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PRIVILEGED AND CONFIDENTIAL
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~~<DRAFT>~~ May ~~<6>~~ **14**, 1997

R. Davis Maxey**, Esquire**
Senior Director, Tax Research
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Enron Corp.
1400 Smith Street
Houston, TX 77002-7361

Re: Enron Leasing Partners, L.P.

Dear Dave:

You have requested our opinion with respect to certain federal income tax consequences of the formation of Enron Leasing Partners, L.P. ("Partnership").

This document is subject to the attorney-client privilege and the work-product doctrine. It contains the legal opinions, thoughts, impressions and conclusions of King & Spalding with respect to certain federal income tax matters. King & Spalding, as special tax counsel for Enron Corp. ("Enron"), has prepared this document at the request of Enron for its sole use. It has been prepared to aid Enron, among other things, in anticipation of possible future litigation regarding the federal income tax matters referenced above and covered herein. In that regard, this document has been prepared to help define, and as part of, the litigation strategy of Enron in the event of any challenge to the federal income tax treatment claimed with respect to the transactions that it addresses.

I. STATEMENT OF FACTS

Prior to the transactions considered in this letter, Enron directly owned all of the common stock, which was all of the outstanding stock, of each of Enron Liquids Holding Corp. ("Liquids"), Enron Operations Corp. ("Operations"), Organizational Partner, Inc. ("OPI"), and Houston Pipe Line Company ("Houston Pipe"). ~~<[Add description of commercial history and assets of each corporation.]>~~ As of March 20, 1997, there was outstanding an intercompany indebtedness from Houston Pipe to Enron in an amount in excess of $1.1 billion. This indebtedness was incurred for

~~<[$____] of>~~ dividends declared but unpaid by Houston Pipe and ~~<[$____] of>~~ obligations of Houston Pipe to third parties, satisfied on behalf of Houston Pipe by Enron prior to March 20, 1997.

Enron's principal offices are located in the building at 1400 Smith Street, Houston, Texas (the "Building"). ~~<[Add prior history of Building - acquisition, ownership, financing.]>~~ Prior to the transactions considered in this letter, the Building was subject to a ~~<synthetic>~~ lease (the "Old Lease") that provided Enron with the ~~<accounting>~~ benefits of **ownership for federal income tax purposes and** off-balance sheet financing **for financial accounting purposes**. Under the Old Lease, Enron was prohibited from transferring its interest in the Building. Prior to the transactions considered in this letter, Enron had entered into negotiations to refinance the Building, replacing the Old Lease with a new ~~<synthetic>~~ lease. ~~<[Describe reasons for refinancing.]>~~ After Enron decided to contribute the Building to the structure created by the transactions considered in this letter, the negotiations with respect to the new ~~<synthetic>~~ lease were conducted with the understanding that ~~<OPI>~~ **a subsidiary of Enron** would be the lessee under the new ~~<synthetic>~~ lease and that ~~<OPI>~~ **the subsidiary** would be permitted to contribute its interest in the Building to a partnership. Pursuant to these negotiations, on April 14, 1997, the Old Lease was terminated and OPI entered into the Land and Facilities Lease Agreement (the "Lease Agreement") with Brazos Office Holdings, L.P. ("Brazos").

During the first week of March 1997, officers of Enron, based primarily on evaluations of the potential accounting benefits available through the structure created by the transactions considered in this letter, decided to enter into negotiations with Bankers Trust Company to set up such a structure and reached a preliminary understanding with Bankers Trust Company on the fees that would be paid to Bankers Trust Company if the negotiations were concluded successfully.

Negotiations relating to an acceptable recapitalization of OPI and Liquids were completed on March 21, 1997, and documents relating to the steps of the recapitalization that involved only members of the Enron consolidated group were executed on that date. The transactions covered by these documents included the reflection of a portion of the intercompany debt of Houston Pipe in a note (the "Note"), the amendment of the Certificate of Incorporation of OPI, the contribution by Enron of the Note ~~<of Houston Pipe>~~ and the Building to OPI, the amendment of the Certificate of Incorporation of Liquids, the contribution by OPI of the ~~<note of Houston Pipe>~~ **Note** to Liquids in exchange for common and preferred stock of Liquids, and the contribution by Enron of the stock of Operations to Liquids.

Negotiations relating to the formation of ~~<Enron Leasing Partners, L.P. ("~~>Partnership ~~<")>~~ were completed on March 27, 1997, and documents involving the participation of EN-BT Delaware, Inc. ("EN-BT") and Potomac Capital Investment Corporation ("PCI") in the structure were executed on that date. The transactions covered by these documents included the contributions by PCI and EN-BT of cash to OPI in exchange for preferred stock of OPI, the formation of Partnership, the

contribution by OPI of the preferred stock of Liquids and the Building to Partnership in exchange for a 98 percent interest as a limited partner, the contribution by EN-BT of cash to Partnership in exchange for a ~~1~~ **one** percent interest as a limited partner, and the contribution by Enron Property Management Corp. ("Enron GP") of U.S. treasuries and cash to Partnership in exchange for a ~~1~~ **one** percent interest as a general partner. Enron GP was a newly formed wholly-owned subsidiary of Enron Cayman Leasing, Ltd. which was a newly formed wholly-owned subsidiary of Enron.

II. DOCUMENTS EXAMINED

In rendering this opinion, we have examined and relied upon the following documents:

Certificate of Incorporation of Organizational Partner, Inc., filed January 25, 1994.

Certificate of Amendment of Certificate of Incorporation of Organizational Partner, Inc., filed March 21, 1997.

Certificate of Incorporation of Enron Liquid Fuels Company, filed April 9, 1990.

Certificate of Amendment of Certificate of Incorporation of Enron Liquid Fuels Company, filed December 23, 1992, changing the name of the corporation to Enron Liquids Holding Corp.

Certificate of Amendment of Certificate of Incorporation of Enron Liquids Holding Corp., filed March 21, 1997.

Promissory Note of Houston Pipe Line Company, dated March 21, 1997, in the amount of $1,097,489,750.

Guaranty of Obligations, dated as of March 21, 1997, by Enron in favor of OPI, relating to the Note.

Contribution Agreement, dated as of March 21, 1997, by and between Enron and OPI ("Enron/OPI Contribution Agreement").

Written consent of the sole stockholder of OPI in lieu of a meeting, executed as of March 21, 1997.

Written consent of all members of the Board of Directors of OPI in lieu of a meeting, executed as of March 21, 1997.

Contribution Agreement, dated as of March 21, 1997, by and between Enron and Liquids ("Enron/Liquids Contribution Agreement").

Subscription and Contribution Agreement, dated as of March 21, 1997, by and between OPI and Liquids ("OPI/Liquids Contribution Agreement").

Assignment of Note and Guaranty Agreement, dated March 21, 1997, by and among OPI, Liquids, and Enron.

Indemnification Agreement, dated March 21, 1997, by and between Enron and Liquids, relating to liabilities for past activities of Liquids and liabilities for past and future activities of subsidiaries of Liquids.

Letter, dated March 21, 1997, to Enron from EN-BT and PCI, relating to intention to invest in OPI ("Intent Letter").

Indemnification Agreement, dated March 27, 1997, by and between Enron and OPI, relating to liabilities for past activities of OPI.

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between PCI and OPI ("PCI Subscription Agreement").

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between EN-BT and OPI ("EN-BT Subscription Agreement").

Limited Partnership Agreement of Enron Leasing Partners, L.P. ~~<("Partnership Agreement")>~~, effective as of March 27, 1997, by and among Enron GP, OPI, and EN-BT **("Partnership Agreement")**

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between Enron GP and Partnership.

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between OPI and Partnership ("OPI/Partnership Contribution Agreement").

Guaranty and Indemnification Agreement, effective as of March 27, 1997, made by Enron in favor of EN-BT and PCI, relating to Enron GP's performance of its obligations under the Partnership Agreement.

Letter, dated March 27, 1997, from PCI to Enron, relating to representations by PCI and liquidity of OPI.

Letter, dated March 27, 1997, from EN-BT to Enron, relating to representations by EN-BT and liquidity of OPI.

Letter, dated March 27, 1997, from Enron to EN-BT, relating to representations by Enron.

Three letters, dated March 27, 1997, from Thomas Finley to Richard A. Causey, relating to the engagement by Enron of Bankers Trust to provide certain services.

~~<[Guaranty, dated as of April 14, 1997, by Enron for and in favor of Brazos, relating to lessee's obligations under the Lease Agreement ("Parent Guaranty").]~~

~~[Indemnification Agreement, effective as of April 14, 1997, by OPI for and in favor of Enron, relating to obligations under the Parent Guaranty.]~~

~~[OPI Indemnity, effective as of April 14, 1997, by OPI for and infavor of the general partners of Partnership, relating to lessee's obligations under the Lease Agreement.]>~~

In our examination of documents and in our reliance upon them in issuing this opinion, we have assumed, with your consent, that all documents submitted to us as photocopies faithfully reproduce the originals, that the originals are authentic, that all documents submitted to us have been duly executed and validly signed to the extent required in substantially the same form as they have been provided to us, that each executed document constitutes the legal, valid, binding and enforceable agreement of the signatory parties, that all representations and statements set forth in the documents are true and correct, and that all obligations, covenants, conditions or terms imposed on the parties by any of the documents have been or will be performed or satisfied in accordance with their terms. We have further assumed that, for our examination in connection with this opinion, you have disclosed to us all of the documents that are relevant to the transactions that are the subject of this opinion and that there are no undocumented agreements related to these transactions that modify or alter the effect of any documents listed above or that create any additional obligations or rights among the parties to those documents. We are not aware of any documents related to these transactions that would alter our opinions as set forth below.

Any capitalized terms not defined herein have the same meaning as in the appropriate documents from the list above.

III. REPRESENTATIONS AND ASSUMPTIONS

In rendering this opinion, we have relied upon the facts as set forth in the Statement of Facts in Section I above, which you have represented to us are true to the best of your knowledge and

belief, and we have relied upon the following, which you have represented to us are true to the best of your knowledge and belief:

1. Enron and its Affiliates[1] will at all times act in accordance with the form of the transactions as reflected in the documents listed above.

2. The predominant purpose of Enron and its Affiliates for participating in the transactions considered in this letter was to generate income for financial accounting purposes. Additional purposes were to shift risk on contributed assets, to raise minority equity capital, and to obtain access to Bankers Trust Company's expertise in leasing transactions. These purposes provide Enron and its Affiliates with significant and material benefits. Enron and its Affiliates did not engage in the transactions considered in this letter with, and do not anticipate availing themselves of ~~<Enron Leasing Partners, L.P. (">Partnership ~~<")~~> in connection with any transaction having, a purpose to reduce substantially the present value (determined 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) of the aggregate federal income tax liability of the partners of Partnership or increasing or decreasing, on a present value basis (determined 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), the aggregate federal income tax liability of the Enron consolidated group or those Affiliates of Enron that are included on Enron's consolidated financial statements.

3. ~~<No tax benefit was anticipated from>~~ **There was a bona fide business purpose, and no tax avoidance purpose, for** the assumption of liabilities by and the transfer of liabilities to OPI in conjunction with the contributions to OPI by Enron.

4. The aggregate adjusted tax basis of the Note and the Building in the hands of Enron exceeded the sum of the aggregate amount of liabilities of Enron assumed by OPI pursuant to the Enron/OPI Contribution Agreement and the aggregate amount of liabilities to which assets transferred to OPI pursuant to the Enron/OPI Contribution Agreement were subject.

5. There were no intercompany obligations between OPI and any member of the Enron consolidated group on March 27, 1997.

6. The Partnership will not elect to be classified as an association.

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

7. On the date the Liquids preferred stock was issued, (i) the annual dividend rate for the stock was no less than the rate that would be required by an investor that owned no common stock of Liquids and that was unrelated to Liquids, (ii) the annual dividend rate for the stock was 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 Liquids would have had on the date of issuance if it were rated, (iii) all terms of the stock were consistent with commercial practices generally prevailing at that time and were terms that could reasonably be expected to be agreed upon in negotiations between unrelated parties having adverse interests, and (iv) the stock had a fair market value, to an investor that owned no common stock of Liquids and that was unrelated to Liquids, equal to its issue price.

8. The issue price of the Liquids preferred stock was not greater than its redemption price and its liquidation value and was not less than its redemption price and its liquidation value (except for a reasonable redemption or liquidation premium).

9. The fair market value of the assets of Liquids 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 Liquids preferred stock will be paid currently. The aggregate current earnings and profits and net cash flow of Liquids for each year will each exceed the annual dividend on the preferred stock.

10. Brazos ~~<Office Holdings, L.P.>~~ is unrelated to Partnership.

11. The amount of the liability represented by the Lease Agreement does not exceed the fair market value of the Building.

In addition, you have consented to our reliance, in rendering this opinion, on the following assumptions:

1. Prior to the transactions considered in this letter, Enron was the owner of the Building for federal income tax purposes **and the obligations created by the Old Lease were liabilities of Enron secured by the Building**. For federal income tax purposes, the lessee under the Lease Agreement is ~~<treated as>~~ the owner of the Building and the obligations created by the Lease Agreement are ~~<treated as a liability>~~ **liabilities** of the lessee secured by the Building. The liability represented by the Lease Agreement is allocable under the rules of Treasury

Regulation § 1.163-8T[2] to capital expenditures with respect to the Building. The sublease to Enron is a true lease for federal income tax purposes.

2. Enron will at all times exercise its voting rights in OPI independently of EN-BT and PCI, and will not exercise any control or influence over EN-BT and PCI in the exercise of their voting rights in OPI.

3. Prior to March 31, 1999, no transfers will be made from Partnership to any partner other than distributions made pursuant to the terms of the Partnership Agreement of amounts that do not exceed Partnership's net cash flow from operations within the meaning of Treasury Regulation § 1.707-4(b)(2).

4. The aggregate fair market value of distributions from Partnership to OPI made prior to March 31, 2002 will not exceed OPI's tax basis in its interest in Partnership.

5. Neither the Building nor any interest therein will be distributed by Partnership to any partner other than OPI within five years of March 31, 1997.

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

7. The terms of the Partnership 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.

8. The terms of any transactions, including any loan, lease, license, or fee for services, between any of OPI, 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.

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[2] All references to sections or to the Code are to the Internal Revenue Code of 1986, as amended and in effect as of the date of this letter, unless otherwise noted. All references to regulations are to Treasury Regulations thereunder, as most recently adopted, amended, or proposed, as the case may be, unless otherwise noted.

9. Enron will at all times exercise its voting rights in Liquids for the benefit of itself and the Enron consolidated group, and not on behalf of or for the benefit of OPI, Enron GP, Partnership, EN-BT and its Affiliates, or PCI and its Affiliates.

10. The Liquids preferred stock will at all times be treated by all parties as stock for tax, financial accounting, regulatory, and all other purposes.

11. Each of Enron, Houston Pipe, Liquids, OPI, and Enron GP will at all times represent itself to third parties as a separate entity in all transactions, observe all corporate and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Partnership will at all ~~<time>~~ **times** represent itself to third parties as a separate entity in all transactions, observe all partnership and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute 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, Houston Pipe, Liquids, and OPI 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.**

12. The transactions reflected in the documents listed above provide the potential for economic profit or loss to the various parties, including EN-BT and PCI. It is anticipated that the structure created by these transactions will remain in place for at least five years.

For purposes of rendering this opinion, you have also consented to our reliance on the additional information that we have obtained through consultation with officers, employees or legal representatives of OPI, Enron GP, Partnership, and members of the Enron consolidated group, as specifically set out in this letter.

IV. OPINIONS

Based upon our analysis of the pertinent authorities as they apply to the information relied upon, it is our opinion that, for federal income tax purposes:

1. OPI should have ceased to be a member of the affiliated group, within the meaning of section 1504(a)(1), of which Enron is the parent at the end of the day on March 27, 1997.

2. The preferred stock of Liquids should be described in section 1504(a)(4).

3. Partnership should be classified as a partnership and should not be a publicly traded partnership.

4. No gain or loss should be recognized on the contributions (i) made by Enron to OPI pursuant to the Enron/OPI Contribution Agreement, (ii) made by Enron to Liquids pursuant to the Enron/Liquids Contribution Agreement, (iii) made by OPI to Liquids pursuant to the OPI/Liquids Contribution Agreement, or (iv) made by OPI to Partnership pursuant to the OPI/Partnership Contribution Agreement.

5. Enron's adjusted basis in the common stock of OPI should be increased by **the excess of** Enron's **aggregate** adjusted ~~<basis>~~ **bases** in the Note **and the Building** immediately before Enron's contribution of ~~<the Note to OPI>~~ **those assets to OPI over the amount of the liabilities represented by the Lease Agreement.**

6. Liquids' adjusted basis in the stock of Operations immediately after the contribution of such stock to Liquids should equal Enron's adjusted basis in the stock of Operations immediately before Enron's contribution of such stock to Liquids.

7. OPI's adjusted basis in the stock of Liquids immediately after the contribution of the Note to Liquids should equal Enron's adjusted basis in the Note immediately before Enron's contribution of the Note to OPI and should be allocated between the common stock and the preferred stock of Liquids in proportion to the fair market value of the stock of each class received by OPI.

8. The contribution of the common stock of Operations to Liquids should increase ~~<Liquids>~~ **Liquids'** accumulated earnings and profits by an amount equal to the accumulated earnings and profits of Operations at the time of the contribution.

9. Partnership's adjusted basis in the preferred stock of Liquids and in the Building should in each case equal ~~<Enron's>~~ **OPI's** adjusted basis **in** such asset immediately before ~~<Enron's>~~ **OPI's** contribution of the asset to OPI.

For purposes of providing you with information that may be relevant in connection with sections 6662 and 6664, we specifically state, without modifying the strength of any of the opinions set forth above, that in reaching the opinions set forth above we concluded, based on our analysis of the pertinent facts and authorities in the manner described in Treasury Regulation § 1.6662-4(d)(3)(ii), that there is substantial authority (within the meaning of Treasury Regulation § 1.6662-4(d)) for the tax treatment of the items as set forth above and there is a greater than 50 percent likelihood that the tax treatment of the items as set forth above will be upheld in litigation if challenged by the Internal Revenue Service (the "IRS").

V. LEGAL ANALYSIS

A. Deconsolidated Status of OPI

In order for OPI 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 OPI. Section 1504(a). Enron owns approximately 98 percent of the value, but only 75 percent of the voting power, of the OPI shares. PCI owns approximately 0.9 percent of the value and approximately 23.8 percent of the voting power of the OPI shares. EN-BT owns approximately 1.1 percent of the value and approximately 1.2 percent of the voting power of the OPI shares. Accordingly, if PCI's ownership of 23.8 percent of the voting power of OPI is respected, OPI will not be an affiliate of Enron.

We do not believe **that** the disproportionality between the voting rights and the value of the shares held by PCI should prevent the voting power of such shares from being taken into account in determining whether OPI 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 IRS 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 IRS has repeatedly respected the use of ~~<heavy voting shares>~~ **stock with disproportionately high voting power as compared to value ("disproportionately high vote" stock)** 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>~~ **six** 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)[3] (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 IRS 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>~~ **disproportionately high vote** 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 IRS has also respected the use of ~~<heavy voting>~~ **disproportionately high vote** stock to break affiliation. In Private Letter Ruling 9714002 (Dec. 6, 1996), the IRS ruled that a subsidiary could not be included in the parent's consolidated return for the period during which, by reason of a change in the voting rights of the outstanding preferred stock, the preferred stock of the subsidiary had 26 percent of the total number of votes of all stock of the corporation, despite the fact that the value of common stock held by the parent represented at least 80 percent of the value of the subsidiary's stock at all times. The IRS specifically rejected any application of section 1504(a)(5)(F) based on the fact that no regulations have been issued under that section and that it is not self-executing. In Private Letter Ruling 6710242620B (Oct. 24, 1967),[4] the taxpayer wanted to deconsolidate a subsidiary using a class of common stock having the power to elect ~~<1/3>~~ **one-third** 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

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[3] Reprinted in Fred W. Peel, Jr., Consolidated Tax Returns (3d ed. 1977).

[4] Reprinted in Fred W. Peel, Jr., Consolidated Tax Returns (3d ed. 1977).

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.[5]

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 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

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[5] Private Letter Ruling 671024262013 refers to an earlier ruling letter to the same taxpayer which held that the ownership by a nonmember of stock representing 21 ~~%~~ **percent** of the nonvoting stock of the corporation and 0.62 ~~%~~ **percent** 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 ~~%~~ **percent** 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 671024262013 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 ~~%~~ **percent** 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).

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 IRS 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. See Priv. Ltr. Rul. 9714002 (affiliation status is much more neutral than ~~<controlled foreign corporation>~~ **CFC** status).

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)~~**(2d** Cir. 1974); Garlock, Inc. v. Commissioner, 489 F.2d 197 ~~(2nd)~~**(2d** Cir. 1973); Estate of Weiskopf v. Commissioner, 64 T.C. 78 (1975), aff'd, 538 F.2d 317 ~~(2nd)~~**(2d** 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[6] 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. **CCA,** 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~~ **shareholder** to acquire the preferred stock, the board of directors was equally divided between representatives of the common ~~shareholders~~ **shareholder** 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~~ **shareholder**, representatives of the preferred shareholders took an active part in shareholder and director meetings, and the U.S. shareholder retained no "significant strings" 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.

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[6] 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.

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>~~ **shareholders** had sought out foreign shareholders who were related to, close personal friends of, or business associates of the U.S. ~~<shareholder>~~ **shareholders**, 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 **(with a portion sold by the original investor to another 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 IRS's application of the regulation under section 957, finding that the preferred ~~<shareholders>~~ **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) and the remaining shares were sold for approximately £810,000. 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>~~ **shareholder's** control and that the U.S. ~~<shareholders>~~ **shareholder** 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 PCI's voting power in OPI should be respected because we believe the relevant facts and circumstances indicate that PCI'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 PCI in the exercise of its voting rights in OPI and PCI will exercise its voting rights in OPI for the benefit of itself and its Affiliates, and not on behalf of or for the benefit of Enron and its Affiliates. In addition, the two classes of preferred stock of OPI, in the aggregate, have an economic interest in ~~<2>~~ **two** percent of the profits of OPI above the base return provided to the shareholders. It appears reasonable to believe that PCI would want to protect its approximately 45 percent interest in this ~~<2>~~ **two** percent ~~<upside>~~ **profit share** through the exercise

of its voting rights. Furthermore, PCI and Enron are not related, and no fee paid by Enron in connection with the transactions described herein is contingent upon the manner in which PCI exercises its voting rights in OPI.[7] Finally, all classes of shares in OPI are freely transferable. While OPI has a right to redeem the shares held by PCI, and PCI has a right to require redemption of its shares, these rights do not arise for more than five years after the issuance of the OPI preferred stock. We believe these redemption rights should not affect the reality of PCI's voting power prior to the first date on which one or more of these rights can be exercised. Accordingly, we believe the voting power held by PCI should be respected prior to such date and that OPI should have ceased to be an affiliate of Enron under section 1504 at the end of the day on March 27, 1997. Treas. Reg. § 1.1502-76(b)(1)(ii)(A).

B. ~~<Preffered>~~ **Preferred** Stock of Liquids

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). 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).

~~<For purposes of section 1504(a),>~~ **Section 1504(a)(4) provides that** 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 Liquids 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, we believe that the facts do not indicate that the preferred stock

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[7] We understand that PCI and EN-BT may have entered into a shareholder agreement and that EN-BT may have paid a fee to PCI in connection with PCI's investment in OPI. Even if these arrangements were to give EN-BT some influence over PCI's exercise of its voting rights in OPI, we believe that such arrangements should not be considered relevant in determining whether the voting rights of the preferred stock should be respected for purposes of determining whether OPI is a member of the Enron consolidated group. Rather, we believe that it would be only the relationship, if any, of Enron to the holders of the preferred stock, and Enron's influence, if any, over the exercise of the preferred stock voting rights, that should be considered relevant. Enron is unrelated to EN-BT and EN-BT will exercise its voting rights in OPI on behalf of itself and its Affiliates, and not for the benefit of Enron. Accordingly, even if EN-BT were in a position to influence PCI's exercise of its voting rights, we believe Enron should not be considered to be in a position to influence EN-BT's direct exercise of its voting rights in OPI or EN-BT's indirect exercise of voting rights through its influence over PCI.

of Liquids has any beneficial interest in or control over the voting power of the common stock of Liquids. The issue price of Liquids 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 Liquids 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.[8]

In the section 382 context, the IRS 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. **See** Priv. Ltr. Rul. 8945055 (Aug. 16, 1989). The IRS has

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[8] 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>~~ **"downside"** risk of the corporate assets ~~<and thus may not constitute>~~**, violating the spirit of** section 1504(a)(4) ~~<stock)>~~).

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. See 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 Liquids was 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 Liquids represented approximately 67 percent of the equity capital of Liquids on the date it was issued. The fair market value of the assets of Liquids 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 Liquids preferred stock will be paid currently. The current earnings and profits and net cash flow of Liquids for each year will each exceed the annual dividend on its preferred 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 IRS has refused to rule on this issue, suggesting that the IRS might challenge the treatment of such preferred stock.[9] 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 Liquids participates in corporate growth to any significant extent. Accordingly, we believe the preferred stock of Liquids is described in section 1504(a)(4).

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[9] 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; IRS 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 IRS to rule whether preferred stock was section 1504(a)(4) stock when it constituted a substantial percentage of the corporate structure).

C. Classification of Partnership

The ~~<Internal Revenue>~~ Code defines a partnership as including ~~<"a>~~"a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation.~~<">~~" Section 7701(a)(2); see also section 761(a). This definition subsumes two issues: (1) whether an arrangement is a syndicate, etc., through or by means of which a business, financial operation or venture is carried on, and (2) if so, whether the arrangement is otherwise classified as a corporation for tax purposes.

As to the first issue, the leading case is Commissioner v. Culbertson, 337 U.S. 733 (1949), in which the Supreme Court stated that the test is:

> ~~<[W]hether>~~ **whether**, considering all the facts -- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent -- the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Id. at 742 (footnote omitted). The Tax Court has focused on a number of factors, none of which is conclusive, in attempting to determine the intent of the parties to form a partnership. See S. & M. Plumbing Co. v. Commissioner, 55 T.C. 702, 707 (1971) (acq.) ~~<("four>~~("**four** basic attributes~~<">~~" of a partnership are the intent of the parties, the contribution of money, property and/or services, an agreement for joint proprietorship and control, and an agreement to share profits); Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964) (the agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise).

Based on the fact that the partners of Partnership intend to form a partnership and the fact that the documents are consistent with this intent, including all of the relevant indicia of partnership, we believe that Partnership will constitute a partnership for federal income tax purposes if it is not otherwise classified as an ~~<"association">~~"**association**" taxable as a corporation. In general an

unincorporated domestic entity that has two or more members and that was formed on or after January 1, 1997 will be treated as a partnership unless it elects to be classified as an association. Treas. Reg. §§ 1.7701-3(a), -3(b). The Partnership will not elect to be classified as an association.

An entity that otherwise qualifies as a partnership for federal income tax purposes may nevertheless be subject to taxation as if it were a corporation if it is a publicly traded partnership within the meaning of section 7704. For taxable years of a partnership beginning after December 31, 1995, publicly traded status can be avoided if interests in the partnership are not traded on an established securities market, are offered and sold within the United States and are not registered under the Securities Act of 1933, and if not more than 100 persons own, directly or indirectly through a partnership, a grantor trust, or an S corporation, interests in the partnership. Treas. Reg. ~~§~~§§ 1.7704-1(a)(1)(i), -1(h). 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.

Accordingly, we believe Partnership should be classified as a partnership and should not be a publicly traded partnership.

D. Contributions to OPI and Liquids

1. Section 351

Generally, gain or loss is not recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the transferee corporation. Section 351(a). Control, for these purposes, means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. Sections 351(a), 368(c).

Pursuant to the Enron/OPI Contribution Agreement, Enron transferred the Note to OPI on March 21, 1997 and transferred the Building to OPI on April 14, 1997.[10] Pursuant to the EN-BT

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[10] Enron did not receive any stock in exchange for its contribution of assets to OPI **or Liquids**. Given Enron's **initial** ownership of 100 percent of the common stock of OPI ~~at all times~~ **and Liquids**, the issuance of additional shares of common stock to Enron would have been meaningless. See Commissioner v. Morgan, 288 F.2d 676 (3d Cir. 1961); King v. United States, 79 F.2d 453 (4th Cir. 1935)~~.~~**. Under such circumstances, we believe the federal income tax consequences of the contributions by Enron to OPI and Liquids should be determined as if Enron had received stock of the transferee in exchange for the contributed assets.** See Lessinger v.

Subscription Agreement and the PCI Subscription Agreement, EN-BT and PCI transferred cash to OPI on March 27, 1997. Transfers by different persons at different times may be aggregated in determining whether the transferors of property are in control of a corporation immediately after the exchange. "The phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." Treas. Reg. § 1.351-1(a)(1)

A binding commitment is not required in order for transfers to be treated as part of a single section 351 transaction. See Turner Construction Co. v. United States, 364 F.2d 525 (2d Cir. 1966); Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940); Von's Inv. Co. v. Commissioner, 92 F.2d 861, 863-64 (9th Cir. 1937); Stanley, Inc. v. Schuster, 295 F. Supp. 812 ~~(S.D. Oh.~~**(S.D. Oh.** 1969), aff'd, **421 F.2d 1360** (6th ~~cir.~~**Cir. 1970)**; Baker Commodities, Inc. v. Commissioner, 48 T.C. 374 (1967)**, aff'd, 415 F.2d 519 (9th Cir. 1969)**; Marcher v. Commissioner, 32 B.T.A. 76, 80 (1935); Rev. Rul. 78-294, 1978-2 C.B. 141, obsoleted by T.D. 8665, 1996-1 C.B. 35~~.~~. Rather, the test that has most commonly been applied is whether the transfers are mutually interdependent, as that test is described in American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949) ("Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series?") In American Bantam Car, the issuance of shares in exchange for a contribution of assets to a newly formed corporation and the issuance of preferred shares to the public pursuant to an underwriting contract entered into five days after the asset transfer were treated as separate transactions. Although contemplated under the same general plan, the sale of preferred stock to the public was "entirely secondary and supplemental to the principal goal of the plan -- to organize the new corporation and exchange its stock for . . . assets. The understanding with the underwriters for disposing of the preferred stock, however important, was not a *sine qua non* in the general plan, without which no other step would have been taken. While the incorporation and exchange of assets would have been purposeless one without the other, yet both would have been carried out even though the contemplated method of marketing the preferred might fail." **American Bantam Car,** 11 T.C. at 406-07.[11]

Commissioner, 85 T.C. 824 (1985), rev'd on other issues, 872 F.2d 519 (2d Cir. 1989); Rev. Rul. 64-155, 1964-1 C.B. 138. ~~Accordingly, we have analyzed the contributions by Enron as if it had received common stock in exchange as part of a section 351 transaction. If Enron were not treated as having received stock in exchange for its contributions, we believe the transfers by Enron should be treated as contributions to capital and the tax consequences to Enron and OPI should be the same. Sections 118, 362, 1012; Rev. Rul. 83-73, 1983-1 C.B. 84.~~

[11] See also Turner Construction, **364 F.2d 525** (issuance of stock to employees and issuance of stock in exchange for assets of business were mutually interdependent, although issuance of stock to employees was delayed seven months while it was decided exactly which employees were to get how much stock); Commissioner v. National Bellas Hess, **Inc.**, 220 F.2d 415 (8th Cir. 1955) (incorporation followed by public stock offering were not mutually

The predominant purpose of Enron and its Affiliates for participating in the recapitalization of OPI was to generate income for financial accounting purposes. The contribution to OPI of the Building and the contributions to OPI by EN-BT and PCI were essential to obtaining the desired financial accounting results. In the absence of such contributions, the contribution of the Note to OPI would not have accomplished the predominant purpose for the recapitalization of OPI. We understand that Enron would not have made any contributions to OPI if it had not believed that, within a short period of time, the transfer of the Building would occur in accordance with the terms of the Enron/OPI ~~<Contributions>~~ **Contribution** Agreement and EN-BT and PCI would execute and make contributions in accordance with their respective subscription agreements.

As reflected in the Intent Letter, the transfer by Enron, EN-BT, and PCI were all contemplated as part of a single plan for recapitalizing OPI. In addition, on March 21, 1997, the ~~<Articles>~~ **Certificate** of Incorporation of OPI ~~<were>~~ **was** amended to provide for the shares ultimately issued to EN-BT and PCI, the Board of Directors of OPI adopted resolutions authorizing the issuance of such shares to EN-BT and PCI, and the sole stockholder of OPI authorized the issuance of such shares. On March 27, 1997, PCI and EN-BT subscribed for shares, and OPI issued shares, on the terms established on March 21, 1997. While there was, on March 21, 1997, no binding commitment on the part of OPI, EN-BT, or PCI with respect to the contributions and stock issuances that occurred on March 27, 1997, we believe the above documents establish that the terms on which the PCI and EN-BT contributions were ultimately made were defined on March 21, 1997.

Based on the facts described above, we believe that the transfers by Enron on March 21 and April 14 and the transfers by EN-BT and PCI on March 27 should all be treated as mutually interdependent and as part of a single section 351 transaction. Immediately after the transfers by Enron, EN-BT, and PCI, those corporations owned all of the stock of OPI. Accordingly, we believe the contributions by Enron to OPI should be nontaxable transfers described in section 351.

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interdependent; Tax Court could properly determine sale of stock to the public did not have any intended controlling relationship on whether the exchange of property and stock would have been carried out; it may have been understood that organizers would attempt to sell stock to the public, but it was a gamble whether it could be done under the economic conditions obtaining in 1932); ~~<H B>~~ **H. B** Zachry Co. v. Commissioner, 49 T.C. 73 (1967) (exchange of assets for stock, followed three days later by exchange of cash for preferred stock, respected as separate transactions; valid business purpose for each transaction standing by itself; only the assets exchanged for stock were required by corporation to carry out its corporate function); Baker Commodities, **48 T.C. 374** (while there appears to have been no written agreement, multiple transfers to a corporation were integrated where, as a result of lengthy negotiations, a plan to transfer various assets to a corporation to be owned equally by the parties had been "carefully formulated and agreed to by all the participants"); Scientific Instrument Co. v. Commissioner, 17 T.C. 1253 (1952), **aff'd, 202 F.2d 155 (6th Cir. 1953)** (core steps of plan were formation of new corporation and transfer to it of assets of old corporation; effectiveness did not depend on new capital; initial transfer of assets not mutually interdependent with sale of stock to public pursuant to underwriting contract entered into before initial asset transfer)

Enron transferred the stock of Operations and OPI transferred the Note to Liquids on March 21, 1997 pursuant to the Enron/Liquids Contribution Agreement and the OPI/Liquids Contribution Agreement. Immediately after those contributions, Enron and OPI owned all of the stock of Liquids. Accordingly, we believe the contributions by Enron and OPI to Liquids should be nontaxable transfers described in section 351.

2. Section 357(c)

Section 357(c) provides for the recognition of gain from the sale or exchange of property in a section 351 exchange to the extent that the sum of liabilities of a transferor assumed by the transferee corporation plus liabilities to which property contributed by the transferor is subject exceeds the adjusted basis of the property contributed by the transferor. The aggregate adjusted tax basis of the Note and the Building in the hands of Enron exceeded the sum of the aggregate amount of liabilities of Enron assumed by OPI pursuant to the Enron/OPI Contribution Agreement and the aggregate amount of liabilities to which assets transferred pursuant to the Enron/OPI Contribution Agreement to OPI by Enron were subject. As discussed above, we believe the transfers by Enron on March 21 and April 14 should be treated as part of a single section 351 ~~<transactions>~~ **transaction**. Accordingly, we believe section 357(c) should not be applicable to Enron's transfers to OPI.

3. Basis Effects

In general, the basis of stock received by a transferor in a section 351 transaction equals the basis of the property exchanged for such stock, decreased by the amount of any liabilities transferred to the issuing corporation. Section 358(a)(1), (d). If a transferor receives stock of more than one class in a section 351 transaction, the basis of the property transferred is allocated among all of the stock received in proportion to the fair market ~~<values>~~ **value** of the stock of each class. Treas. Reg. § 1.358-2(b)(2). In general, the basis of property received by a corporation in exchange for its stock in a section 351 transaction equals the basis of the property in the hands of the transferor immediately before the exchange. Section 362(a).

Accordingly, we believe that (1) Enron's adjusted basis in the common stock of OPI should be increased by **the excess of** Enron's **aggregate** adjusted ~~<basis>~~ **bases** in the Note **and the Building** immediately before Enron's contribution of ~~<the Note to OPI>~~ **those assets to OPI over the amount of the liabilities represented by the Lease Agreement**, (2) Liquids' adjusted basis in the stock of Operations immediately after the contribution of such stock to Liquids should equal Enron's adjusted basis in the stock of Operations immediately before Enron's contribution of such stock to Liquids, (3) OPI's adjusted basis in each of the Note and the Building immediately after they were received by OPI should equal Enron's adjusted basis in the Note and the Building, respectively, immediately before they were contributed to OPI, and ~~<(3)>~~**(4)** OPI's adjusted basis in the common and preferred stock of Liquids immediately after OPI's contribution of the Note to Liquids should

equal OPI's adjusted basis in the Note immediately before such contribution (i.e., Enron's adjusted basis in the Note immediately before it was contributed to OPI) and such basis should be allocated between the common stock and the preferred stock of Liquids in proportion to the fair market value of the stock of each class received by OPI.

4. Earnings and Profits Effects

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~~ **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. For example, 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. Id. Accordingly, we believe the transfer by Enron of all of the common stock of Operations to Liquids should cause all of the earnings and profits of Operations to "tier up" to Liquids.

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>~~ **Treas. Reg.** § 1.1502-33(g). The primary earnings and profits effect of the transfer of Operations to Liquids is the duplication of all of Operation's earnings and profits in Liquids.

We believe that 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 this effect. The rules cause the earnings and profits of Operations to "tier up" to Liquids, which is a higher-tier member in the Enron group as a result of the contribution of the Operations stock to Liquids. Reflecting the earnings and profits of Operations in Liquids 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 contribution of Operations to Liquids.

E. OPI Contribution to Partnership

1. In General

In general, gain or loss is not recognized by a partnership or its partners on the contribution of property to a partnership in exchange for a partnership interest. Section 721(a). In general, the basis of property contributed to a partnership by a partner is equal to the adjusted basis of such property to the contributing partner at the time of the contribution. Section 723. Accordingly, we believe no gain or loss should be recognized on the contribution by OPI to Partnership and Partnership should have a basis in the Building equal to the adjusted basis of the Building in the hands of Enron immediately prior to the contribution.

2. Section 707

Notwithstanding the general rule of section 721(a), a purported "contribution" of property to a partnership would be taxable if it were a disguised sale of property. Section 707(a)(2)(B). In order for the contribution by OPI to Partnership to be treated as part of a disguised sale, there would have to be a related transfer of money or property from Partnership to OPI that, when viewed in combination with OPI's contribution, is properly characterized as a sale or exchange of property. Id. Transfers from Partnership to OPI that are more than two years after the contribution by OPI, and distributions of Partnership's net cash flow from operations (as that term is defined in Treasury Regulation § 1.707-4(b)(2)) that are made to the partners in accordance with their minimum percentage interests in Partnership profits are presumed not to be part of a disguised sale unless the facts and circumstances clearly establish that the transfer is part of a sale. Treas. Reg. §§ 1.707-3(d), -4(b). The transfer of a liability to a partnership (whether by assumption or by taking property subject to the liability) is not treated as a transfer of property from the partnership to the partner if the liability

is a "qualified liability" (and the contribution is not otherwise treated as a disguised sale) or if the contributing partner's share of that liability after the transfer equals the full amount of the liability. Treas. Reg. §§ 1.707-5(a)(1), -5(a)(5).

OPI transferred to Partnership the liability associated with the Building. The liability associated with the Building is a qualified liability if the amount of the liability does not exceed the fair market value of the Building and the liability is allocable under the rules of Treasury Regulation § 1.163-8T to capital expenditures with respect to the Building. Treas. Reg. § 1.707-5(a)(6). For federal income tax purposes, the lessee under the Lease Agreement is treated as the owner of the Building and the obligations created by the Lease Agreement are treated as a liability of the lessee secured by the Building. The liability represented by the Lease Agreement is allocable under the rules of Treasury Regulation § 1.163-8T to capital expenditures with respect to the Building. The amount of the liability represented by the Lease Agreement does not exceed the fair market value of the Building. The sublease to Enron is a true lease for federal income tax purposes. Accordingly, we believe that such liabilities should be qualified liabilities and the transfer of liabilities under the Lease Agreement to Partnership should not be treated as part of a disguised sale.

VI. CONCLUSION

This opinion letter is based upon existing statutory, regulatory, judicial and administrative authority in effect as of the date of this opinion letter, any of which may be changed at any time with retroactive effect. In addition, our analysis is based solely on the documents we have examined, the representations you have made, the facts that we have assumed with your consent, and the additional information that we have obtained. If any of the facts contained in these documents or in such additional information are, or later become, inaccurate, or if any of the representations you have made or any of the assumptions that we have made are, or later become, inaccurate, our conclusions could well be different and this opinion cannot be relied upon. Similarly, our opinion is qualified by the preceding discussion and analysis and cannot be relied upon if we have not been informed of any material or relevant fact that would adversely affect our analysis.

Our opinion is rendered solely for your benefit and is not to be relied upon by any other person without our prior written consent. Finally, our opinion letter is limited to the specific issues described above.

Sincerely,

KING & SPALDING

By: _____
William S. McKee

By: _____
Abraham N.M. Shashy, Jr.