Interoffice Memorandum

DRAFT

To: File

From: J. Anthony Jarrett

Department: Corp. Tax Planning

Date: August 6, 2002

Subject: SALE OF PGE:
OPTIONS FOR TRUST OWNED LIFE INSURANCE

Confidential & Privileged Attorney/Client Communication

I. BACKGROUND

Portland General Electric Company ("PGE") sponsors several deferred compensation plans[1] for senior management and outside directors. These plans are funded with life insurance policies owned by rabbi trusts. The policies insure various PGE employees, with proceeds paid to the trust as beneficiary.

The following information was prepared by the plan administrator and Enron's Corporate Compensation group regarding the PGE trust assets:

Cash Surrender Value of Policies		
-Owned by PGE	$79M	
-Owned by Enron entities	59M[2]	$138M
Basis		
-Owned by PGE	$54M	
-Owned by Enron entities	43M	$97 M
Current Benefit Obligations		$130M
NPV of Death Benefits		$263M

Shortly before agreeing to sell PGE to Sierra Pacific Resources ("Sierra"), Enron's Corporate Development group expressed an interest in retaining as many of the trust assets as possible. A couple alternatives were considered, whereby PGE would either (i) withdraw proceeds from the policies and dividend the amount to Enron, or (ii) transfer the policies directly to Enron.

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[1] One of these plans was frozen in 1996; the others will be frozen immediately prior to Enron's sale of PGE.

[2] This figure includes certain policies that were transferred in mid-1999 (without Enron's knowledge) from PGE to PGH. Estimates of the cash value and basis of such policies was $21M and $13M respectively.

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For the reasons discussed below, Enron decided to receive the policies via a transfer from PGE.

II. ANALYSIS

A. Withdrawal of Basis

One alternative considered would involve PGE withdrawing an amount up to policy basis ($54M) and forwarding the amount to Enron as a dividend. As PGE's sole shareholder, Enron would receive this amount tax-free, while the policies would remain with PGE. Enron's basis in PGE would decrease by $54M.

While exploring this alternative, Enron was advised by the trustee (whose advice was reviewed by outside counsel) that plan assets generally may not be transferred unless the recipient also assumes corresponding benefit obligations. Two exceptions to this general rule apply. First, "excess assets"—assets exceeding 125 percent of the present value of benefit obligations—may be taken out of the trust prior to a change in control. Second, any assets remaining after all benefits are paid to participants may revert to the company.

Neither of these special rules applied to PGE's trust assets. Assets and liabilities were roughly equal ($138M to $130M); there were no excess assets to withdraw. Benefits will be paid over time under the terms of the plans (generally after termination of employment or retirement); therefore, the asset reversion rule is inapplicable.

Thus, if Enron were to attempt this approach, it would receive $54M in cash, leaving behind both the policies and the $25M cash value build-up. While the $54M could be redeployed into new policies or other investment alternatives, the company would start with less money to invest than under the policy-transfer scenario. In addition, counsel and the plan administrator were concerned whether a legal and feasible solution could be reached as to the transfer of corresponding benefit obligations to Enron.

B. Policy Transfer

Under the second alternative, PGE could transfer the policies to Enron. This would result in PGE realizing an intercompany gain equal to $25M[3] and recognizing such gain upon deconsolidation. PGE would expense $10M in taxes on the gain and would report a $10M receivable on its balance sheet. Enron's basis in PGE would increase by $15M,[4] thereby reducing the gain recognized on the sale of PGE by this same amount. The net tax expense of the transfer would be $4M.[5]

In addition to the front-end tax hit, there is another tax related to the transfer of life insurance policies that was analyzed. A policy transferred for valuable consideration may cause

[3] $79M (cash value) less $54M (basis) equals $25M.
[4] $25M (gain on transfer) less $10M (tax expense that flows to balance sheet) equals $15M.
[5] $10M (tax expense on policy transfer) less $6M (tax savings from increasing Enron's basis in PGE) equals $4M.

policy proceeds to become taxable *unless* the transfer is made to a corporation in which the insured is a shareholder or officer.[6] To resolve this potential problem, Enron and outside counsel determined that the company could provide one share of Enron common stock to insureds (mostly employees of PGE) shortly before policies were transferred, thereby satisfying the shareholder-exception to the transfer-for-value rules. These shares would be nontransferable until the sale of PGE was consummated.

Calculations prepared by the Corporate Development and Corporate Compensation groups indicate that transferring the policies would yield an after-tax benefit to Enron of $129M.[7] A decision was therefore made to transfer the remaining policies owned by PGE to Enron following regulatory approval of the proposed sale of PGE to Sierra.

jaj/rdm

cc: R. Davis Maxey
Greek L. Rice
Alicia Goodrow

[6] I.R.C. § 101(a)(2)(B).
[7] $263M (NPV death benefits) less $130M (benefit obligations) less $4M (net tax expense on the transfer) equals $129M.

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