effect of duplicating an adjustment. Treas. Reg. § 1.1502-33(a)(2).

The general rule is that S's earnings and profits are "tiered up" to P. Under Treasury Regulation § 1.1502-33(b)(1), P's earnings and profits are adjusted to reflect changes in S's earnings and profits in accordance with the applicable principles of Treasury Regulation § 1.1502-32 (the investment adjustment rules), S's earnings and profits are allocated among S's shares under the principles of Treasury Regulation § 1.1502-32(c) of the investment adjustment rules, and the principles of the investment adjustment rules are modified in that P's earnings and profits adjustment is determined by reference to S's earnings and profits, rather than S's taxable and tax-exempt items.

The earnings and profits rules contain a provision that deals with a change in location of a subsidiary within the group. Treas. Reg. § 1.1502-33(f)(2). Under this rule, if the location of a member changes within a group, "appropriate adjustments" must be made to the earnings and profits of the members to prevent the earnings and profits from being eliminated. If P transfers all the stock of S to another member in a section 351 transaction, the transferee's earnings and profits are adjusted immediately after the transfer to reflect the earnings and profits of S immediately before the transfer. Accordingly, we believe the transfer by Enron of X percent of the common stock of Regulated to Enron Sub III should cause X percent of the earnings and profits of Holdco to "tier up" to Enron Sub III. Similarly, we believe the transfer by Enron and Enron Sub III of all of the stock of Regulated to Holdco should cause the earnings and profits of Regulated to "tier up" to Holdco. Given the clear "tier up" example in the regulations, we do not believe that the transfer by Enron Sub III of Regulated stock to Holdco should affect the "tier up" of X percent of Regulated's earnings and profits to Enron Sub III.

3. Earnings and Profits Anti-avoidance Rule

The earnings and profits rules contain an anti-avoidance rule that provides for adjustments as necessary to carry out the purposes of the rules if any person acts with a principal purpose contrary to the purpose of the rules, to avoid the effect of the rules, or to apply the rules to avoid the effect of any other provision of the consolidated return regulations. Treasury Regulation § 1.1502-33(g). The primary earnings and profits effects of the formation of Holdco and Enron Sub III on members of the Enron consolidated group are the duplication of all of Regulated's earnings and profits in Holdco and the duplication of X percent of the earnings and profits of Regulated in Enron Sub III. These earnings and profits effects will cause redemption distributions by Holdco to Enron Sub III and by Enron Sub III to Partnership to be treated as dividends.

The statement of the purpose of the earnings and profits rules (to treat a parent and a subsidiary as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent) is consistent with these effects. The rules cause the earnings and profits of Regulated to "tier up" to Holdco and Enron Sub III, which are higher-tier members in the Enron group. Reflecting the earnings and profits of Regulated in Holdco and Enron Sub III is consistent with treating the Enron consolidated group as a single entity. Accordingly, we do not believe that the earnings and profits anti-avoidance rule should be applicable to the formation of Holdco and Enron Sub III.

E. Holdco Redemption

1. Dividend Treatment

A distribution in redemption of stock from a corporate shareholder is treated as a sale or exchange of stock if the redemption is not essentially equivalent to a dividend, is substantially disproportionate with respect to the shareholder, or is in complete redemption of all of the stock of the corporation owned by the shareholder. Sections 302(a), 302(b). In general, the constructive ownership rules of section 318(a) apply for purposes of these tests. Section 302(c)(1). A redemption that is not treated as a sale or exchange under section 302(a) is treated as a distribution of property to which section 301 applies. Section 302(d).

Enron Sub III owns all of the preferred stock of Holdco. Under the constructive ownership rules of section 318, Enron Sub III owns all of the stock owned by Enron. Enron owns all of the common stock of Holdco. Applying the constructive ownership rules, Enron Sub III should be treated as owning all of the stock of Holdco both before and after a Holdco Redemption. In the absence of any change in Enron Sub III's ownership of Holdco as a result of a Holdco Redemption, the redemption would not be substantially disproportionate or a complete redemption of all stock of Holdco owned by Enron Sub III. Moreover, we believe such a redemption should not be treated as not essentially equivalent to a dividend. See United States v. Davis, 397 U.S. 301 (1970). Accordingly, we believe the redemption should not be treated as a sale or exchange under section 302(a) and should be treated as a distribution of property to which section 301 applies.

Under section 301(c)(1) and section 316, a distribution is treated as a dividend to the extent of the earnings and profits of the distributing corporation. Given current and accumulated earnings and profits of Holdco for the year in which Holdco Redemption occurs in excess of the aggregate amount of the redemption price plus all other actual or deemed section 301 distributions by Holdco for that year, the full amount of the redemption should be treated as a dividend from Holdco to Enron Sub III.

2. Section 312 Earnings and Profits and Section 302 Basis Effects

Under section 312, the earnings and profits of Enron Sub III should be increased by the amount of the dividend and the earnings and profits of Holdco should be decreased by the amount of the dividend. Under section 302, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Treas. Reg. § 1.302-2(c). The examples in Treasury Regulation § 1.302-2(c) suggest that the "proper adjustment" is to increase the basis of stock retained by the taxpayer by the amount of the taxpayer's basis in the redeemed stock, even where dividend treatment is based on constructive ownership of shares held by someone other than the taxpayer. See Treas. Reg. § 1.302-2(c) *Example (1)*, *Example (3)*. Accordingly, we believe the proper adjustment in the case of a Holdco Redemption of some, but not all, of Holdco preferred stock held by Enron Sub III should be to increase the basis of the remaining Holdco preferred stock held by Enron Sub III by the amount of the basis of Holdco preferred stock that is redeemed.

3. Consolidated Return Adjustments

In addition to the above effects under sections 312 and 302, the consolidated return regulations provide for earnings and profits adjustments and investment adjustments in connection with the dividend. Treas. Reg. §§ 1.1502-32, -33. Under the consolidated return regulations, the dividend should be excluded from Enron Sub III's income to the extent that Enron Sub III has a corresponding negative basis adjustment under the investment adjustment rules. Treas. Reg. §§ 1.1502-13(f)(2)(ii).

a. Investment Adjustment Rules

The consolidated return regulations provide for adjusting the basis of the stock of S owned by P to reflect S's distributions and S's items of income, gain, deduction, and loss taken into account for the period that S is a member of the consolidated group. Treas. Reg. § 1.1502-32(a)(1). The purpose of these adjustments (the "investment adjustment rules") is to treat P and S as a single entity so that consolidated taxable income reflects the group's income. Id. Adjustments to P's basis in S's stock under these rules are in addition to adjustments under other rules of law (e.g., section 1016), subject to the limitation that P's basis in S's stock must not be adjusted in a manner that has the effect of duplicating an adjustment. Treas. Reg. § 1.1502-32(a)(2). Adjustments are made as of the close of each consolidated return year, and as of any other time (an interim adjustment) if a determination at that time is necessary to determine a tax liability of any person. Treas. Reg. § 1.1502-32(b)(1).

The amount of the adjustment to P's basis in S's stock is the net amount of S's (i) taxable income or loss, (ii) tax-exempt income, (iii) noncapital, nondeductible expenses and (iv) distributions with respect to S's stock. Treas. Reg. § 1.1502-32(b)(2). Distributions, for these purposes, are distributions with respect to S's stock to which section 301 applies and all other distributions treated as dividends. Treas. Reg. § 1.1502-32(b)(3)(v).

The portion of an adjustment that is described in Treasury Regulation § 1.1502-32(b)(2)(iv) (the "negative distribution adjustment") is allocated to the shares of S's stock to which the distribution relates. Treas. Reg. § 1.1502-32(c)(1). The remainder of the net adjustment (the "net remainder adjustment") is allocated among the shares of S's stock according to a series of rules. If the net remainder adjustment is positive, it is allocated first to any preferred stock to the extent required (when aggregated with prior allocations) to reflect distributions described in section 301 (and all other distributions treated as dividends) to which the preferred stock becomes entitled, and arrearages arising, during the period that S is a member of the consolidated group. Treas. Reg. § 1.1502-32(c)(1), -32(c)(3). If the net remainder adjustment is negative, it is allocated only to common stock. Treas. Reg. § 1.1502-32(c)(1). If S has more than one class of common stock, the extent to which a net remainder adjustment is allocated to each class is determined by taking into account the terms of each class and all other facts relating to the overall economic arrangement. The allocation generally must reflect the manner in which the classes participate in the economic benefit or burden (if any) corresponding to the items of income, gain, deduction, or loss allocated. Treas. Reg. § 1.1502-32(c)(2)(ii). Within a single class of common stock, the net remainder adjustment is generally allocated equally to each share within the class. Treas. Reg. § 1.1502-32(c)(2)(i).

A member's basis in each share of S's preferred and common stock must be redetermined whenever necessary to determine the tax liability of any person. Treas. Reg. § 1.1502-32(c)(4)(i). The redetermination is made by reallocating S's net remainder adjustment for each consolidated return year (or other applicable period) of the group by taking into account all of the facts and circumstances affecting allocations as of the redetermination date. Id.

The redemption of Holdco preferred stock from Enron Sub III should be treated as a distribution subject to section 301 and as a dividend, creating a negative adjustment for the distribution which is allocated to the shares of Holdco stock to which the distribution relates.[23] Section 302(d) characterizes the redemption as a distribution to which section 301 applies, but does not identify the shares to which such distribution relates. The preamble to the proposed investment adjustment rules justifies the negative basis adjustment for all distributions based on the fact that a distribution always reduces the value of S's stock, and the basis adjustments reflect this decrease. Based on this explanation for the negative distribution adjustment and on the transfer of the basis of the redeemed shares to the Holdco shares retained by Enron Sub III, we believe the shares to which the Holdco Redemption distribution relates should be considered, for purposes of the investment adjustment rules, to be the Holdco shares retained by Enron Sub III. Accordingly, we believe the negative distribution adjustment attributable to the Holdco Redemption should be allocated to Enron Sub III.

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[23] Section 1059 adjustments, if any, are taken into account as noncapital, nondeductible expenses. Treas. Reg. § 1.1502-32(b)(3)(iii)(B). The legislative history of section 1059 indicates that basis reductions under section 1059 are not to be made if they would duplicate basis adjustments under the consolidated return rules with respect to distributions or deemed distributions. See S. Rep. 100-445, at 42, 43-44 (1988); H.R. Rep. No. 100-795, at 40, 42 (1988); H.R. Conf. Rep. No. 99-841, vol. II, at II-166 (1986); S. Rep. No. 99-313, at 250 (1985). Under the current investment adjustment regulations, a negative basis adjustment is required for all distributions between members of a consolidated group. Accordingly, any application of section 1059 to a dividend between members of a consolidated group would result in duplicate basis adjustments, contrary to the expressed intent of Congress. While the consolidated return regulations do not specifically state that section 1059 is not applicable within a consolidated group, they do prohibit duplicate basis adjustments. Treas. Reg. § 1.1502-32(a)(2). Furthermore, we believe the preamble to the proposed investment adjustment regulations implicitly recognizes that section 1059 is not applicable to transactions between members of a consolidated group. The preamble, in justifying the rule that all distributions result in negative investment adjustments, points out that providing exceptions to this rule would require special rules to implement section 1059(e)(2)(B) in certain cases. Based on the above authorities, we believe that section 1059 is not applicable to dividends between members of a consolidated group.

Treating the Holdco Redemption as a distribution with respect to the Holdco preferred stock retained by Enron Sub III, the allocation rules of Treasury Regulation § 1.1502-32(c)(1), -32(c)(3), and -32(c)(4) direct that positive net remainder adjustments be allocated, either from the current year or from prior years under a cumulative redetermination, to the Holdco preferred stock retained by Enron Sub III to the extent required (when aggregated with prior allocations to the Holdco preferred stock) to reflect the Holdco Redemption distribution plus all other distributions described in section 301 (and all other distributions treated as dividends) and arrearages with respect to the preferred stock. To the extent that positive investment adjustments with respect to Regulated common stock are reflected in the basis of the Holdco preferred stock, it might be argued that some portion of these adjustments already "reflect" the Holdco Redemption distribution in the basis of the Holdco preferred stock and no further positive investment adjustment is necessary. Similarly, if Holdco investment adjustments were allocated to the Holdco preferred stock in excess of the coupon on the Holdco preferred stock in order to reflect the liquidation preference of those shares in the unrealized appreciation of Regulated represented by the value of the Regulated common shares at the time of their contribution to Holdco by Enron Sub III, some portion of such investment adjustments might be viewed as "reflecting" the Holdco Redemption distribution. Under such a view, the positive adjustment required to reflect the Holdco Redemption distribution would equal the excess of the Holdco Redemption distribution over prior investment adjustments allocable to the Holdco preferred stock (including investment adjustments allocable to the Regulated common stock that Enron Sub III contributed to Holdco) that reflect the amount paid in the redemption. To the extent that the positive investment adjustment required to reflect the Holdco Redemption distribution is less than the full amount of the Holdco Redemption payment (i.e., the amount of the negative investment adjustment attributable to the distribution), the net investment adjustment with respect to the Holdco Redemption will be negative.[24]

b. <u>Earnings and Profits Rules</u>

The application of the earnings and profits rules to a Holdco Redemption is unclear, both because of difficulties in translating the principles of the investment adjustment rules to apply in the context of earnings and profits adjustments and because of the existence of special rules modifying the general rule in the earnings and profits rules. Looking first at the translation issue, under the investment adjustment rules, negative distribution adjustments are allocated to the

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[24] To the extent that Holdco's current year positive net remainder adjustment is insufficient to match all previously unmatched section 301 distributions and other dividends with respect to its preferred stock, application of the cumulative redetermination rule as described above should result in a reduction of prior positive adjustments to the basis of Holdco common stock (or the predecessor shares of Regulated common stock) held by Enron. <u>See</u> Treas. Reg. § 1.1502-32(c)(5) *Example 3*.

shares of S stock to which the distribution relates and the net remainder adjustment is allocated among shares of S's stock in accordance with the rules set forth in Treasury Regulation § 1.1502-32(c). Since distributions are reflected in S's earnings and profits (which would be part of the net remainder adjustment) but not in S's taxable income, an issue arises whether the reduction in earnings and profits attributable to a distribution should be treated as a negative distribution adjustment or as an element of the net remainder adjustment. In the absence of any clear direction, we have considered the effects of both approaches.[25]

Treating the earnings and profits effects of a distribution as a separate item, and treating the Holdco Redemption/section 301 dividend as relating to the Holdco preferred stock retained by Enron Sub III, the reduction in Holdco's earnings and profits attributable to the Holdco Redemption/section 301 dividend should be allocated to Enron Sub III and positive net remainder adjustments, either from the current year or from prior years under a cumulative redetermination, should be allocated to the Holdco preferred stock retained by Enron Sub III in an aggregate amount equal to the excess of the amount of the Holdco Redemption/section 301 dividend over prior allocations of positive net remainder adjustments that are treated as reflecting the Holdco Redemption/section 301 dividend (e.g., positive net remainder adjustments with respect to Regulated common stock that are reflected in Enron Sub III's earnings and profits as a result of the contribution of the Regulated common stock to Enron Sub III). The net effect of these adjustments on Enron Sub III would be to reduce Enron Sub III's earnings and profits by the amount of any prior "tier up" of Regulated's or Holdco's earnings and profits that are treated as reflecting the redemption distribution, leaving Enron Sub III with earnings and profits, after the

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[25] The one example in the earnings and profits rules that involves a distribution during a year in which a corporation has current earnings and profits contains language that suggests a netting approach. Treas. Reg. § 1.1502-33(b)(3)(ii) *Example 1*(c). In the example, S distributes $50 to P in a year during which S has $100 of current earnings and profits. The example concludes that "P's earnings and profits are increased by $100 (S's $50 of undistributed earnings and profits, plus P's receipt of the $50 distribution)." This statement suggests that the rules are applied by netting the $50 earnings and profits reduction from the distribution with the $100 of current earnings and profits, resulting in an adjustment equal to the net change in S's earnings and profits of $50. The language could be explained, however, as a summary of the net effects of application of the rules first to reduce P's earnings and profits by the $50 reduction in S's earnings and profits attributable to the distribution and then to increase P's earnings and profits by the $100 increase in S's earnings and profits attributable to other items. Accordingly, we do not believe this example is conclusive as to the manner in which the earnings and profits reduction attributable to a distribution is treated. But cf. Treas. Reg. § 1.1502-32(b)(5) *Example 5(a)* (describing investment adjustments for current distribution; "P increases its basis in S's stock . . . by a $110 net amount ($120 of taxable income, less a $10 distribution)").

section 312 increase for the dividend and the net earnings and profits adjustments, equal to the amount of the Holdco Redemption/section 301 dividend.[26]

Treating the earnings and profits effects of a distribution as an element of the net remainder adjustment, the excess of the Holdco Redemption/section 301 dividend over Holdco's current earnings and profits should result in a negative net remainder adjustment. Negative net remainder adjustments are allocated only to common stock. Accordingly, under this view there would be no adjustments to Enron Sub III's earnings and profits, leaving Enron Sub III with section 312 earnings and profits equal to the amount of the Holdco Redemption/section 301 dividend plus the amount of any prior "tier up" of earnings and profits. (Presumably a cumulative redetermination would not allocate positive net remainder adjustments to Enron Sub III in the amount of the Holdco Redemption/section 301 dividend because that distribution is already "reflected" by the inclusion of the earnings and profits effects of the distribution in the net remainder adjustment for the year of the distribution. Moreover, it would appear that future dividend distributions on the Holdco preferred should be treated as already "reflected" to the extent of the lesser of the negative remainder adjustment created by the Holdco Redemption and any prior "tier up" of earnings and profits that is treated as reflecting the Holdco Redemption /section 301 dividend.)

4. Anti-avoidance Rules

The investment adjustment rules contain an anti-avoidance rule which calls for adjustments to be made to carry out the purpose of the investment adjustment rules if a person acts "with a principal purpose which is contrary to the purpose of [the investment adjustment rules], to avoid the effect of [the investment adjustment rules], or to apply [the investment adjustment rules] to avoid the effect of any other provision of the consolidated return regulations." Treas. Reg. § 1.1502-32(e)(1). The purpose of the investment adjustment rules is to treat the shareholder/member and the subsidiary as a single entity so that consolidated taxable income reflects the group's income. Treas. Reg. § 1.1502-32(a)(1).

The examples under the investment adjustment anti-avoidance rule suggest that it is applicable where stock ownership or affiliated status is manipulated in order either to obtain the benefits of positive investment adjustments without bearing the burden of corresponding negative investment adjustments (Examples 1, 4, 5) or to shift basis among group members or among

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[26] This assumes that any prior tier up of earnings and profits that reflect the redemption distribution has been retained by Enron Sub III. This should be the case where there have been no Enron Sub III Redemptions prior to a Holdco Redemption and Enron Sub III has current earnings and profits in each year in excess of all distributions (other the Enron Sub III Redemptions) made on its stock.

classes of stock, thereby reducing gain recognition on an anticipated sale (Examples 2, 3). Treas. Reg. § 1.1502-32(e)(2) *Examples 1-5*. A Holdco Redemption will not have any direct or indirect federal income tax effect on members of the Enron consolidated group other than the section 312 transfer of earnings and profits from Holdco to Enron Sub III and any investment and earnings and profits adjustments attributable to a Holdco Redemption. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a Holdco Redemption. There is no current plan or intention, and there will be no plan or intention at the time of any Holdco Redemption, that any member of the Enron consolidated group dispose of any stock of Holdco or Enron Sub III except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to a Holdco Redemption. Based on these facts, we believe that neither Enron nor any of its Affiliates should be considered to have a principal purpose which is contrary to the purposes of the investment adjustment rules, to avoid the effect of the investment adjustment rules, or to apply the investment adjustment rules to avoid the effect of any other provision of the consolidated return regulations.

The earnings and profits rules contain an anti-avoidance rule that provides for adjustments as necessary to carry out the purposes of the rules if any person acts with a principal purpose contrary to the purpose of the rules, to avoid the effect of the rules, or to apply the rules to avoid the effect of any other provision of the consolidated return regulations. Treasury Regulation § 1.1502-33(g). The primary earnings and profits effect of Holdco Redemption on members of the Enron consolidated group is the transfer of earnings and profits of a Holdco to Enron Sub III. This earnings and profits effect will cause a distribution by Enron Sub III to Partnership in redemption of Enron Sub III preferred stock to be treated as a dividend.

The statement of the purpose of the earnings and profits rules (to treat a parent and a subsidiary as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent) provides little real guidance against which to measure the effect of a mechanical application of the rules to a Holdco Redemption. The allocation rules reflect the earnings and profits of Holdco in Enron Sub III, which appears to be a higher-tier member in that it owns stock of Holdco. Moreover, reflecting the earnings and profits of Holdco in Enron Sub III seems to be consistent with treating the Enron consolidated group as a single entity.

The attempt to deduce a more detailed purpose for the earnings and profits adjustments as applied to redemptions by looking at the detailed rules is equally disappointing, since the detailed rules appear to provide diametrically opposed results in the case of a redemption depending on whether the redemption dividend relates to preferred or common stock. A redemption dividend that relates to common stock would appear to require a corresponding allocation of earnings and profits pro rata to each share of common stock or, in the case of more than one class of common stock, to the various classes of common stock based on the manner in which each class shares in the economic benefits or burdens associated with the earnings and profits. In contrast, a redemption dividend that relates to preferred stock appears to require a corresponding allocation of earnings and profits to the preferred stock, without regard to the manner in which various classes of stock share in the economic benefits or burdens associated with the earnings and profits.

Given a clearly stated mechanical rule with respect to the manner in which earnings and profits are allocated to preferred stock with respect a distribution to which that stock is entitled, it is difficult to see how the statement of purpose in the earnings and profits rules would justify a conclusion that a redemption transaction produces a result that is contrary to the purposes of the rules. The Service might argue, however, that the purposes of the rules are not limited to treating the group as a single entity. In support of its position, the Service could point to the fact that the purpose is implemented by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent (i.e., tiering profits upstream through the ownership chain only). If single entity treatment were the sole purpose of the regulations, earnings and profits should be tiered downstream through a chain as well as upstream. Moreover, the change in location provision indicates that the earnings and profits rules are concerned with the location of earnings and profits within a group as well as with the consolidation of earnings and profits in the ultimate parent of the group.

The Service might also point to the preamble to the regulations, which describes the earnings and profits system as "fundamentally concerned with measuring dividend paying capacity. . . ." T.D. 8560, 1994-2 C.B. 200, 201. The Service might argue that the earnings and profits rules are designed to "tier up" earnings and profits to reflect the economic interest in earnings and profits of shareholders that are "upstream" in the corporate chain from those earnings and profits, thereby reflecting the dividend paying capacity of such higher-tier members. Based on this theory, the Service might argue that, economically, Enron Sub III has no dividend paying capacity in excess of that attributable to the coupon it receives on Holdco preferred stock. While the Enron consolidated group has dividend paying capacity attributable to Holdco's accumulated earnings and profits, the economics supporting that dividend paying capacity remain with the Holdco common stock. Given that the dividend characterization of a Holdco Redemption is inconsistent with the economics of the transaction vis-a-vis Enron Sub III (i.e., without regard to Enron Sub III's constructive ownership of Holdco common stock held by

Enron), the Service might argue that such a dividend should not carry earnings and profits with it in a consolidated group.

This argument fails to explain the reasons for the disparate treatment by the earnings and profits rules of redemption dividends relating to preferred stock and redemption dividends relating to common stock. While the common stock allocation rules key off of economics, the preferred stock allocation rules look exclusively to the entitlement to distributions, without reference to economics. Given the conflict between the view of the earnings and profits regulations as reflecting economic dividend paying capacity and the clearly stated mechanical rule relating to allocations to preferred stock, we believe the purposes of the earnings and profits rules as applied to redemption dividends that relate to preferred stock are so vague as to make application of the anti-avoidance rule difficult. Nevertheless, where a transaction is specifically structured to put a taxpayer in the position of utilizing a mechanical rule to its own advantage, we believe there is a risk that a court would sustain an application of the earnings and profits anti-avoidance rule.

There is no current plan or intention, and there will be no plan or intention at the time of any Holdco Redemption, that any member of the Enron consolidated group dispose of any stock of Holdco or Enron Sub III except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to a Holdco Redemption. Under these circumstances, we believe that neither the investment adjustment anti-avoidance rule nor the intercompany transaction anti-avoidance rule should be applicable to a Holdco Redemption.

F. Enron Sub III Redemption

1. Dividend Treatment

A distribution in redemption of stock from a corporate shareholder is treated as a sale or exchange of stock if the redemption is not essentially equivalent to a dividend, is substantially disproportionate with respect to the shareholder, or is in complete redemption of all of the stock of the corporation owned by the shareholder. Sections 302(a), 302(b). A pro rata redemption from all shareholders cannot satisfy any of these conditions. Accordingly, we believe an Enron Sub III Redemption should be treated as a distribution of property to which section 301 applies. Section 302(d).

Under section 301(c)(1) and section 316, a distribution is treated as a dividend to the extent of the earnings and profits of the distributing corporation. Given current and accumulated earnings and profits of Enron Sub III, determined without regard to any Holdco Redemptions and without regard to any Enron Sub III Redemptions, for the taxable year in which the Enron Sub III Redemption occurs in excess of the aggregate amount of any distributions, other than an Enron Sub III Redemption, made or deemed made by Enron Sub III to its shareholders during such year, the full amount of the redemption should be treated as a dividend from Enron Sub III to each redeemed shareholder.

2. Section 312 Earnings and Profits and Section 302 Basis Effects

Under section 312, the earnings and profits of each redeemed shareholder should be increased by the amount of the dividend and the earnings and profits of Enron Sub III should be decreased by the amount of the dividend. Under section 302, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Treas. Reg. § 1.302-2(c). The examples in Treasury Regulation § 1.302-2(c) suggest that the "proper adjustment" is to increase the basis of stock retained by the taxpayer by the amount of the taxpayer's basis in the redeemed stock, even where dividend treatment is based on constructive ownership of shares held by someone other than the taxpayer. See Treas. Reg. § 1.302-2(c) *Example (1)*, *Example (3)*. Accordingly, we believe the proper adjustment in the case of an Enron Sub III Redemption of some, but not all, of the Enron Sub III stock held by a shareholder should be to increase the basis of the remaining Enron Sub III stock held by the shareholder by the amount of the basis of the Enron Sub III stock that is redeemed.

We believe that each partner's distributive share of Partnership's dividend income from an Enron Sub III Redemption should increase the basis of the partner's interest in Partnership and that there should not be any reduction in such basis for any dividends received deduction that may be allowable to the partner. Section 705(a)(1)(A) and (B); Treas. Reg. § 1.705-1(a)(2)(ii) (a partner's basis is increased by tax-exempt receipts of the partnership).

3. Consolidated Return Adjustments

In addition to the above effects under sections 312 and 302, the consolidated return regulations provide for earnings and profits adjustments and investment adjustments in connection with the dividend. Treas. Reg. §§ 1.1502-32, -33. The earnings and profits adjustments and the investment adjustments attributable to an Enron Sub III Redemption relate primarily to the allocation between Enron Sub III's common and preferred stock of Enron Sub III's earnings and profits and investment adjustments.

The investment adjustment rules contain an anti-avoidance rule which calls for adjustments to be made to carry out the purpose of the investment adjustment rules if a person acts "with a principal purpose which is contrary to the purpose of [the investment adjustment rules], to avoid the effect of [the investment adjustment rules], or to apply [the investment adjustment rules] to avoid the effect of any other provision of the consolidated return regulations." Treas. Reg. § 1.1502-32(e)(1). The purpose of the investment adjustment rules is to treat the shareholder/member and the subsidiary as a single entity so that consolidated taxable income reflects the group's income. Treas. Reg. § 1.1502-32(a)(1). The examples under the investment adjustment anti-avoidance rule suggest that it is applicable where stock ownership or affiliated status is manipulated in order either to obtain the benefits of positive investment adjustments without bearing the burden of corresponding negative investment adjustments (Examples 1, 4, 5) or to shift basis among group members or among classes of stock, thereby reducing gain recognition on an anticipated sale (Examples 2, 3). Treas. Reg. § 1.1502-32(e)(2) *Examples 1-5*.

The earnings and profits rules contain an anti-avoidance rule that provides for adjustments as necessary to carry out the purposes of the rules if any person acts with a principal purpose contrary to the purpose of the rules, to avoid the effect of the rules, or to apply the rules to avoid the effect of any other provision of the consolidated return regulations. Treasury Regulation § 1.1502-33(g). The primary earnings and profits effect of the Enron Sub III Redemption on members of the Enron consolidated group is the reduction under section 312 of the earnings and profits of Enron Sub III.

A Enron Sub III Redemption will not have any direct or indirect federal income tax effect on members of the Enron consolidated group other than the section 312 earnings and profits effects and any investment and earnings and profits adjustments attributable to the Enron Sub III Redemption. A Enron Sub III Redemption will not (i) alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Enron Sub III Redemption) by members of the Enron consolidated group to nonmembers that are treated as made out of earnings and profits or (ii) result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Enron Sub III Redemption on the earnings and profits of members of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to an Enron Sub III Redemption. There is no current plan or intention, and there will be no plan or intention at the time of any Enron Sub III Redemption, that any member of the Enron consolidated group dispose of any stock of Holdco, Enron Sub II, or Enron Sub III except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to an Enron Sub III Redemption. Based on these facts, we believe that neither Enron nor any of its Affiliates should be considered to have a principal purpose which is contrary to the purposes of the investment adjustment rules, to avoid the effect of the investment adjustment rules, or to apply the investment adjustment rules to avoid the effect of any other provision of the consolidated return regulations. Under these circumstances, we believe that neither the investment adjustment anti-avoidance rule nor the intercompany transaction anti-avoidance rule should be applicable to an Enron Sub III Redemption.[27]

4. Intercompany Transaction Rules

Based on the same analysis as set forth above relating to a Purchase, we believe that the intercompany transaction anti-avoidance rule should not be applicable to an Enron Sub III Redemption.

5. Dividends Received Deduction

a. Section 243

SPVCo directly owns 20 percent of the common stock of Enron Sub III. Accordingly, we believe the applicable percentage for determining SPVCo's dividends received deduction should be 80 percent.[28]

b. Section 246

Each shareholder of Enron Sub III stock will have a holding period of at least 45 days in such stock at the time of an Enron Sub III Redemption. Accordingly, we believe the holding period requirement of section 246(c)(1) should be satisfied.

In the case of stock having a preference in dividends, the required holding period is extended to 90 days if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days. Section 246(c)(2). The Service might argue that the 90 day holding period is applicable if the earnings and profits that support the dividend character of an Enron Sub III Redemption were accrued over a period of more than 366 days. The Service might further argue that the disposition in the Enron Sub III

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27 We have not analyzed the specific earnings and profits and investment adjustments that would be required under the consolidated return regulations with respect to a Enron Sub III Redemption. The specifics of those adjustments are not critical to our analysis of the application of the anti-avoidance rules, given the facts set forth in the text above.

28 As discussed above, one of the revenue proposals int he President's fiscal year 1998 proposed budget would deny the dividends received deduction with respect to dividends on certain preferred stock, including preferred stock of Enron Sub III if it were issued more than 30 days after the date of enactment of the proposal.

Redemption of some of the Enron Sub III preferred shares prevented those shares from satisfying the 90 day holding period requirement, triggering the application of section 246(c) to deny the dividends received deduction. Such an argument requires that the Enron Sub III Redemption dividend be treated as paid on the redeemed Enron Sub III preferred stock. We believe a redemption dividend is more appropriately treated as paid on stock retained by the shareholder. See H.R. Conf. Rep. No. 98-861, at 817 (1984) ("if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to stock of the shareholder which is not redeemed"). Moreover, where the basis of the redeemed shares is added to the basis of the retained shares, and assuming the 90 day holding period will be satisfied with respect to the retained shares prior to any disposition of those shares, we believe the case for applying section 246(c)(2) to deny the dividends received deduction would be weak. Accordingly, we believe that the holding period requirement of section 246(c)(2), if applicable, should be satisfied.

c. Section 246(b)

The discussion above with respect to the potential application of section 246(b) to SPVCo's distributive share of a section 304 dividend is equally applicable to its distributive share of an Enron Sub III Redemption dividend.

d. Section 246A

As discussed above, section 246A reduces the percentage used in computing the dividends received deduction "in the case of any dividend on debt-financed portfolio stock." SPVCo owns 20 percent of the common stock of Enron Sub III and Enron owns the remaining 80 percent of the common stock of Enron Sub III. Thus, SPVCo owns stock of Enron Sub III that satisfies the 20 percent ownership test and one corporation (Enron) owns stock of Enron Sub III that satisfies the 50 percent test with respect to Enron Sub III. Accordingly, we believe that section 246A should not be applicable to reduce the dividends received deduction of SPVCo with respect to any dividend income on Enron Sub III stock.

6. Section 1059

a. Pro Rata Redemption

An Enron Sub III Redemption is a redemption of identical percentages of Enron Sub III common and preferred stock. Such a redemption has no effect on the relative holdings of any shareholder. We believe an Enron Sub III Redemption should be considered pro rata for purposes of section 1059(e).

b. Two-Year Holding Period

Where a redemption is pro rata, a second threshold question for application of section 1059 is whether the stock with respect to which the dividend is received has been held by the corporation for more than two years before the dividend announcement date. Partnership's holding period in Enron Sub III's preferred stock would not exceed this threshold two-year period in the case of an Enron Sub III Redemption occurring within two years of Partnership's acquisition of the Enron Sub III preferred stock. Accordingly, we believe an Enron Sub III Redemption that has an announcement date within two years of Partnership's acquisition of Enron Sub III's preferred stock will be subject to section 1059 unless the resulting dividend is not an extraordinary dividend. (See the discussion of the threshold percentage test for extraordinary dividends, below.)

The term "dividend announcement date" means the date on which the corporation declares, announces, or agrees to the amount or payment of such dividend, whichever is the earliest. Section 1059(d)(5). The legislative history of this provision states that "[i]f there is a formal or informal agreement to pay the particular dividend prior to the declaration date, the date of such agreement shall be treated as the dividend announcement date for purposes of applying the two-year holding period requirement." H.R. Conf. Rep. No. 99-841, vol. II, at II-164 (1986). While it is anticipated that a substantial portion of the preferred stock of Enron Sub III may be redeemed over time, the timing and amount of Enron Sub III Redemptions will be contingent on a variety of factors, including the continued availability of the anticipated accounting treatment of such transactions and the financial position of Enron and its Affiliates that are included in its consolidated financial statements. With respect to any Enron Sub III Redemption that may occur more than two years after the 302 Start Date, there is currently no fixed plan as to the date or amount of any such Enron Sub III Redemption and there will be no announcement, action by Enron Sub III's board of directors, formal or informal agreement or fixed plan, commitment, or other action relating to the amount or the time of such Enron Sub III Redemption within two years of the 302 Start Date. Based on these facts, we believe that, with respect to an Enron Sub III Redemption that occurs after the date that is two years after the 302 Start Date, the dividend announcement date also should be more than two years after the 302 Start Date.

c. Threshold Percentage

In the case of an Enron Sub III Redemption that occurs within two years of Partnership's acquisition of the Enron Sub III preferred stock, the characterization of a dividend as extraordinary will be significant. In general, the term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds 10 percent (5 percent in the case of stock which is preferred as to dividends) of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends received within an 85-day period, or exceeds 20 percent of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends having ex-dividend dates within an 365-day period. Section 1059(c).

Enron Sub III will not, during any 85 day period that begins within two years of Partnership's acquisition of Enron Sub III preferred stock, redeem from Partnership Enron Sub III preferred stock having, in the aggregate, a value greater than the excess of 5 percent of Partnership's basis in its Enron Sub III preferred stock over the sum of all dividends on such stock that are received by Partnership or have an ex-dividend date during such 85 day period. Enron Sub III will not, during any 365 day period that begins within two years of Partnership's acquisition of Enron Sub III preferred stock, redeem from Partnership Enron Sub III preferred stock having, in the aggregate, a value greater than the excess of 20 percent of Partnership's basis in its Enron Sub III preferred stock over the sum of all dividends on such stock that are received by Partnership or have an ex-dividend date during such 365 day period. Based on these facts, we believe a dividend attributable to an Enron Sub III Redemption that occurs within two years of Partnership's acquisition of Enron Sub III's stock should not be treated as exceeding the threshold percentage.[29]

d. Disqualified Preferred Stock

Any dividend with respect to disqualified preferred stock is treated as an extraordinary dividend subject to section 1059(a) without regard to the period the taxpayer held the stock. Section 1059(f)(1). Disqualified preferred stock means any stock which is preferred as to dividends if:

> (A) when issued, such stock has a dividend rate which declines (or can reasonably be expected to decline) in the future,
>
> (B) the issue price of such stock exceeds its liquidation rights or its stated redemption price, or

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[29] As discussed above, we believe that section 1059 should be applied with respect to the section 304 dividend attributable to a Purchase by reference to the stock of Enron Sub II. Accordingly, we believe that, for purposes of applying section 1059 to an Enron Sub III Redemption, no portion of a section 304 dividend attributable to a Purchase should be treated as a dividend with respect to the Enron Sub III preferred stock retained by Partnership. If, contrary to our view, a court were to treat section 304 dividends as dividends with respect to Enron Sub III stock, such dividends would have to be taken into account in applying the threshold percentage test of section 1059 to an Enron Sub III Redemption.

(C) such stock is otherwise structured --

(i) to avoid the other provisions of [section 1059], and

(ii) to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of stock.

Section 1059(f)(2).

The Enron Sub III preferred stock is preferred as to dividends. The dividend rate on the Enron Sub III preferred stock is a floating rate based on LIBOR. The spread over LIBOR is fixed and does not decline over time. The legislative history of section 1059(f) states that the provision is not intended to apply to dividends on floating rate or auction rate preferred stock whose dividend rate declines solely in response to changes in prevailing market conditions. Committee on Finance, 101st Cong., 1st Sess., Revenue Reconciliation Act of 1989, Explanation of Provisions Approved by the Committee on October 3, 1989, 64 (Comm. Print 1989). Accordingly, we believe the Enron Sub III preferred stock should not be treated as described in section 1059(f)(2)(A).[30] The issue price of the Enron Sub III preferred stock does not exceed its liquidation rights or its stated redemption price. Accordingly, we believe the Enron Sub III preferred stock should not be treated as described in section 1059(f)(2)(B). Finally, neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the partners of Partnership (in the aggregate), to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable,

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[30] If the dividends resulting from Purchases and/or Enron Sub III Redemptions were taken into account, it might be argued that the dividend rate on the Enron Sub III preferred stock can reasonably be expected to be higher during the period when Purchases and/or Enron Sub III Redemptions occur and lower in later years. The legislative history of section 1059(f) identifies the provision as requiring basis reduction for the nontaxed portion of dividends on self-liquidating stock and states the reason for change as follows: "Corporate stockholders may receive dividends eligible for the dividends received deduction in circumstances where the dividends more appropriately should be characterized as a return of capital. . . . The committee believes that basis reduction in such cases is appropriate to accurately reflect the true economic effect of these types of transactions." H.R. Rep. No. 101-247, at 63 (1989). We do not believe section 1059(f)(2)(A), which is premised on a true economic effect of a transaction being a return of capital, should be applied to require a basis reduction for a transaction (a redemption) that is in form a capital transaction but that has been recharacterized by section 302 as being economically equivalent to a dividend.

directly or indirectly, to a Purchase or an Enron Sub III Redemption. Accordingly, we believe the Enron Sub III preferred stock should not be treated as described in section 1059(f)(2)(C).[31]

G. Partnership Anti-abuse Rule

Under the partnership anti-abuse rule:

> [I]f a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of Subchapter K.

Treas. Reg. § 1.701-2(b). In the absence of any purpose to reduce the present value of the aggregate federal tax liability of the partners of Partnership, the partnership anti-abuse rule should not be applicable.

In order to apply this threshold test, it is necessary to determine a baseline aggregate federal tax liability of the partners in order to determine whether a transaction reduces the present value of the partners' aggregate federal tax liability. In determining the tax reduction purpose of a transaction, it seems logical to look at the tax position the taxpayer would have been in if it had not done the transaction. In order to do this, one must determine the scope of a "transaction" in order to determine the tax effects of not doing the transaction.

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31 Section 1503(f) applies to a subsidiary of a consolidated group that pays dividends on section 1504(a)(4) stock held by a nonmember. The provision denies the use of certain tax attributes of any other member of the group against a portion of the subsidiary's separate taxable income for the year equal to the amount of the dividend distribution. Section 1503(f)(4) states that the Secretary "shall" prescribe such regulations as may be necessary or appropriate to carry out the provisions of section 1503(f), including regulations to provide rules for cases in which the subsidiary owns (directly or indirectly) stock in another member. The legislative history of section 1503(f) states that, except as the Treasury Department may otherwise provide, it is expected that regulations will provide that the separately computed taxable income of any distributing corporation shall include an allocable portion of the separately computed taxable income of any other member of the group whose stock the distributing corporation holds directly or indirectly, as necessary to prevent avoidance of the provisions. H.R. Rep. No. 101-386, at 549-50 (1989). These regulations are expected to be effective as of the effective date of the provision. Id. at 550. Retroactive regulations under section 1503(f)(4) (or a determination that section 1503(f)(4) is self-executing in the absence of regulations) might deny the use of current or carryover net operating losses or credits of the group against the separately computed income of Enron Sub III or the tax liability thereon.

The maximum scope of a transaction for these purposes would include a particular step that produces a tax benefit (the "goal step") and all other steps ("related steps") that would not have been done if the goal step were not done. In the instant case, the goal step would be creating the potential for deductions with respect to tax basis in excess of the book value of assets ("excess basis"). The related steps would be all elements of the proposal, including the formation and capitalization of SPVCo, Enron GP, Enron Sub III, Holdco, and Partnership. Under this view of what constitutes the transaction, two of the partners of Partnership (SPVCo and Enron GP) would not exist if the transaction were not done. It seems reasonable to believe that the tax liability of a partner that does not exist in the absence of the transaction would be determined by looking to the tax liability of the persons that own the assets that would have been transferred to the partner. Under this view, the baseline would be the present value of the aggregate tax liability of the Enron consolidated group, and BT Sub if no steps are taken to execute the transactions described in the facts above.

Given a baseline that includes the tax liability of the Enron consolidated group, it would seem that any comparison of (i) the aggregate tax liability of the partners to (ii) the baseline tax liability should include the effects of the transaction on the tax liabilities that are included in the baseline, including the tax liability of the Enron consolidated group. Thus, the effects on the Enron consolidated group tax liability of transferring assets (and related income) from the Enron consolidated group to the SPVCo structure and of transactions between the Enron consolidated group and the SPVCo structure (e.g., the interest payments from Enron to Partnership on Partnership investments in Enron securities) would have to be taken into account along with the net tax liability of SPVCo and changes in the tax liability of BT Sub attributable to the transaction.

A more limited view of what constitutes a "transaction" would include the goal step and those other steps ("enabling steps") that are required in order to make the goal step possible. In the instant case, the enabling steps would be the steps required to create the excess basis (e.g., a Purchase or an Enron Sub III Redemption) and any steps taken to utilize that basis (e.g., section 732(c) distributions). Under this view, the baseline would be the tax liability of the partners if all steps of the proposal are executed except the Purchase or the Enron Sub III Redemption. The effects of the formation and capitalization of, and investments by, SPVCo and Partnership on the Enron consolidated group would be the same in the baseline as in the actual transaction, and accordingly would be irrelevant under this view. The change in tax liabilities as compared to the baseline would be attributable to the transaction increasing the income of the partners by the amount of the dividend income in excess of the dividends received deduction and decreasing the income of the partners by the amount of the deductions attributable to excess basis. The timing of these effects would be affected by the time at which the partners trigger deductions attributable to the excess basis.

A minimum view of what constitutes a "transaction" would treat each separate step as a transaction. In the instant case, under this view, each step of the proposal (e.g., the formation, a Purchase, an Enron Sub III Redemption, a section 732(c) distribution, or a triggering of deductions attributable to excess basis) would be a transaction. The baseline could be the tax liability of the partners determined as if any one step was not done. Under this view, reductions in the aggregate tax liability of the partners could be caused by transactions that invoke specific provisions of subchapter K to create a tax benefit (e.g., a section 732(c) distribution that converts basis in one asset into basis in another asset that has a greater tax benefit to the partners), or by the triggering of a deduction of excess basis.

In the absence of any authority indicating which of these approaches is most appropriate, we have considered the potential application of the partnership anti-abuse rule under each approach. There will be no present value tax benefit to the partners in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron when both dividend income and deductions attributable to a Purchase or an Enron Sub III Redemption are taken into account. There will be no present value tax benefit to the Enron consolidated group, SPVCo, Enron GP, BT Sub, and their Affiliates, in the aggregate, taking into account all of the transactions described above. Accordingly, we believe that under either the maximum or a limited view of the meaning of the term "transaction" in the partnership anti-abuse regulation, the regulation should not be applicable.

Under a minimum view of what constitutes a transaction, certain transactions (e.g., the triggering of a deduction, a liquidating distribution subject to section 732(c)), when viewed in isolation, may reduce the tax liability of the partners. Once it has been determined that a transaction reduces the present value of the partners' aggregate tax liability, it is necessary to determine whether that effect is inconsistent with the intent of subchapter K.

The tax reduction effects of a transaction that triggers a deduction attributable to an earlier Purchase or Enron Sub III Redemption could be duplicated without the use of a partnership (although the accounting benefits of the transaction could not be duplicated without a partnership). We believe that tax results that could be achieved without the use of a partnership should not be considered to be inconsistent with the intent of subchapter K.

The analysis of transactions that invoke specific provisions of subchapter K (e.g., section 732(c)) to create a tax benefit that would not be available in the absence of Partnership is more difficult. The anti-abuse rule includes a list of factors that may be indicative of the proscribed effect. The first negative factor is that the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. Treas. Reg. § 1.701-2(c)(1). This factor is apparently applied as if all transactions occur. See Treas. Reg. § 1.701-2(d) *Example 6, Example 7, Example 8.* Assuming transactions that result in a reduction of the partners' aggregate federal tax liability as compared to direct ownership of the assets (e.g., transactions that invoke section 732(c) to convert a capital deduction into a more beneficial ordinary deduction), we believe there is a risk that the Service would argue that the transaction produces results that are inconsistent with the intent of subchapter K.

The partnership anti-abuse rule provides little guidance on when the application of a provision of subchapter K in accordance with its terms should be viewed as producing results that are inconsistent with the intent of subchapter K. While the text of the abuse-of-subchapter K rule is illustrated by a series of eleven examples, these examples confuse as much as elucidate the interpretation of the abuse-of-subchapter K rule. All three of the "bad" examples (i.e., examples that permit the Commissioner to recast the transactions) involve a partnership that was formed with a view to achieving a particular tax result, a partner who became a partner with a view to achieving such a result, and/or property that is introduced into the transaction to achieve the desired result, suggesting that these factors cause a literal application of the rules of subchapter K to produce results that are inconsistent with the intent of subchapter K. Several of the "good" examples (i.e., examples where the abuse-of-subchapter K rule is not violated), however, also involve partnerships that were formed with a view to achieving a favorable (sometimes very favorable) tax result. The conclusory statements in the examples provide no substantive analysis distinguishing the "good" tax planning examples from the "bad" tax planning examples. In the absence of a transaction that is virtually identical to an example in the regulations, we believe the anti-abuse rule should not be interpreted to alter the application of a mechanical rule of subchapter K.

The Service might argue that the mechanical rules of subchapter K should not be applied literally based on general factors rather than particular examples, and in particular based on a substantial tax avoidance purpose at the time the partnership is formed, or on the magnitude of the tax benefits created by its application. Absent clearly expressed legislative intent to the contrary, the unambiguous language of a statute is controlling under all but rare and exceptional circumstances. Crooks v. Harrelson, 282 U.S. 55, 60 (1930). If the intent of Congress in drafting a rule (e.g., to allocate basis in proportion to the relative bases of the distributed property under section 732(c)) is clear, the regulation cannot change that rule. If the statute is silent or ambiguous, then the regulation may fill the gap with a reasonable interpretation. Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-43 (1984); see also National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 476-77 (1979). We believe the intent of Congress to have the mechanical rules of subchapter K apply without regard to tax motivations is clear. In view of this Congressional intent, we believe a regulatory interpretation of a mechanical rule that alters its application based on the presence or absence of tax motivation or the magnitude of tax benefits should not be considered a reasonable interpretation.

The overriding purpose of the drafters of subchapter K in 1954 was to eliminate confusion. The "vital need" was "clarification." S. Rep. No. 83-1622, at 89 (1954). Beyond the need for clarification, the drafters cited the principles of "simplicity, flexibility and equity as between the partners." Id. Conditioning the application of the literal language of provisions of subchapter K on the presence or absence of a tax avoidance motive would operate to defeat these stated legislative purposes. Moreover, the contemporary legal context in 1954 indicates that tax avoidance motives were not relevant, unless specifically made so by statute. Prior to 1954, the Supreme Court had clearly stated that the tax motivation of taxpayers does not alter what would otherwise be the result of the application of the tax law to a transaction. Gregory v. Helvering, 293 U.S. 465, 469 (1935); Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-96 (1930). The Supreme Court had also implicitly extended this principle to partnerships. Commissioner v. Culbertson, 337 U.S. 733 (1940); see also Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935) (cert. denied). The issue of the effect of a tax avoidance motivation on the validity of partnerships had been clearly presented to and considered by Congress prior to 1954 in the context of family partnerships. The Congressional response was to disregard tax motivation. See sections 191 and 3797(a)(2) of the Internal Revenue Code of 1939. Congress clearly knew how to address the issue of tax avoidance in general, and in the context of partnerships, when it wanted to. See section 129 of the Internal Revenue Code of 1939; section 704(b)(2) as enacted in 1954. Moreover, despite repeated examples of tax motivated uses of partnerships since 1954, Congress has failed to enact a broad, general, subjective intent based limitation on the literal application of the provisions of subchapter K. Instead, Congress has repeatedly addressed tax avoidance transactions involving partnerships by enacting specific rules which generally are applied based on objective factors. See, e.g., sections 704(c)(1)(B), 707(a)(2), 737.

The examples in the abuse-of-subchapter K rule suggest that the rule is also intended to expand upon judicial doctrines, primarily by requiring that the tax motivation for a transaction be taken into account in applying those doctrines. Generally, the courts have not taken tax motivation into account in determining whether a transaction is a sham, a transaction has a substantial business purpose, the step transaction is applicable, or the substance of a transaction matches its form. See, e.g., Knetsch v. United States, 364 U.S. 361, 365 (1960); Gregory v. Helvering, 293 U.S. 465, 469 (1935). But cf. Sheldon v. Commissioner, 94 T.C. 738 (1990). In contrast to the virtual unanimity in the courts with respect to the role of tax avoidance motivation under these doctrines, some controversy has arisen in recent years with respect to the issue of the role of tax motives in the determination of whether the profit motive requirement of various Code provisions (e.g., sections 162, 165(c)(2), 183, and 212) has been satisfied. While the test is often described as requiring a primary purpose of realizing a profit, the cases generally have considered the relative weight of profit motive only in comparison to personal motives. See Portland Golf Club v. Commissioner, 497 U.S. 154 n.16 (1990); Snyder v. Commissioner, 674 F.2d 1359 (10th Cir. 1982). In commercial transactions, where personal motives are not at issue, in some cases the courts have analyzed the facts of the transaction to determine whether a profit motive existed. In general, the finding of a profit motive has been sufficient for the courts to hold in favor of the taxpayer without further analysis. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Levy v. Commissioner, 91 T.C. 838 (1988). There have, however, been some tax shelter cases in which the courts have expanded their inquiry to consider the primacy of the profit motive as compared to the tax motive. See, e.g., Estate of Baron v. Commissioner, 83 T.C. 542 (1984), aff'd, 798 F.2d 65 (2d Cir. 1986); Fox v. Commissioner, 82 T.C. 1001 (1984). It remains to be seen whether tax motivation will play a significant role in the determination of whether a profit motive requirement within a particular Code provision is satisfied.

It has long been settled case law that tax motivation does not affect the qualification of an organization as a partnership. Culbertson. Furthermore, to date there has been no decision applying a "primarily for profit" requirement to the definition of partnerships or to any provision of subchapter K. But see Brannen v. Commissioner, 78 T.C. 471 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984) (dissent by J. Whitaker, suggesting that profit motive identical to that required under section 162 would be required for a partnership to be recognized for tax purposes). Accordingly, we believe, based on sixty years of case law that consistently denies any relevance of a tax avoidance motivation in applying the business purpose and substance over form doctrines, case law and legislation denying the relevance of a tax avoidance motivation in determining whether an organization is a partnership for tax purposes, and repeated reenactments of the entire Code in the context of that case law, that the regulation should not be considered a reasonable interpretation of the statute to the extent that it requires that judicial doctrines be modified to take into account tax motivation when applying those doctrines to partnership transactions.

We believe that a court should not interpret the partnership anti-abuse rule as overriding specific mechanical rules provided in subchapter K in the absence of an example that cannot reasonably be distinguished from the transaction on its facts. In the event that the partnership anti-abuse rule were nevertheless interpreted as being applicable to a particular transaction, we believe that a court should find the regulation to be invalid to the extent that it alters the clear rules of subchapter K based on the presence of a tax motivation.

H. Substance Over Form Doctrine

The tax consequences of a transaction are generally based on the substance of the transaction. Where the form reflects the substance, the tax consequences of the form are generally recognized. Where the form of a transaction does not reflect its substance, however, a variety of judicial approaches have been used to determine the tax consequences of the transaction. These approaches include refusing to recognize a participant in a transaction as a separate taxable entity and disregarding a transaction as a sham.

1. Separate Taxable Entity

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the Supreme Court established the test for determining whether a corporation will be recognized as a separate taxable entity, stating that "so long as [the purpose for forming the corporation] is the equivalent of a business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Id. at 438-39. The level of activity necessary to constitute the "carrying on of business" within the meaning of the Moline Properties test appears to be quite minimal.[32] In practice, it seems to require little more than the observance of bookkeeping formalities, maintenance of separate bank accounts, having employees, executing contracts where appropriate, and representing the corporation to third parties as an independent organization. The separate entity tests set forth in Moline Properties have been applied to partnerships. Campbell County State Bank, Inc. v. Commissioner, 37 T.C. 430, 441-42 (1961), reversed on another issue, 311 F.2d 374 (8th Cir. 1963).

Each of Enron, Holdco, Enron Sub II, SPVCo, Enron GP and Enron Sub III represents itself to third parties as a separate entity in all transactions, observes all corporate and bookkeeping formalities, maintains separate bank accounts, has employees and/or pays fees for services that would otherwise be rendered by employees, and executes contracts in a manner consistent with its status as a separate entity. Partnership represents itself to third parties as a separate entity in all transactions, observes all partnership and bookkeeping formalities, maintains separate bank accounts, has employees and/or pays fees for services that would otherwise be rendered by employees, and executes contracts in a manner consistent with its status as a separate entity. Each of the entities listed in the preceding two sentences holds significant assets. In addition, each of Enron, Regulated, and Enron Sub II has been in existence for a substantial period of time and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons. SPVCo and Enron GP entered into a substantial joint venture (Partnership) with an unrelated person (BT Sub). Partnership has entered into financial transactions with respect to the Building with unrelated parties. Enron Sub III will engage in financial or business transactions with unrelated persons in each of its taxable years.

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[32] Britt v. United States, 431 F.2d 227, 235 (5th Cir. 1970); Hospital Corp. of America v. Commissioner, 81 T.C. 520, 579 (1983) (nonacq. in part); Strong v. Commissioner, 66 T.C. 12, 24 (1976), aff'd without published opinion, 553 F.2d 94 (2d Cir. 1977); see also, B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 2.07[2] (6th ed. 1994).

Transactions with third parties are generally considered sufficient business activity to satisfy the Moline Properties test. For example, obtaining a loan from third parties has been found to be sufficient business activity to prevent taxpayers from disavowing the separate status of a corporation that admittedly served no business purpose. See Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945). Based on the above facts, we believe that each corporation described above and Partnership should be respected as a separate entity for federal income tax purposes.

2. Sham

The sham transaction doctrine is a judicially created theory under which a transaction can be ignored for tax purposes if, in effect, the transaction affects nothing but tax consequences to the parties. The most recent Supreme Court discussion of the sham transaction doctrine is the case of Frank Lyon Co. v. United States, 435 U.S. 561 (1978), in which the Court upheld the sale and leaseback of a building against the government's argument that the transaction was really a financing. Modern sham transaction theory originated in the Court's frequently quoted defense of a "genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . ." Frank Lyon Co., 435 U.S. at 583-84.

A two-pronged test for sham transactions emerged from that quotation. In order to find a sham, a court must determine both that the taxpayer was motivated by no business purposes other than obtaining tax benefits and that the transaction had no economic substance, independent of its tax consequences. Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985).[33] The business purpose test is a subjective analysis of the taxpayer's state of mind, while the economic substance test is objective, based upon the particular facts and circumstances.

Transactions between parent and subsidiary corporations and among other related persons are subject to a heightened level of scrutiny by the Service and are often the focus of sham transaction attacks. While transactions among related corporations often are suspect, they are not *per se* subject to recharacterization under the sham transaction doctrine. Indeed, the consolidated return regulations promulgated under section 1502 set forth myriad rules prescribing the treatment to be accorded transactions among members of a consolidated group. Such

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[33] The text describes a "sham in substance." A second category of sham, sham in fact, occurs when a court finds that the purported transaction did not actually occur. We assume, for purposes of this memorandum, that all transactions described in the assumed facts actually occur, so that there is no question of the transactions being a sham in fact.

transactions may result in items of income, deduction, gain, or loss being eliminated, deferred, or disallowed, but such items are not disregarded on the basis that they arise from sham transactions.

In order to fail the business purpose portion of the sham test in Rice's Toyota World, a taxpayer can have no motive other than tax purposes. The predominant purpose for the transactions considered in this memorandum is to generate income for financial accounting purposes. Additional purposes include shifting risk on the Building to BT Sub and raising minority equity capital. These effects of the transactions provide Enron and its Affiliates with significant and material benefits independent of federal income tax considerations. The transactions were structured to achieve the above purposes without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements.

Improving a company's balance sheet has been recognized as a valid business purpose. See Frank Lyon Co., 435 U.S. at 577-78 (effect of debt on company's balance sheet has "distinct element of economic reality"); Newman v. Commissioner, 902 F.2d 159, 163 (2d. Cir. 1990) (business purposes in entering into operating agreement rather than lease for balance sheet purposes); Priv. Ltr. Rul. 9017061 (Jan. 31, 1990) (improvement of balance sheet for company's lenders is business purpose for section 355); Tech. Adv. Mem. 8803001 (Sept. 29, 1987), (movement of assets from non-member to member corporation of affiliated group to improve consolidated balance sheet is business purpose for section 368(a)(1)(C)), revoked by Tech. Adv. Mem. 8941004 (July 11, 1989) (based on insufficiency of facts submitted at time of examination). We believe that the presence of the nontax business purposes described above should be sufficient to satisfy the business purpose portion of the sham test in Rice's Toyota World.

The economic substance test depends upon all of the facts and circumstances. In the transactions at issue, Enron and BT Sub share in the combined net operating income, gains, and losses generated by all of the assets of Partnership. The terms of the various instruments issued in the transactions (including the interest and dividend rates, as the case may be) are consistent with commercial practices generally prevailing at the time of issue and are terms that could reasonably be expected to be agreed upon in negotiations between unrelated parties having adverse interests. Economic risk on the Building is shifted to BT Sub. We believe that these facts should be sufficient to satisfy the economic substance portion of the test.

Transactions involving the transfer, distribution, or exchange of the debt and equity securities of a corporate issuer to or by a related corporation or unincorporated entity are respected notwithstanding the circular ownership resulting from such transactions. In Peter Pan Seafoods, Inc. v. United States, 417 F.2d 670 (9th Cir. 1969), it was held that cancellation of indebtedness income did not arise when a newly formed corporation, 85 percent of whose stock was held by shareholders of the corporate obligor, purchased debt of the corporate obligor at a discount. The acquiring corporation was formed for the purpose of acquiring the debt and in order to avoid the adverse cancellation of indebtedness income consequences that would result from the corporate obligor's acquisition of its own debt. The Commissioner argued that the notes were in substance acquired by the obligor.

The Court refused to recharacterize the transaction in the manner argued for by the Commissioner. The court first noted that the corporate obligor and the acquiring corporation were separate legal entities and, more specifically, that the acquiring corporation was not a shell as was the corporation in Gregory. Id. at 672-673. While the relatedness of the two corporations and the formation of the acquiring corporation to avoid the adverse tax consequences associated with a direct acquisition by the obligor of its own debt justified close scrutiny of the acquiring corporation's activities, it did not *per se* justify ignoring the separateness of the acquiring corporation or the form of the transaction. Id. at 673. So long as the transaction had economic substance and was economically realistic, it was entitled to be recognized in accordance with its form for tax purposes. Id.

In finding economic substance, the court noted that the acquiring corporation raised its own funds from some of the obligor's shareholders, from some who were not shareholders of the obligor, and from a bank that had no other connection with the transaction. Id. In addition, by purchasing the notes at a discount, the acquiring corporation acquired the possibility of ultimately making a substantial profit if it turned out that the obligor could pay them off. Id. at 672. To that end, there was no evidence that the acquiring corporation would refrain from enforcing the notes, or would contribute them to the capital of the obligor,[34] or that there was any other understanding whereby the obligor would acquire the notes at a discount.

Peter Pan Seafoods supports treating the transactions addressed herein in accordance with their form for federal income tax purposes. BT Sub, an entity unrelated to Enron and its Affiliates, will contribute almost $32 million of capital to SPVCo and Partnership, acquiring an economic interest in the assets and liabilities of SPVCo and Partnership. Those assets and liabilities include preferred stock of Enron Sub III. It is anticipated that the structure created by these transactions will remain in place for at least seven years. While some stock of Enron Sub III may be sold or redeemed over time, it is anticipated that a substantial portion of the stock of

[34] While the acquiring corporation did in fact contribute the notes to the obligor's capital two years after their acquisition when it became the sole shareholder of the obligor, there was no evidence that this was the purpose, or a part of the deal, at the time the acquiring corporation was founded and purchased the notes.

Enron Sub III will be retained by Partnership for at least two years. The presence of outside capital and the absence of any plan or obligation to unwind the transactions at issue immediately after they are entered into, with all of the funds being returned to each of the entities participating therein, distinguishes Peter Pan Seafoods and the instant transactions from various cases discussed below in which transactions were held to be shams.[35]

In contrast to the instant case, in which the economic rights of various parties, including BT Sub, are affected by the transactions, transactions among related entities that have been successfully challenged by the Service under the sham transaction doctrine generally involve circular financing schemes in which the transactions have no economic effect. Erhard v. Commissioner, 46 F.3d 1470 (9th Cir. 1995), aff'g 62 T.C.M. (CCH) 1 (1991), involved a series of circulating transactions throughout a "system" designed by the taxpayer's tax attorney (Margolis) pursuant to which Werner Erhard purported to cause the assets held by est, a.e.c. ("est"), a corporate entity, to be acquired by Werner Erhard and Associates ("WEA"), a sole proprietorship. The acquisition was structured as a purchase of assets by WEA from est, which purchase was funded by loans from ICF, a non-system entity. The ICF loans, however, were funded by system entities and, in fact, the transactions consisted of WEA receiving $15 million from system entities in the form of loans and returning $12 million to system entities in the form of purchase price for assets (the $3 million of retained funds were to be used for operating expenses). WEA paid interest to ICF on the loan and properly withheld ICF's federal income tax from its payments to ICF and transmitted these amounts to the Service.

The Tax Court found the transactions engaged in by WEA to be without economic substance, being merely circular money movements that "began and ended with system entities, with no change in the economic position of the system viewed as a whole." Erhard, 62 T.C.M. at 26. More importantly, the Tax Court concluded that the est organizational structure was simply a means of shielding "the true ownership of assets that in reality belong to the Werner Erhard operation." Id. at 28. Moreover, the series of transactions involving WEA was held to represent the "clean-up" phase in which the structure initially created for Erhard via est was to be shed in

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35 See also, United States v. General Geophysical Co., 296 F.2d 86 (5th Cir. 1961) (contention of the taxpayer-corporation that it was entitled to a stepped-up basis for certain property by virtue of a transfer of the property to its major shareholders and a simultaneous repurchase from them by the corporation at an enhanced valuation was rejected, in part, on the basis that the distribution and repurchase occurred on the same day and without interruption in the corporation's control and use of the property); Priv. Ltr. Rul. 9447024 (Aug. 23, 1994) (temporal element was among factors mentioned in ruling by the Service that a $10 million cash contribution on January 21, 1991 by a corporation to one of its subsidiaries that was a PFIC, which funds were invested in an interest bearing account at a wholly owned foreign commercial banking affiliate of the two entities and then distributed back to the contributing corporation on April 29, 1991, had no economic substance and could be disregarded as a sham).

favor of the new WEA structure. Id. at 27. In connection with this restructuring, the appeals court noted that "Erhard needed to balance accounts with the system and to remove the assets which, *in reality were his, but which had been acquired in the name of various system entities.*" Erhard, 46 F.3d at 1477 (emphasis added). Indeed, the $3 million WEA retained to cover operating expenses were found to constitute est's "excess cash balances in the system that needed to be transferred to Erhard in order to square the accounts." Id. at 1478.

The court also rejected Erhard's contention that he had a clear business purpose for engaging in the transactions because he wished to terminate his relationship with Margolis, stating as follows:

> [E]ven if Erhard had a legitimate business purpose for terminating his relationship with Margolis, that did not give him a business purpose for engaging in the specific transactions at issue here. The fact that he may have a good business reason for separating from Margolis does not necessarily justify resorting to circular money movements (that just happened to create tax benefits) to effectuate that separation.

Id. Notwithstanding this broad language which seems to allow the Service to strike down the manner in which a transaction supported by sufficient business purpose is effected, the holding of the case appears to be based on the much narrower conclusion that the true ownership of the assets WEA purported to acquire from est in fact already resided in Erhard. Accordingly, the court refused to accord tax recognition to such an "acquisition" irrespective of where the funds used to "acquire" the assets originated. The transaction was a separation of Erhard from the Margolis system and not a loan followed by an asset acquisition. As in the other cases involving Margolis systems, the transaction purported to have been effected was not, in fact, actually entered into and the court, once again, refused to allow a fiction to determine the tax consequences. See also United States v. Clardy, 612 F.2d 1139 (9th Cir. 1980) (purported loans struck down as shams where check swapping used to generate circulation of funds that created self-canceling transactions of artificial loans and interest payments; taxpayers had no intent to complete transactions entered into); Goldberg v. United States, 789 F.2d 1341 (9th Cir. 1986) (deductions generated by transactions involving circulation of funds among system entities struck down; transactions wholly lacking in the indicia of arms length transaction; record devoid of any indication that taxpayers incurred any actual economic liabilities of any substance); United States v. Schulman, 817 F.2d 1355 (9th Cir. 1987) (series of loans generated by circulation of funds among system entities held to be a sham that lacked substance because of absence of economic risk associated with loans); Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543 (9th Cir. 1987) (taxpayer used fictitious transfers of money to borrow money from one entity and pay principal and interest back with loans from related entity; no evidence that loans could have benefited the taxpayer economically).[36]

Although there is a circulation of funds among various members of the Enron consolidated group and their Affiliates, we believe the transactions in which these entities are participating are not of the type that have been struck down using the sham transaction doctrine. In the first instance, the various Enron entities will not be in the same position as they were immediately prior to the execution of the transactions. The equity and debt instruments created in the transactions provide the holders thereof with specific rights and obligations. The terms of these instruments provide the potential for economic profit or loss to the various parties, including BT Sub. Moreover, these transactions will shift economic risk with respect to the Building to BT Sub and will raise minority equity for Enron. It is anticipated that the structure created by these transactions will remain in place for at least seven years. While some stock of Enron Sub III may be sold or redeemed over time, it is anticipated that a substantial portion of the stock of Enron Sub III will be retained by Partnership for at least two years.

In sum, we believe the transactions addressed herein should be recognized as creating legal rights and obligations such that the form of the transactions should be considered to be consistent with their substance.

I. Section 269

Section 269 applies to the acquisition of control of a corporation when the principal purpose of such acquisition is the "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which . . . would not otherwise [be] enjoy[ed]." For this purpose, control is defined as 50 percent of vote or value. The following acquisitions of control occurred as a result of the transactions described above:

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[36] Goldberg, Schulman, Bail Bonds by Marvin Nelson, and Erhard all addressed transactions designed by Margolis, which transactions were described as "characterized by convoluted transfers of overvalued property rights, circular money movements among foreign trusts, delayed drafting, signing and backdating of documents, and client oblivion to the financial realities of their investments. . . . The contrived nature of his schemes has been succinctly described as a 'labyrinthian design of tax avoidance . . . and a concomitant hopelessness from the beginning of any economic benefit or effect, other than tax reduction. . . . Margolis transactions constitute financial gymnastics, devoid of economic substance. Margolis clients typically purchase highly inflated investments and tax shelters, oblivious of the economics of the investment. Indeed, proclaimed ignorance of the fact is a hallmark of Margolis clients. Even so, their ignorance is explained by the fact that there is no economic risk, since the transactions often are not legally binding, but shams." Goldberg, 789 F.2d at 1342-43.

Enron acquired control of SPVCo;

Enron acquired control of Forco;

Enron acquired control of Enron GP;

Partnership, Enron, and SPVCo acquired control of Enron Sub III;

Enron Sub III and Holdco acquired control of Regulated; and

Enron and Enron Sub III acquired control of Holdco.

In order to apply section 269, it is necessary first to identify a deduction, credit, or other allowance that benefits the acquired corporation or the acquiring persons and that stems from, and could not have been obtained in the absence of, the acquisition of control. See Zanesville Investment Co., v. Commissioner, 335 F.2d 507, 512 (6th Cir. 1964); Cromwell Corp. v. Commissioner, 43 T.C. 313, 320 (1964) (acq.); Commodores Point Terminal Corp. v. Commissioner, 11 T.C. 411, 417 (1948); Tech. Adv. Mem. 9134003 (May 6, 1991); Gen. Couns. Mem. 39472 (Aug. 2, 1985). We question whether any such deduction, credit, or other allowance is made available by any of the acquisitions of control listed above.

It might be argued that the acquisition of control of Enron Sub III allows Enron to receive, through SPVCo, the benefit of SPVCo's dividends received deduction and losses with respect to the basis in excess of value created by an Enron Sub III Redemption. The tax-free tiering up of earnings and profits from Regulated to Enron Sub III on the contribution of Regulated to Enron Sub III or on a Holdco Redemption occurs only if Enron Sub III is a member of the Enron consolidated group. Therefore, Enron must acquire control of Enron Sub III in order for the tax-free transfer of earnings and profits of Regulated to Enron Sub III.[37]

[37] In the absence of an old and cold subsidiary to which stock of Regulated could be transferred, it is questionable whether the transfer of Regulated's earnings and profits to another corporation could be achieved other than through the acquisition of control of such corporation by Enron. While transfer of the earnings and profits of Regulated to a corporation that is not controlled by Enron is theoretically possible, through the issuance of stock of Regulated and the payment of dividends on such stock, such an approach is not a realistic possibility because of the economic consequences of such a transaction. Moreover, such a transaction would generate substantial federal income tax on the dividends paid to the noncontrolled corporation. It might be possible to structure the ownership of a noncontrolled (for purposes of section 269) corporation such that either redemptions of stock of Regulated held by the noncontrolled corporation would be treated as a dividend, or purchases of such stock would be section 304 dividends, in each case based on constructive ownership that is not relevant for purposes of section 269. While such a transaction may be feasible as an economic matter,

Earnings and profits are required in Enron Sub III in order for an Enron Sub III Redemption to produce the desired dividend treatment. The same tax benefits could be obtained by using an old and cold subsidiary of Enron (assuming such a subsidiary exists) as Enron Sub III. Similarly, the same tax benefits could be obtained by using Regulated in place of Enron Sub III (i.e., if Regulated issued its own preferred stock directly to Partnership and made pro rata redemptions of all of its stock at a later date). We believe that the availability of these alternative approaches suggests that the benefits are "otherwise available" to Enron, even if business reasons or regulatory restrictions make the use of a newly created subsidiary more desirable.

Even if the required deduction, credit, or other allowance could be identified, it is necessary to show that obtaining that benefit was <u>the</u> principal purpose for an acquisition of control. The predominant purpose for these transactions is to generate income for financial accounting purposes. Additional purposes include risk shifting and raising minority equity capital. The transactions, including the formation of SPVCo, Enron GP, Holdco, and Enron Sub III were structured to achieve these purposes without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements. We believe that these facts present a strong case for refuting any claim that <u>the</u> principal purpose of any of these transactions was the evasion or avoidance of tax. Accordingly, we believe that section 269 should not be applicable to any of these acquisitions.

J. <u>Application of Section 482</u>

Section 482 grants broad authority to the Secretary to allocate gross income, as necessary to clearly reflect income, among two or more entities that are controlled by the same interests. We assume, for purposes of discussion, that Enron and Partnership are under common control by virtue of Enron's control over Partnership's managing partner, Enron GP.

The threshold requirement for application of section 482 is that a transaction does not reflect arm's-length dealing between the parties. <u>See</u> <u>Simon J. Murphy Co. v. Commissioner</u>, 231 F.2d 639, 644-45 (6th Cir. 1956) (describing limits of predecessor of section 482, court stated that allocation not permitted where related parties deal with each other at arm's length; in case before court, failure of return to clearly reflect income was inherent in accrual method, not due to

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substantial federal income tax would be incurred on the dividend income of the noncontrolled corporation. Unless the loss to the noncontrolled corporation on the retained stock of Regulated were to offset this tax burden, the Service might argue that a tax benefit that is available without the acquisition of control only at a significant tax cost is not "otherwise available" (within the meaning of section 269) without the acquisition of control.

control over related parties); Haag v. Commissioner, 88 T.C. 604, 615 (1987), aff'd, 855 F.2d 855 (8th Cir. 1988) (to determine whether a reallocation is necessary to clearly reflect income or to prevent the evasion of taxes, court must decide whether the agreement reflected arm's-length dealing); Van Dale Corp. v. Commissioner, 59 T.C. 390, 398 (1972) (unless the tax benefit stems from less than arm's-length dealings, the threshold point for applying section 482 is simply not reached); Seminole Flavor Co. v. Commissioner, 4 T.C. 1215, 1229-31 (1945) (nonacq.) (court rejected government's argument that contract was for purpose of evading tax based on finding that terms of contract were arm's length); Treas. Reg. § 1.482-1(b)(1) (purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer; standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer); Tech. Adv. Mem. 7927009 (March 22, 1979) (conditioning application of section 482 on finding that control relationship was utilized to effect the transaction at bargain sale price). Given BT Sub's interest in Partnership, and terms of the purchase agreement that are, at the time the transaction is entered into, commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree, we believe that section 482 should not be applicable to reallocate among the entities the section 304 dividend or the basis adjustments resulting from a Purchase.