II. TAX OPINION LETTERS

RELATING TO

PROJECT VALOR

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December 27, 1996

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Mr. Jordan Mintz
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Dear Deborah and Jordan:

You have requested that we provide our opinion on the U.S. federal income tax consequences to Enron Capital & Trade Resources Corp. ("ECT") with respect to a proposed transaction involving ECT and ECT Strategic Value Corp. ("ECTS"), a previously established consolidated subsidiary organized to oversee certain credit reserve and fixed price and risk management contract liability management functions associated with ECT's commodity trading activities. The purpose of this letter is to memorialize our prior advice. For a further description of the factual circumstances of these transactions see Appendix A, Facts and Assumptions As Provided By Management. Our opinions are limited to the following tax issues.

1. ECT's transfer of notes receivable to ECTS, subject to the contractual assumption of ECT's credit reserve obligations and fixed price and risk management contract liabilities, in exchange for all of the voting preferred stock of ECTS should, more likely than not, qualify for nonrecognition of gain or loss under IRC Section 351(a).

2. ECT's tax basis in the voting preferred stock of ECTS should, more likely than not, equal the tax basis in the notes receivable contributed to ECTS, and should not be reduced by the amount of the credit reserve obligations and fixed price and risk management contract liabilities assumed by ECTS in excess of ECT's unamortized option and swap premiums.

3. Losses on the sale of the voting preferred stock of ECTS should, more likely than not, not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1)(iii), not be disallowed under the anti-avoidance or anti-stuffing rules of Treasury Regulation Section 1.1502-20(e), and not be disallowed by the intercompany transaction rules of Treasury Regulation Section 1.1502-13.

4. ECT's contribution of the notes receivable to ECTS in exchange for its voting preferred stock should, more likely than not, not constitute an acquisition made to evade or avoid income tax within the meaning of Internal Revenue Code Section 269.

Furthermore, based on our analysis, we have concluded that the overall tax result of the transaction should, more likely than not, be the recognition of a capital loss by ECT on the sale of the voting preferred stock of ECTS.

In analyzing the authorities relevant to the potential tax issues outlined in opinions one through four, above, and the overall tax result, we have applied the standards of "substantial authority" and "more likely than not . . . proper," as used in IRC Section 6662 under current law. Based upon our analysis, we have concluded that there is substantial authority for the indicated tax treatment of these issues and result, and we also believe the indicated tax treatment of such issues and result is more likely than not proper.

In rendering our opinion, we have relied upon the facts, information, assumptions and representations as contained in Appendix A, including all exhibits attached thereto. We have assumed that these facts are complete and accurate and have not independently audited or otherwise verified any of these facts or assumptions. You have represented to us that we have been provided all the facts necessary to render our opinion. A misstatement or omission of any fact or a change or amendment in any of the facts, assumptions or representations we have relied upon may require a modification of all or a part of this opinion. Our opinion reflects our advice up to and through the date of this letter and we have no responsibility to update this opinion for events, transactions, circumstances or changes in any of the facts, assumptions or representations occurring after this date.

We have not considered any non-income tax or state, local or foreign income tax consequences, and, therefore, do not express any opinion regarding the treatment that would be given the transactions of ECT and its Subsidiaries by the applicable authorities on any state, local or foreign tax issues. We also express no opinion on nontax issues such as corporate law or securities law matters. We express no opinion other than that as stated immediately above, and neither this opinion nor any prior statements are intended to imply or to be an opinion on any other matters.

The discussion and conclusions set forth herein are based upon the Internal Revenue Code, Treasury Regulations and existing administrative and judicial interpretations thereof, as of the date of this letter, all of which are subject to change. The opinions expressed herein are not binding on the IRS, and there can be no assurance that the IRS will not take a position contrary to any of the opinions expressed herein. If there is a change, including a change having retroactive effect, in the Internal Revenue Code, Treasury Regulations, Internal Revenue Service rulings or releases or in the prevailing

judicial interpretation of the foregoing, the opinions expressed herein would necessarily have to be re-evaluated in light of any such changes. We have no responsibility to update this opinion for any such changes occurring after the date of this letter.

The opinions expressed herein reflect our assessment of the probable outcome of litigation and other adversarial proceedings based solely on an analysis of the existing tax authorities relating to the issues. It is important, however, to note that litigation and other adversarial proceedings are frequently decided on the basis of such matters as negotiation and pragmatism. We have not considered the effect of such negotiation, pragmatism and judicial willingness upon the outcome of such potential litigation or other adversarial proceedings.

These opinions are solely for your benefit and are not intended to be relied upon by anyone other than you. We assume no responsibility for tax consequences to other parties. Instead, each of the other parties must consult and rely upon the advice of his/her/its own counsel, accountant or other adviser. Without the prior written consent of this firm except to matters relating to the examination by the Internal Revenue Service, this letter may not be quoted in whole or in part or otherwise referred to in any documents or delivered to any other person or entity.

The opinions expressed herein reflect what we regard to be the material federal income tax effects to ECT and its Subsidiaries of the transactions as described herein; nevertheless, they are opinions only and should not be taken as assurance of the ultimate tax treatment.

Very truly yours,

ARTHUR ANDERSEN LLP

Arthur Andersen LLP

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FACTS AND ASSUMPTIONS AS PROVIDED BY MANAGEMENT

DESCRIPTION OF TRANSACTION

Background

Enron Corp. ("Enron") is the parent of a consolidated group of subsidiaries engaged in businesses ranging from gas transmission and marketing to the development of energy infrastructures and "upstream" oil and gas operations. Such businesses are conducted both domestically and internationally. The Enron group of corporations includes Enron Capital & Trade Resources Corp. ("ECT"). ECT, in turn, is the largest purchaser and marketer of natural gas and the largest non-regulated marketer of wholesale electricity in North America. In addition, ECT manages the world's largest portfolio of natural gas fixed-price and risk management contracts offering innovative physical and financial energy products and services.

With respect to these commodity trading activities, ECT enters into numerous fixed price and risk management contracts, collectively referred to herein as "FPRM contracts". Due to changes in commodity and interest rate price curves over time, some of these contracts currently represent a net liability to ECT. Additionally, certain other contracts which represent a net asset to ECT (*i.e.*, "in the money" contracts) may expose ECT to credit losses varying in degree and magnitude. ECT has represented that it has potential credit reserve obligations of approximately $120 million and fixed price and risk management contract liabilities of approximately $2 billion as of November 30, 1996.

Credit Reserve Management

ECT's credit reserves are identified by using a sophisticated financial model which considers certain "credit spreads" derived from historical studies of publicly-traded bonds for various categories of risk. The appropriate credit spreads are then applied to ECT's exposure by counterparty in order to determine the appropriate level of reserve. This credit model further incorporates advanced statistical methods established for capturing both current and potential movements in the related commodity prices and interest rates. In short, ECT's credit reserve liability quantifies the value of the estimated loss associated with "in-the-money" gas contracts as required under mark-to-market financial accounting principles.

In order to ensure that the credit reserve liability is minimized on a going-forward basis, ECT actively manages this category of liabilities through one or more of the following techniques:

1. Daily Monitoring -- ECT's Credit "Procedure and Process" is as follows:

   ECT has nine credit professionals within ECT Treasury that independently manage counterparty credit risk. Currently, there are approximately 6,000 counterparties within a variety of ECT's business sectors that receive at least quarterly monitoring.

   Credit management at ECT entails a thorough examination of a counterparty's creditworthiness. This process requires a complete review of counterparty financial statements. Additional supporting information provided by the counterparty and any available public information, including credit rating agencies' publications, industry analysis, and other financial publications are utilized. The review process includes:

   - assigning an internal counterparty risk grade (the "E" rating) that is synthetically calculated through a sophisticated proprietary credit model;
   - setting appropriate credit limits; and
   - negotiating additional third-party credit enhancement in order to mitigate potential losses.

   ECT actively monitors credit exposures by counterparty to ensure credit risks do not exceed existing credit limits. Various forms of collateral are regularly negotiated to support excess credit exposures. These forms include letters of credit, parent guarantees, and other third party instruments.

   The inclusion of credit covenants within counterparty contracts further protects ECT by triggering additional rights to ECT upon negative changes in the counterparty's financial structure. Additional collateral is collected to support excess exposures in the case of this financial credit deterioration.

   Annual reviews of counterparty credit standing are performed and aggregate exposures by counterparty are monitored on a daily basis.

2. Credit Derivatives – ECT may also attempt to alter the risk profile of a particular credit, counterparty, or portfolio by going into the financial markets and either purchasing or selling certain proprietary credit derivatives. The broad definition of a credit derivative is nothing more than a financial contract for the exchange of payments in which at least one component of the instrument is linked to the underlying credit price of one or more referenced names or credits. Therefore, a credit instrument is structured to best manage "default risk" of the counterparty by allocating the overall risk into discrete, manageable components. Credit derivatives fall into three main categories:

   - *default puts* - an option designed to reimburse the buyer if a particular credit

event occurs;

- *total rate of return swaps* - a swap instrument designed to enable one party to effectively reduce its exposure to one borrower by accepting exposure to another; and

- *credit spread forwards* - allows counterparties to express views on future credit spreads and benefit from a narrowing or widening of the credit spread between debt instruments.

3. **Monetizations** -- Through a proprietary structure, ECT may also manage its credit reserve liabilities by "stripping" the risk element from a series of cash flows and selling such flows to third parties, often resulting in a complete or partial mitigation of the original credit risk exposure. ECT has successfully completed three of these complex transactions and is in the process of completing a fourth transaction.

ECT utilizes each of these risk minimization techniques in managing its credit exposure.

ECT's Credit Department has developed rapidly over the past five years into one of the most advanced credit departments in the energy business. The group has an extremely efficient and educated staff with numerous years of credit experience. They monitor thousands of counterparties in one of the most difficult industries for credit analysis, utilizing the most sophisticated methods. The credit reserve models are street tested at least on a monthly basis for price movement in the underlying commodity and interest rates. To that end, by identifying its more significant risks and dedicating certain individuals with the expertise for managing this "risk portfolio," ECT believes that such individuals will more efficiently perform their responsibilities, thus enhancing the possibilities for success in avoiding credit losses.

Fixed Price and Risk Management Contract Liabilities

ECT currently has on its balance sheet approximately $2 billion of liabilities from fixed price and risk management contracts. These liabilities are accounted for using the "mark-to-market" method of accounting for financial reporting purposes, which reflects changes in the market value of outstanding swaps, forwards, swaptions, caps, floors, collars and physical options and recognizes these changes as gain or loss in the period of change. To that end, the market prices used to value these transactions reflect management's best estimate considering various factors, including closing exchange and over-the-counter quotations and time value and volatility factors underlying the commitments. The values are adjusted to reflect the potential impact of liquidating ECT's position in an orderly manner over a reasonable period of time under present market conditions.

In order to minimize liabilities from fixed price and risk management activities, ECT actively manages this category of liabilities through one or more of the following techniques:

1. Market risk hedging including price, basis, index, and interest rate risk which is performed and valued on a daily basis through its trading department and its support departments.

2. Renegotiations with counterparties to adjust contract terms, maturity, price, and related factors to create value for ECT through a reduction in the underlying mark-to-market liability. Potential methods include changing a fixed price to a floating price, extending or shortening the contract term, by cashing out a contract, by partially cashing out a contract and revising the price or term thereof, changing index or basis points, locking in another component of the contract such as basis pricing utilizing a BTU swap, embedding a swaption or options, converting an option to a swaption or vice versa, and any other methods approved by ECT.

With respect to FPRM contracts currently recorded as liabilities, these strategies are utilized by a few groups of traders on a random basis to reduce liabilities in their respective portfolios to obtain targeted income goals in a given month. In order to target such liabilities, the marketers must scrutinize the entire fixed price book for potential liabilities. These strategies are essentially used to generate income (through a reduction in the liability). Nevertheless, the primary focus of the marketers is to generate new business through the creation of new valuable contracts rather than minimizing liabilities on existing contracts. ECT believes that additional opportunities exist for the success of the company if a greater emphasis were placed on minimizing these existing liabilities.

Objective

As can be seen from the above discussions, ECT continually strives to control liabilities associated with its commodity trading and interest rate activities. This is particularly true with respect to ECT's exposure to credit losses and liabilities on FPRM contracts. These liability management efforts are consistent with other cost control efforts being implemented in all phases of Enron's business. For example, Enron has recently outsourced its internal audit function, its information system functions, and graphics. In its continuing effort to manage liabilities, ECT is considering offering certain employees responsible for managing these functions an incentive to manage these liabilities and to share in the successes of their efforts. ECT hopes to utilize the skills and experience of these employees to develop additional creative and innovative strategies for managing liabilities.

ECT has identified four significant credit reserve obligations where close scrutiny is needed due to unique characteristics of the counterparties and/or contracts involved. By isolating these credit reserve obligations, the responsible employees will have a

greater sense of focus on the outstanding exposures and will thus be more aware of monitoring the liabilities for credit deterioration. The concept of isolation coupled with the skills of the credit employees will allow these credit liabilities to receive extremely close scrutiny and analysis for any negative movement. By employing one or more of the credit risk-mitigating methodologies discussed above, the responsible employees should have a greater likelihood for success in controlling and reducing the credit exposure associated with the contracts and counterparties selected for inclusion.

ECT has identified certain FPRM contract liabilities where significant opportunities may exist to restructure the contracts to reduce the liabilities. By isolating these liabilities, the responsible employees will have a greater sense of focus on restructuring these specific liabilities. The employees will be provided a concentrated portfolio in an easily accessible risk management book. This will eliminate the inefficiency of identifying these liabilities on a frequent basis in such a large portfolio, thereby eliminating the barriers to pursuing the strategy. With this emphasis, the responsible employees should have greater success in targeting the contracts to renegotiate and, thus, should be able to focus their efforts directly on counterparty renegotiations.

Such arrangements are consistent with new methods of approaching employee compensation which are tied to performance in areas where the employees have direct control, and which are not at the mercy of the overall performance of the company.

Structure of Transaction

To achieve the objectives described above, ECT reorganized an already existing subsidiary, Enron Gas Gathering, Inc. ("EGGI"), to oversee certain credit reserve obligations and FPRM contract liabilities. EGGI was previously formed in March of 1985 to manage various gathering assets for Enron Corp. These assets included various partnership interests. In 1995, all the gathering assets were sold to Enron Gathering Company. In the 1st quarter of 1996, EGGI sold its remaining 25% interest in Dauphin Island Gathering Partners. As of November 30, 1996, EGGI has assets consisting of intercompany accounts receivable and trade accounts receivable with a current book value of approximately $ 4.563 million and liabilities for taxes payable of approximately $163,000. EGGI does not have a net operating loss carryover, built-in deduction or any other favorable tax attribute. EGGI was previously incorporated and capitalized for the purposes described above and not for the purpose of managing credit reserve obligations and FPRM contract liabilities. However, as part of its reorganization, EGGI's name was changed to ECT Strategic Value Corp. ("ECTS") and its purpose, likewise, was altered so as to undertake responsibilities associated with credit reserve obligations and FPRM contract liabilities.

As of January 1, 1997, certain employees of ECT will become employees of this subsidiary. In addition, it is envisioned that this subsidiary will utilize, to the extent necessary, current ECT employees in the treasury group and the trading group. The principal purpose of such reorganization was to segregate the credit reserve and FPRM

contract liability management functions to allow management to better manage these obligations.

The transfer of certain credit reserve and FPRM contract liability management functions took the following form: As noted, ECT changed the name of EGGI to ECTS. Next, ECT transferred a 10-year note receivable from JILP-L.P., Inc. ("JILP") with a tax basis of $217.0 million and a 10-year note receivable from Enron Industrial Natural Gas Company ("EING") with a tax basis of $50.32 million, subject to a contractual assumption of $5.01 million of ECT's credit reserve obligation and $262.27 million of ECT's FPRM contract liabilities. With respect to certain written options, swaptions, caps and floors, ECT has received $32.02 million of cash premiums which have not been amortized into taxable income. The contribution of these notes coupled with the assumption of the credit reserve obligations and FPRM contract liabilities results in ECTS having a net worth of approximately $4.44 million. (See Exhibit A, ECTS Balance Sheet, attached.)

Since certain of the FPRM contracts underlying the assumed liabilities require consent for any assignments, ECT and ECTS entered into a Master Swap Agreement and a Liability Management Agreement. Such agreements provide for the transfer of the economic liability for, and management of, the credit reserve obligations and FPRM contract liabilities from ECT to ECTS without breaching the terms of any of the FPRM contracts.

The notes receivable from JILP and EING were formalized from existing intercompany accounts receivable which were transferred from Enron to ECT in satisfaction of certain intercompany balances between Enron and ECT. The notes have a term of 10 years and accrue interest at a floating rate tied to LIBOR. Interest accrues and is payable quarterly and the principal will be due on maturity of the notes.

In exchange for the transfer, ECT received all of a newly created class of voting preferred stock in ECTS which pays an annual 9 percent dividend and represents, in the aggregate, $40,000 of ECTS' existing Net Equity of $4.44 million and 4 percent of any increase in ECTS' Net Equity up to a maximum redemption value of $2.0 million. The holders of the voting preferred stock have the right to elect one of the six directors of ECTS. The voting preferred shareholders have no other voting rights. ECT has represented that it did not receive any other property in the transaction. In addition, the amended Certificate of Incorporation grants the holders of these shares the right to require ECTS to redeem (*i.e.*, "put") its shares any time after five years from the date of initial issuance based on the formula described above, calculated using a Redemption Value balance sheet based on generally accepted accounting principles.

Similarly, ECTS may call the voting preferred shares after six years from the date of initial issuance based on the same formula. However, the redemption value is capped at $2.0 million.

The $2.0 million redemption cap was determined by setting up various cash flow models based on potential favorable and unfavorable resolutions of the credit reserves and FPRM contract liabilities. For instance, under the scenario in which all credit reserves and FPRM contract liabilities experience no significant change from the amounts currently projected based on information currently available, the potential fair market value and Redemption Value of ECTS remains unchanged. Thus, the holders of these shares would be able to recover their initial investment. Under the most favorable foreseeable conditions (*i.e.*, where actual future credit and FPRM contract losses are less than the amounts projected) the Redemption Value of ECTS was computed to be approximately $50 million. Since the voting preferred shares represent $40,000 of the first $4.44 million of Redemption Value and 4 percent of the excess, the voting preferred shareholders would be entitled to a $2.0 million redemption price under the most favorable scenario.

The value of the notes is $40,000 greater than the current estimated value of the credit reserves and FPRM contract liabilities contractually assumed by ECTS. As a result, the value of the voting preferred is $40,000 at the time of the exchange. As stated above, the future redemption value of this stock is contingent on the success of the liability management efforts in that the voting preferred stock will be entitled to 4 percent of the total liability reduction generated by ECTS as measured principally by the value of the notes receivable, less the liabilities under the revolving credit facility, the credit reserves and the FPRM contracts.

ECT plans to sell the voting preferred stock in ECTS to certain employees in the ECT treasury group and origination or marketing group to provide them with an incentive to manage the liabilities and share in the rewards of these liability reduction efforts. At the time of ECT's receipt of the voting preferred stock, ECT did not have a firm commitment from any party to participate in this venture. In addition, ECT was not contractually bound to sell this stock. Furthermore, following the sale of the voting preferred stock, ECTS will continue to be a part of Enron's affiliated group under the provisions of Section 1504[1].

It is anticipated that the interest income on the notes receivable and certain management fee income will provide some of the funds necessary to cover day-to-day payroll and operating expenses of ECTS and to fund some of ECTS' obligation under the Liability Management Agreement. Additionally, ECT has agreed to lend ECTS additional funds through 2006 on a revolving basis at a rate equal to LIBOR. Furthermore, ECTS has entered into several intercompany service agreements with ECT to provide and receive various services established at customary intercompany rates.

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[1] All citations to Section or Treasury Regulation Section are in reference to the Internal Revenue Code (IRC) of 1986, as amended (Code), and the regulations thereunder.

ECT STRATEGIC VALUE CORP.
PROFORMA INITIAL BALANCE SHEET
as of December 20, 1996

Exhibit A

Assets		
	Accounts Receivable	$ 4,563,411
	Notes Receivable	267,318,698
	Total Assets	$ 271,882,109
Liabilities		
	Income Taxes Payable	$ 155,555
	Accrued Taxes Payable	6,923
	Credit Reserves	5,007,130
	FPRM Contract Liabilities	262,271,568
Total Liabilities		267,441,176
Equity		
	Common Stock	4,400,933
	Preferred Stock	40,000
Total Equity		4,440,933
Total Liabilities and Equity		$ 271,882,109

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TRANSFERS TO CONTROLLED CORPORATIONS – GENERAL RULES

ECT reorganized an existing subsidiary to oversee its credit reserve and FPRM contract liability management functions by changing the name of EGGI, which is currently 100 percent owned by ECT, to ECTS. ECT transferred to ECTS a $217.0 million 10-year intercompany note receivable and a $50.32 million 10 year intercompany note receivable, subject to a contractual assumption (via a Master Swap Agreement and Liability Management Agreement) of $267.28 million of ECT's credit reserve and FPRM contract obligations. In exchange, ECT received 100 percent of ECTS' voting preferred stock, a newly created second class of stock. Based on the discussion below, this exchange should, more likely than not, qualify for nonrecognition of gain or loss under IRC Section 351.

IRC Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for its stock and if the transferor (or transferors) control the corporation immediately after the exchange. If the transferor receives money or other property in addition to stock, the transferor will recognize gain, limited to the amount of money received plus the fair market value of other property received. IRC Section 351(a). No loss may be recognized. IRC Section 351(b).

Although IRC Section 351 itself does not define the term "property," the term has been broadly defined to include almost any asset a taxpayer may own. Revenue Ruling 69-357, 1969-1 C.B. 101, indicates that the term "property" as used in IRC Section 351 includes money. A transferor's own stock also constitutes property for purposes of IRC Section 351. See Rev. Rul. 74-503, 1974-2 C.B. 117 (a corporation's transfer of treasury stock to its controlled subsidiary was held a tax-free transfer of property under IRC Section 351). The term "property" also includes installment obligations. See Rev. Rul. 73-423, 1973-2 C.B. 161, Jack Ammann Photogrammetric Engineers Corporation v. Commissioner, 39 TC 500 (1965).

The transferor will receive tax-free treatment only if the transfer of property occurs "solely for stock." The concept of "stock" has been generally understood to refer to instruments that provide the holder with an equity interest in the issuing corporation. Treasury Regulation Section 1.351-1(a)(1) indicates that "stock" does not include stock rights and stock warrants.

If money or other property is received by the transferor in addition to stock, the transferor must recognize gain, not in excess of the amount of money or the fair market value of such other property received, but it may not recognize loss. IRC Section 351(b). The assumption of liabilities is treated not as boot under IRC Section 351(b), but under the assumption of liability rules of IRC Section 357. These rules are discussed in Appendix C.

The requirement that the transferor must be in control immediately after the exchange employs the IRC Section 368(c) definition of control. To have "control" the transferor must have:

1. 80 percent of the total combined voting power of all classes of stock entitled to vote, and

2. 80 percent of the total number of shares of all classes of nonvoting stock.

Rev. Rul. 59-259, 1952-2 C.B. 115, clarifies the second prong of the test to mean that 80 percent ownership of total shares in the aggregate does not suffice; to satisfy the "control" requirement 80 percent of each class must be held.

The "control" requirement is measured immediately after the exchange. Control need not be acquired in the exchange itself; the transferor may already have control entering into the exchange. See, *e.g.*, Rev. Rul. 73-473, 1973-2 C.B. 115. The IRS and courts have found in some circumstances that mere physical ownership immediately after the transfer may not satisfy the control requirement. These authorities typically find that a binding commitment to sell the stock at the time of the transaction will defeat the control immediately after requirement.

It is important to note that in this transaction, ECT acquired voting preferred stock of ECTS entitled to elect one of the six directors of ECTS. Based on the rationale in Rev. Rul. 69-126, 1969-1 C.B. 218, this class of stock possesses approximately 16.7% of the voting power of the corporation. More importantly, besides the existing common and new voting preferred stock classes, there are no other classes of stock in the corporation. Consequently, throughout the transactions contemplated ECT will possess a range of 83.3% to 100% of the total combined voting power of all classes of stock entitled to vote. Thus, ECT has continued to meet the control requirement of IRC Section 368(c) throughout the transaction. In the unlikely event the Service attempts to argue that the voting preferred stock possesses more than 20% of the combined voting power of all classes of stock of ECTS, ECT should nonetheless meet the control requirement since it had not entered into any contracts or other legal commitments to sell or otherwise relinquish its legal ownership in the stock.

In Rev. Rul. 79-70, 1979-1 C.B. 144, Corporation X transferred property to a newly organized corporation, Newco, in exchange for Newco's stock. Pursuant to a prearranged binding agreement between X and Corporation Y, X sold 40 percent of Newco's stock to Y, and Y purchased securities for cash from Newco. The agreement was an integral part of the incorporation; Newco would not have been formed if Y had not agreed to purchase securities for cash from Newco and a portion of the Newco stock from X.

The ruling held that the control requirements of IRC Section 351(a) were not satisfied under these facts. Y's ownership of Newco stock purchased from X cannot be counted in determining whether the control requirement is met. For purposes of IRC Section 351(a), X only owned 60 percent of Newco stock immediately after the exchange.

The Tax Court in Intermountain Lumber Company v. Commissioner, 65 TC 1025 (1976), reached the conclusion that the control requirement was not met in light of the existence of a preexisting binding contract to sell a portion of the stock. In that case, the transferor irrevocably contracted as part of the incorporation transaction to sell 50 percent of the stock received in the transfer to a third party. The court found that the transfer did not satisfy the "control" requirement due to the presence of the contract and, therefore, did not qualify for nonrecognition treatment under IRC Section 351(a). However, this court stated that a mere plan to dispose of stock would not violate the control immediately after requirement of IRC Section 351:

> A determination of "ownership," as that term is used in Section 368(c) and for purposes of control under Section 351, depends upon the obligations and freedom of action of the transferee with respect to the stock when he acquired it from the corporation. Such traditional ownership attributes as legal title, voting rights, and possession of stock certificates are not conclusive. If the transferee, as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of Section 351. By contrast, if there are no restrictions upon freedom of action at the time he acquired the shares, it is immaterial how soon thereafter the transferee elects to dispose of his stock or whether such disposition is in accord with a preconceived plan not amounting to a binding obligation. Id. at 1031-1032 (emphasis added).

As the Intermountain Lumber decision suggests, cases and rulings involving a binding commitment to sell stock are distinguishable from cases where no binding commitment existed and stock is sold soon after the IRC Section 351 transaction.

In American Bantam Car Co. v. Commissioner, 11 TC 397 (1948), *aff'd per curiam*, 177 F2d 513 (3d Cir. 1949), the owners of a manufacturing company transferred its assets to a new corporation ("Newco") in exchange for all its common stock. The shareholders had a general plan to issue Newco preferred stock to the public soon after the transfer of assets to Newco. Under the plan, the underwriters of the preferred stock were to receive common stock from the shareholders if a target amount of preferred stock was sold to the public. Five days after the contribution of assets to Newco, and receipt of 100 percent of Newco's stock by the shareholders, Newco, the shareholders and the underwriter entered into a binding agreement to sell the preferred stock. The

agreement provided that the underwriter would be entitled to a maximum of 33 percent of the Newco common stock if its sales efforts were successful. This contract could be canceled by Newco. Eventually, 29 percent of Newco's common stock was transferred to the underwriter 16 months after the IRC Section 351 transaction. The Tax Court held that the requisite control existed immediately after the exchange, and that the loss of control that occurred 16 months later was not an integral part of the transaction. The language used by the court indicates that the mere existence of a plan to dispose of control is irrelevant. As the court stated:

> The understanding with the underwriters for disposing of the preferred stock, however important, was not a sine quo 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 stock might fail. The very fact that in the contracts of June 8, 1936, the associates retained the right to cancel the marketing order and, consequently, the underwriters' means to own common stock issued to the associates, refutes the proposition that the legal relations resulting from the steps of organizing the corporation and transferring assets to it would have been fruitless without the sale of the preferred stock in the manner contemplated. Id. at 406-407.

In a later case, the Tax Court confirmed that a mere plan to transfer control after an IRC Section 351 transaction will not destroy the tax-free nature of the transaction. In Wilgard Realty Company, Corporation v. Commissioner, 127 F2d 514 (2nd Cir. 1942), an individual transferred real estate and cash to a newly formed corporation in exchange for 197 shares of the company's stock. The company transferred three additional shares of stock to the individual's children for no consideration. On the same day, the individual made a gift of 156 shares to his children. The court found that the requisite control was met immediately after the exchange. As stated by the court:

> In the absence of any restriction upon (the transferor's) freedom of action after he acquired the stock, he had "immediately after the exchange" as much control of the (corporation) as if he had not before made up his mind to give away most of his stock and with it consequently his control. And that is equally true whether the transaction is viewed as a whole or as a series of separate steps where the recipient of the stock on the exchange has not only the legal title to it "immediately after the exchange" but also the legal right then to determine whether or not to keep it with the control that flows from such ownership, the requirements of the statute are fully satisfied. (Emphasis added.)

Thus, under the Wilgard and American Bantam decisions, a disposition of stock soon after an IRC Section 351 transfer will not taint the transaction, unless the transferor had relinquished his legal rights to the stock received from the corporation prior to the exchange.

Application of IRC Section 351 to the Transaction

ECT transferred to ECTS a $217.0 million 10-year note receivable and a $50.32 million 10-year note receivable subject to ECTS' contractual assumption of $267.28 million of credit reserves and FPRM contract obligations. In exchange, ECT received 100 percent of the voting preferred shares of ECTS. Additionally, ECT previously owned and continues to own 100 percent of the common stock of ECTS. Thus, ECT controlled 100 percent of ECTS immediately before and after the transfer. Furthermore, ECT has exchanged property (the notes receivable) solely for stock of ECTS. Therefore, the contribution to ECTS should qualify as an IRC Section 351 transaction, if the "control immediately afterward" requirement is met.

ECT has represented that at the time of the transaction, it had not entered into any contracts or other binding agreements to sell the voting preferred stock or in any other way relinquish its legal ownership in the stock. Therefore, ECT should be treated as being in control of ECTS immediately after the contribution of property regardless of any subsequent sale of the voting preferred stock.

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Based on the discussion above, ECT's contribution to ECTS of the intercompany notes, subject to the contractual assumption of the credit reserve and FPRM contract obligations in exchange for all of the voting preferred stock of ECTS should, more likely than not, qualify for nonrecognition of gain or loss under IRC Section 351(a).

ECT'S BASIS IN THE PREFERRED STOCK OF ECTS

IRC Section 358 sets forth the rules for determining the basis of stock received by a transferor in an IRC Section 351 exchange. This section generally provides that the basis of stock received by a transferor is equal to the basis of the property transferred to the controlled corporation, decreased by the money and fair market value of any property received by the transferor and increased by the amount of gain recognized by the transferor. IRC Section 358(a).

ECT has represented that its basis in the intercompany notes receivable transferred to ECTS is $267.32 million. ECT has also represented that it did not receive any other property in the transaction. Thus, under the general rules, ECT's basis in the ECTS voting preferred stock should be equal to its basis in the intercompany notes receivable of $267.32 million.

IRC Section 358(d) treats a controlled corporation's assumption of certain types of liabilities in an IRC Section 351 transaction as a receipt of money by the transferor. This causes a basis reduction under the general rules discussed above.

However, not all liabilities fall under this rule. IRC Section 358(d) states:

> (1) In general – Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.
>
> (2) Exception – Paragraph (1) shall not apply to the amount of any liability excluded under Section 357(c)(3).

Thus, in certain situations, the assumption of a liability by the company issuing stock in a transaction in which IRC Section 351 applies may result in a decrease in the tax basis of the stock received in the transaction. With exception for that portion of the FPRM liabilities attributable to the $32.02 million unamortized cash premium received by ECT[1], this provision should not apply to the transaction consummated by ECT because the credit reserve and FPRM contract obligations do not yet rise to the level to liabilities within the meaning of the Internal Revenue Code. Since the credit reserve and FPRM contract obligations are not liabilities under the Internal Revenue Code, they should not

[1] The discussion that follows will assume that all of the liabilities assumed by ECTS are excluded for purposes of IRC Section 358(d), except where specifically noted.

result in a basis adjustment in the ECTS voting preferred stock received in the transaction. Even if, theoretically, the IRS were to assert on audit that the credit reserve and FPRM contract obligations rose to the level of liabilities, they should not result in a basis adjustment in the voting preferred stock. As described more fully below, the expenditures related to the FPRM contract liabilities would have been deductible if paid by ECT or when paid by ECTS. Additionally, losses related to the credit reserves would have been deductible when incurred by ECT, or when paid by ECTS. Consequently, these obligations are excludable for purposes of this basis adjustment rule. Although we are not rendering an opinion on the deductibility of these expenses when paid by ECTS, a discussion of the relevant law is included in support of this alternative position.

ECT has generated potential losses with respect to its credit reserves and generated obligations under its FPRM contracts in the course of its normal business operations. Although ECT can estimate the potential expense related to these obligations, actual future expenses will depend on many factors including future interest rates and commodity prices. ECTS has contractually assumed ECT's obligations for credit reserves and FPRM contract liabilities.

Credit Reserves

The credit reserve obligations contractually assumed by ECTS do not yet rise to the level of liabilities as defined under the Internal Revenue Code. Under IRC Sections 461 and 461(h), a liability of an accrual basis taxpayer is incurred, and generally taken into account for federal income tax purposes in the taxable year in which: (i) "All events" have occurred that establish the fact of the liability, (ii) the amount of the liability can be determined with reasonable accuracy; and (iii) economic performance has occurred. Treasury Regulation Section 1.461-1(a)(2). If any one of these requirements is not met, a liability cannot be taken into account for federal income tax purposes.

IRC Section 461(h) provides that the "all events" test of IRC Section 461 will not be satisfied any earlier than when economic performance occurs with respect to the liability in question. IRC Section 461(h) applies to capital expenditures under IRC Section 263, as well as to current deductions under IRC Section 162.

At the time ECTS assumed the credit reserve obligations, ECT was not allowed (and had not taken) a deduction for bad debts under IRC Section 166 with respect to any of the credit reserve obligations assumed by ECTS. Furthermore, the events necessary to give rise to a tax deduction by either ECT or ECTS with respect to the credit reserve obligations had not yet occurred at the time of the contractual assumption. Therefore, ECTS' contractual assumption of an obligation to make payments to ECT to cover such credit losses should fail the "all events" and "economic performance" tests of IRC Section 461.

Fixed Price and Risk Management Contracts

ECT's FPRM contract liabilities relate to forward contracts, options on physical product, swaps[2], and options to enter into swaps ("swaptions"). As discussed below in detail for each type of instrument, the FPRM contract liabilities assumed by ECTS through individual confirms under the Master Swap Agreement do not yet rise to the level of liabilities as defined under the Internal Revenue Code.

ECT is not required to account for its FPRM contract activity under the mark-to-market accounting method for dealers in securities under IRC Section 475 because none of the FPRM contracts meet the definition of a security.[3]

Forward Contracts - A forward contract is a privately negotiated agreement to buy or sell a commodity at a specified price at some time in the future. The rights and obligations of a party to a forward contract may be terminated by making or taking delivery of the underlying commodity or closed out by a mutual cancellation of the contract accompanied by payment to or receipt of payment from the counterparty. No special rules such as IRC Section 475 or 1256 apply to govern the timing of gain or loss inherent in or realized by a party that enters into a forward contract. Accordingly, the timing is governed by the general rules applicable to gain or loss realized on the sale or disposition of an asset.

Pursuant to Treasury Regulation Section 1.461-4(d)(2) economic performance occurs as, for example, the natural gas is actually provided to ECT under the contracts[4].

ECT has not made payments related to, nor taken delivery with respect to, the forward contract obligations assumed by ECTS. Therefore, "economic performance" should not have occurred with respect to these obligations at the time they were contractually assumed by ECTS.

Options on Physical Product - ECT receives upfront premium payments for granting certain counterparties "put" options to sell gas to ECT and "call" options to buy gas from ECT at a specified price in the future. As a result of changes in the natural gas price curves, certain of these options are "out-of-the-

[2] The term "swaps" is used in this discussion to refer to all commodity based notional principal contracts (i.e. swaps, caps, floors, and collars) as described in Treas. Reg. Sec. 1.446-3(c)(1).

[3] See IRC Section 475(c)(2). IRC Section 475(c)(2)(D) includes interest rate, currency, or equity notional principal contracts in the definition of a security. However, this subparagraph does not include commodity based notional principal contracts in the definition of a security.

[4] Alternatively, economic performance occurs when the commodity is purchased by ECT in order for ECT to deliver on its commitments under the contracts.

money" to ECT. ECTS has assumed certain "out-of-the-money" obligations on ECT's options. The assumed obligation exceeds the upfront premium received by ECT upon granting the options.

The receipt of the option premiums does not result in immediate taxable income to ECT. ECT's recognition of gain or loss on these options is deferred until (1) the option expires unexercised, (2) ECT terminates its obligation by entering into a closing purchase transaction, (3) the holder disposes of his rights under the option in a closing sale transaction, or (4) the option is exercised. See Rev. Rul. 78-182, 1978-1 C.B. 265. In the event of the exercise of a call, ECT may recognize its loss immediately. In the event of the exercise of a put, ECT has no immediate tax consequences; the cash payment under the put option, reduced by the amount of the upfront premium payment received, is the basis of the property acquired and gain or loss is recognized only when the property acquired is actually disposed of.

Except for the deferred option premiums, no portion of the "out-of-the-money" amounts have been taken into account for federal income tax purposes. Therefore, the option obligations in excess of the deferred premiums have not yet risen to the level of "liabilities" for purposes of the Internal Revenue Code.

Swaps - ECT has entered into certain swap transactions through the normal course of its business. As a result of changes in the natural gas price curves, certain of these swaps are "out-of-the-money" to ECT. Through the Master Swap Agreement, ECTS has assumed the "out-of-the-money" obligation on ECT's swaps. In some of these transactions ECT has received upfront premium payments for entering into the swaps. In these cases, ECTS has assumed "out-of-the-money" obligations in excess of the unamortized upfront premiums.

ECT accounts for its swap transactions under the rules of Treasury Regulation Section 1.446-3. Accordingly, pursuant to Treasury Regulation Sections 1.446-3(d),(e) and (f), ECT's net deduction for these "out-of-the-money" swaps for a taxable year is the total of all periodic payments made with respect to those swaps for the taxable year reduced by the amortization into income of the upfront premium received on the swaps.

Except for the unamortized deferred swap premiums, no portion of the "out-of-the-money" amounts have been taken into account for federal income tax purposes. Therefore, the swap obligations in excess of the unamortized deferred premiums have not yet risen to the level of "liabilities" for purposes of the Internal Revenue Code.

Swaptions -A swaption is essentially an option to enter into a swap contract. (See Treasury Regulation Section 1.446-3(f)(1)). Accordingly, the analysis that applies to the options should apply to a swaption until it is exercised, sold or terminated

in a closing transaction, or lapses. If a swaption is exercised, the swap rules discussed above become applicable.

ECTS assumed ECT's FPRM contract obligations via an offmarket swap which was entered into between ECTS and ECT. As previously discussed, ECTS should account for its payments to ECT under the swaps in accordance with Treasury Regulation Sections 1.446-3(d) and (e). Accordingly, based on the above discussion, the incidence of taxation with respect to the FPRM contracts is deferred until some future events, including the passage of time, occur.

As discussed above, the credit reserve and FPRM contract obligations have not been taken into account for federal income tax purposes under various applicable provisions of the Internal Revenue Code, except for the unamortized premiums received on the options, swaps and swaptions. Accordingly, these obligations in excess of the unamortized premiums should not be taken into account under IRC Section 358(d) because they have not yet arisen to the level of "liabilities" for purposes of the Internal Revenue Code. Thus, the assumption of the credit reserve and FPRM contract obligations in excess of the unamortized premiums should not be treated as money received on the exchange and should not reduce ECT's basis in the ECTS voting preferred stock.

The IRS has seemingly adopted this same reasoning in PLR 9343011 (July 16, 1993)[5]. In this ruling, the IRS has held (Holding number 11) that unspecified liabilities (the "Q" and "R" liabilities) assumed by the transferee corporation pursuant to a Section 351 incorporation "will be excluded in determining the amount of liabilities assumed or to which the property transferred is subject for purposes of Sections 357(c) and 358(d) of the Code (Sections 357(c)(3) and 358(d)(2))". Under the facts of PLR 9343011, an accrual basis member in a consolidated group of corporations transferred the assets of a division and stock in other members to a newly incorporated subsidiary in exchange for stock. As part of this transfer the subsidiary assumed the Q and R liabilities. None of the Q and R liabilities assumed by the transferee subsidiary had been previously taken into account for tax purposes by the transferor corporation.

The Service has since formalized its position on this issue in Rev. Rul. 95-74, 1995-2 C.B. 36. In this ruling, the Service held that contingent environmental liabilities that have not been deducted or capitalized by the transferor and are assumed by the transferee corporation in an IRC Section 351 incorporation are not liabilities for purposes of IRC Sections 357(c) and 358(d). The Service also ruled that the liabilities assumed by the new subsidiary in the IRC Section 351 exchange are deductible by it as business expenses under IRC Section 162 or are capital expenditures under IRC Section 263, as

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[5] Private Letter Rulings ("PLRs") cannot be used or cited as precedent by any taxpayer other than the one who requested it. However, PLRs do provide insight into the Internal Revenue Service's position on certain issues and can provide substantial authority under Treasury Regulation Section 1.6662-4(d)(iii).

appropriate, under its method of accounting. Under the facts of the ruling, P, an accrual basis corporation, transferred the assets of a division to a newly incorporated subsidiary, S, in exchange for all of the stock of S and for S's assumption of the liabilities associated with the division, including environmental liabilities. P did not undertake any environmental remediation efforts before the transfer and did not deduct or capitalize any amount with respect to the contingent environmental liabilities. P had no plan or intention to dispose of (or have S issue) any S stock at the time of the transfer. In later years S undertook remediation efforts relating to property transferred in the IRC Section 351 exchange.

These transactions were intended and were held to qualify as tax-free transfers under IRC Section 351. As stated above, the IRS held that such previously not deducted liabilities would not reduce the basis of the stock received by the transferor corporation as provided in Section 358(d). Thus, in applying the holdings in PLR 9343011 and Rev. Rul. 95-74 to the instant case, the assumption of the previously not deducted credit reserve and FPRM contract obligations should not reduce ECT's basis in the ECTS voting preferred stock.

Recently, the Service issued a Revenue Ruling in which it held that a short sale obligation transferred in an IRC Section 351 transaction does give rise to a basis reduction in the underlying shares. In Revenue Ruling 95-45, 1995-1 C.B. 53, Corporation P entered into a short sale of XYZ securities. P's broker took XYZ securities on hand and sold them on P's behalf for $1000x. P left the cash proceeds with the broker and was thereafter obligated to deliver identical XYZ securities in the future to close out the short sale. Prior to the delivery of these securities P contributed its interest in the cash proceeds from the short sale to the capital of S corporation in a valid IRC Section 351 transaction. S assumed the obligation of P to deliver the XYZ securities.

The Service held that since the proceeds of the short sale were not taxed to the short seller but nonetheless created an asset with tax basis, the concurrent obligation of the short seller to return the borrowed securities was a liability for purposes of determining basis reduction under IRC Section 358. Thus, the basis that P had in the additional S stock of $1000x was similarly reduced by $1000x, the amount of the liability assumed by S to deliver the XYZ securities.

This ruling is distinguishable from the transaction at hand and should not affect the basis that ECT had in the ECTS voting preferred stock. First, the basis of the short sale asset was completely dependent on the short sale obligation. The tax basis created in the short sale asset was entirely a function of the creation of the concurrent liability to deliver the underlying securities. Here, the credit reserve obligations do not give rise to any basis and are completely unrelated to the note receivable contributed to ECTS. ECT has tax basis in the note receivable regardless of the existence of any credit reserve or FPRM contract obligation.

Furthermore, unlike a short sale liability, the credit reserve and FPRM contract obligations assumed by ECTS are entirely contingent in nature. The amount and certainty of the credit reserve and FPRM contract obligations are uncertain and indeterminate. Short sale liabilities, on the other hand, are fixed and quantifiable in that the short seller is obligated to return a fixed amount of securities at a future time. The value of the obligation may fluctuate with market conditions, but the obligation remains fixed and determinable at any point in time. Thus, because the nature of the short sale obligations is so different from the credit reserve and FPRM contract obligations, Rev. Rul. 95-45 should be inapplicable to the present transaction.

As discussed above, since the credit reserve and FPRM contract obligations in excess of the unamortized premiums have not been taken into account for federal income tax purposes, these obligations should not reduce ECT's basis in the ECTS voting preferred stock. However, even if in the unlikely event the IRS were to successfully assert on audit that the credit reserve and FPRM contract obligations rose to the level of "liabilities" under IRC Section 461 or other provisions of the Internal Revenue Code, the obligations are the type specifically excluded from IRC Section 358(d). Thus, even if these obligations theoretically rose to the level of "liabilities," they should not result in a basis reduction in the voting preferred stock received in the exchange.

As discussed above, IRC Section 358(d) treats the controlled corporation's assumption of certain types of liabilities as the receipt of money by the transferor in an IRC Section 351 transaction. This treatment results in a decreased basis in the controlled company's stock received in the transaction. IRC Section 358(a). However, not all liabilities fall under this rule. IRC Section 358(d)(2) excludes the liabilities listed under IRC Section 357(c)(3) from this treatment. IRC Section 357(c)(3) provides:

> (3) Certain Liabilities Excluded –
>
> (A) In General – If a taxpayer transfers, in an exchange to which Section 351 applies, a liability the payment of which either–
>
> (i) would give rise to a deduction, or
>
> (ii) would be described in Section 736(a),
>
> then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject.
>
> (B) Exception – Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

Thus, even if ECT's credit reserves and FPRM contract liabilities in excess of the unamortized premiums theoretically rise to the level of "liabilities" under IRC Section 461 or other provisions of the Internal Revenue Code for all tax purposes, these obligations should not cause a basis adjustment in the voting preferred stock if they would have been deductible when paid by ECT or will be deductible when paid by ECTS. Additionally, Rev. Rul. 95-74 has expanded the IRC Section 357(c)(3) exception to include not only liabilities that give rise to deductible items, but also to liabilities that give rise to capital expenditures as well.

Therefore, even if the IRS were to successfully assert that certain payments related to ECT's credit reserves and FPRM contract liabilities gave rise to a capital expenditure under IRC Section 263 through an application of INDOPCO Corporation v. Comm., 112 S. Ct. 1039 (1992), the exception under IRC Section 357(c)(3) remains applicable.

To summarize, these credit reserve and FPRM contract obligations in excess of the unamortized premiums have not been accrued as liabilities under various provisions of Internal Revenue Code. Therefore, they should not constitute "liabilities" within the meaning of the Internal Revenue Code and should not decrease ECT's basis in the voting preferred stock received in the transaction. Alternatively, in the unlikely event the credit reserve and FPRM contract obligations in excess of the unamortized premiums assumed by ECTS constitute "liabilities," they should not be liabilities that decrease ECT's basis in its ECTS voting preferred stock since these obligations should be deductible (or capitalizable) when paid and, thus, are specifically excluded under IRC Section 358(d)(2) and IRC Section 357(c)(3)(A)(i) as interpreted by Rev. Rul. 95-74.

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Based on the arguments discussed above, ECT's tax basis in the voting preferred stock of ECTS should, more likely than not, equal ECT's basis in the intercompany notes contributed to ECTS not reduced by the amount of credit reserve and FPRM contract obligations in excess of the unamortized premiums assumed by ECTS.

CONSOLIDATED RETURN REGULATIONS

ECT transferred the intercompany notes subject to ECTS' contractual assumption of ECT's credit reserve and FPRM contract obligations in exchange for ECTS voting preferred stock. The value of the intercompany notes is approximately $267.32 million and the amount of ECT's credit reserve and FPRM contract obligations is approximately $267.28 million. Therefore, ECT's preferred stock should have nominal fair market value of $40,000. ECT may later sell the voting preferred stock to management and certain employees in the treasury and trading groups to provide them with an incentive to manage liabilities and to allow them to share in the rewards of these liability reduction efforts. Since the fair market value of ECT's voting preferred stock is only $40,000 while ECT's basis in the voting preferred stock should be $235.30 (its basis in the intercompany note of $267.32 million, reduced by the unamortized premium of $32.02 million) (see Appendix C for a detailed discussion), ECT should recognize a loss on the sale of the voting preferred stock. A loss on the sale of the voting preferred stock of ECTS should not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1)(iii).

The consolidated tax return regulations (specifically Treasury Regulation Section 1.1502-20) generally limit the recognition of loss on the sale or other disposition of stock of a consolidated group member where a "duplicated loss" exists in that member.

Treasury Regulation Section 1.1502-20(c)(2)(vi) provides the definition of a duplicated loss. It states:

> (vi) Duplicated loss. "Duplicated loss" is determined immediately after a disposition or deconsolidation, and equals the excess (if any) of
>
> (A) The sum of–
>
> (1) The aggregate adjusted basis of the assets of the subsidiary other than any stock and securities that the subsidiary owns in another subsidiary, and
>
> (2) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and
>
> (3) Any deferred deductions (such as deductions deferred under Section 469) of the subsidiary, over

(B) The sum of--

(1) The value of the subsidiary's stock, and

(2) Any liabilities of the subsidiary, and

(3) Any other relevant items.

At the time of the disposition of the voting preferred stock, the only assets that ECTS has are intercompany accounts receivable and the intercompany notes. The intercompany notes should be excluded from this computation since, by their terms, they should qualify as securities.

Subsection (vi)(A)(1)

There are two important parts to the provision in Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(1):

1. Another subsidiary; and
2. Security.

The question is what constitutes "another subsidiary." Treasury Regulation Section 1.1502-1(c) states that "the term 'subsidiary' means a corporation other than the common parent which is a member of such [consolidated] group." This definition is unaltered by Treasury Regulation Section 1.1502-20. Thus, it is clear that through the use of the defined term "subsidiary," the exception in the above regulation is meant to apply to the stock and securities of any other member of the consolidated group (other than the common parent) and not just to a subsidiary of ECTS. Treasury Regulation Section 1.1502-20 supports this interpretation in the very next clarifying sentence by stating that "the amounts determined under this paragraph (c)(2)(vi) with respect to a subsidiary include its allocable share of corresponding amounts with respect to all lower tier subsidiaries." [Emphasis added.] In this sentence, the regulations use the modifier "all lower tier" to distinguish between *any* subsidiary of the consolidated group as compared to a *direct* subsidiary of the subsidiary whose stock is being sold. Had the regulations intended to limit the application of Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(1), the modifier "lower tier" could have been inserted there as well. Therefore, provided that the security is from another member of the consolidated group, except the common parent, that security should be excluded from the computation of a duplicated loss pursuant to Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(1).

The second part of subsection (vi)(A)(1) requires ECTS to own a "security" in some consolidated group member (besides the common parent). The term "security" is not defined anywhere in Treasury Regulation Section 1.1502-20 and, in fact, is not defined anywhere else in the Internal Revenue Code or regulations. Rather, the definition of

security has been developed by judicial decisions. The leading case on whether a debt obligation constitutes a security is Camp Wolters Enterprises Corporation v. Commissioner, 22 TC 737 (1954), *aff'd*, 230 F2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956). In Camp Wolters, the court stated:

> The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to cash payment, the purpose of the advances, etc.

Even though the controlling consideration of whether a note is a security is the "overall evaluation of the nature of the debt," the length of time to maturity is usually the most important factor. "Notes with a five-year term or less rarely seem able to qualify as securities, while a term of 10 years or more ordinarily is sufficient to bring them within the statute." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, [paragraph 3.04 (6th ed. 1994).]

The intercompany notes should be securities because they give the holder of the notes a significant degree of participation and continuing interest in the business as required by Camp Wolters. The notes have 10 year terms with none of the principal payable until maturity. Clearly, the holder of the notes has a significant continuing interest in the issuers such that the notes should qualify as securities.

As discussed above, the intercompany notes should qualify as securities. Based on the facts and assumptions, the only other assets held by ECTS with any adjusted tax basis should be the intercompany accounts receivable possessing a tax basis of approximately $4.563 million. Thus, since both the issuers and ECTS are subsidiaries of Enron and members of Enron's consolidated group, under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(1), the aggregate adjusted basis of the assets of ECTS, other than the stock and securities that ECTS owns in other subsidiaries (*i.e.*, the intercompany notes), should be approximately $4.563 million.

Subsections (vi)(A)(2) and (3)

Immediately after the disposition of the voting preferred stock of ECTS by ECT, ECTS should have no losses attributable to it that will be carried over to its next taxable year under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(2). Although ECTS' predecessor EGGI had been a going concern for many years, it did not have any losses attributable to it that can be carried over to its next taxable year after the disposition of the voting preferred stock. However, if significant credit reserve and FPRM contract payment activities occur before the sale of any of the voting preferred stock, ECTS must be reevaluated to determine if there is any loss to be carried over to its next taxable year.

Currently, since ECTS has interest income from the intercompany notes and, since it is anticipated that substantial credit reserve and FPRM contract expenditures will not be incurred for some time, ECTS has no losses attributable to it that will be carried over to its taxable year under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(2).

Immediately after the disposition of the voting preferred stock of ECTS by ECT, ECTS should not have any deferred deductions under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(3). The term "deferred deduction" is not defined anywhere in the regulations and the only example given is a deduction deferred under IRC Section 469. IRC Section 469 limits the amount of passive losses that can be deducted in any one year. Any passive loss realized in a tax year, but disallowed due to the passive loss limitations of IRC Section 469, is allowed to be carried over to the next taxable year. Presumably, a deferred deduction is a deduction or loss that is realized in a taxable year and would generally be recognized for tax purposes but for some other limitation in the Internal Revenue Code.

> Lerner, Antes, Rosen and Finkelstein, Federal Income Taxation of Corporation Filing Consolidated Returns, Section 21.02[4] n. 80.2 (1993) states with regard to deferred deductions:
>
> No other example of "deferred deductions" is provided in the regulations. Presumably, other comparable items, such as losses deferred under IRC Section 267(f), at risk losses subject to Section 465, and excess interest carryovers under Section 163(j), would also be taken into account under this provision.

Each of these types of "deferred deductions" are deductions that are realized, but whose recognition for tax purposes is deferred. ECTS did not and does not have any of these kinds of deferred deductions. Clearly, the credit reserve and FPRM contract obligations assumed by ECTS should not rise to the level of realized deductions, as ECTS should not be entitled to a deduction until payments are made. See Appendix C for a more detailed discussion. Thus, ECTS should have no deferred deductions under Treasury Regulation Section 1.1502- 20(c)(2)(vi)(A)(3).

Thus, the sum of the amounts under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(1), (2) and (3) should be $4.563 million.

Subsections (vi)(B)(1), (2) and (3)

Immediately after the disposition of the voting preferred stock of ECTS by ECT, the value of that stock under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(1) should be approximately $40,000, the value of the intercompany notes contributed to ECTS in exchange for the voting preferred stock of $267.32 million reduced by the amount of ECT's credit reserve and FPRM contract obligations assumed by ECTS of $267.28 million. The value of the common stock retained by ECT should be $4.40 million, the

net equity of ECTS reduced by the amount of net equity attributable to the voting preferred stock.

Immediately after the disposition of the voting preferred stock of ECTS by ECT, ECTS has liabilities for taxes payable of approximately $163,000 and liabilities attributable to the unamortized premium of $32.02 million under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(2). ECT's credit reserves and FPRM contract obligations should not rise to the level of liabilities for federal income tax purposes. See Appendix C for a more detailed discussion of this issue.

Immediately after the disposition of the voting preferred stock of ECTS by ECT, ECTS should not have "any other relevant items" under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(3). No indication is given as to the meaning of the term "other relevant items." The preamble to the regulations states that guidance will be issued in connection with IRC Section 338 and IRC Section 382(h) which use similar terminology. To date however, no such guidance has been published. It is unlikely however, that ECTS has any relevant items that would impact a duplicated loss. When final guidance is issued, this issue may need to be reexamined.

Thus the sum of the amounts under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(1), (2) and (3) should be $36.623 million.

Since the amount of a duplicated loss is the excess (if any) of the sum of the items under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A) over the sum of the items listed under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B), the amount of duplicated loss on the disposition of the voting preferred stock of ECTS should be zero ($4.563 million is less than $36.623 million).

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Thus, based on the clear language of the regulations, a loss on the sale of the voting preferred stock of ECTS by ECT should, more likely than not, not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1)(iii).

Judicial Interpretation of the Consolidated Return Regulations

Despite the conclusion above that the transaction does not produce a duplicated loss, the Service might try to argue that the transaction, while meeting the technical requirements of the regulations, is inconsistent with the intent of the consolidated regulations. However, in situations where taxpayers have relied on provisions in the consolidated regulations which lead to results which are arguably inconsistent with the intent of the consolidated regulations, courts have shown some willingness to hold in favor of the taxpayer since the Treasury, in drafting the regulations, is primarily responsible for the results dictated by those regulations.

For instance, in Woods Investment Co. v. Comm'r, 85 T.C. No. 14 (1985), the Tax Court allowed the taxpayer an effective double depreciation deduction on amounts in a controlled subsidiary's assets. The issue in Woods involved a provision in the Investment Adjustment regulations under Treasury Regulation Section 1.1502-32(b) which allowed a taxpayer to make negative basis adjustments to the subsidiary's stock using only the straight-line depreciation method even if the taxpayer was using accelerated depreciation on its consolidated return. The IRS contended that allowing the taxpayer to use accelerated depreciation in computing its consolidated income and straight-line depreciation to compute the parent's basis adjustment in the subsidiary's stock would in fact allow the taxpayer to achieve a "double deduction." The Service argued that this result violated Treasury Regulation Section 1.1016-6(a) which provides that "[a]djustments must always be made to eliminate double deductions or their equivalent."

The court in Woods first noted that Congress gave the Treasury unusually broad power to promulgate the rules for filing a consolidated return when it enacted IRC Section 1502. The court stated the Service must be held accountable therefore for any adverse results that might arise due to the construction it chooses in writing these regulations. The court further noted that if the Treasury is not satisfied with these provisions it can always act unilaterally to amend the regulations to make them more uniform and consistent. Since the Treasury had not taken such steps the court did not feel justified to step in and essentially interfere in what the court labeled a legislative and administrative matter. Furthermore, the court stated that if it sided with the Treasury in this instance it would be "opening doors" for the Service every time it was dissatisfied with the particular wording and construction of the regulations it had written.

Similarly, in CSI Hydrostatic Testers, Inc. v. Comm'r, 103 T.C. 398 (1994), a bankrupt subsidiary in a consolidated group did not include over $4 million dollars of cancellation of indebtedness ("COD") income in its taxable income pursuant to IRC Section 108(a) but did include such an amount in its earnings and profits pursuant to IRC Section 312(l). Inclusion of the COD income in earnings and profits allowed the parent to increase its basis in the subsidiary's stock under Treasury Regulation Section 1.1502-32(b). The IRS argued that the adjustments sought by the taxpayer should be disallowed because Treasury Regulation Section 1.1502-32(b) did not specifically mandate the application of IRC Section 312(l) for the inclusion of COD income in earnings and profits for the consolidated basis adjustment calculation. The Service further argued, as it had in Woods, that the taxpayer's position unjustly allowed it to enjoy double tax benefits from the same transaction.

In holding for the taxpayer, the Tax Court found that the rules concerning the calculation of earnings and profits contained in IRC Section 312 did apply to the consolidated regulations in situations where those regulations expressly provide for adjustments based on an entity's earnings and profits. Moreover, the court reaffirmed its holding in Woods Investment Co. v. Comm'r, and stated that the Treasury must be

held accountable for the construction it chooses for the consolidated regulations. The court reiterated that the Treasury was free to amend the consolidated regulations if it felt their application was inconsistent with other provisions in the code and regulations. (See also Transco Exploration Co. v. Comm'r, 95 T.C. 373 (1990); Walt Disney Inc. v. Comm'r, 97 T.C. 221 (1991) ("When the authority to prescribe legislative regulations exists, this Court is not inclined to interfere if the regulations as written support the taxpayer's position.")). Finally, the court distinguished its holding from its prior decision in Wyman-Gordon Co. v. Comm'r, infra, a case factually similar to CSI, since the taxpayer there sought to base its position on a Code section enacted subsequent to the taxable years at issue.

In contrast to Woods and CSI, in Wyman-Gordon Co. v. Comm'r, 89 T.C. 207 (1987), the Tax Court held that a taxpayer's interpretation of an ambiguous provision in the Code and consolidated regulations violated the overriding policy behind those regulations. Specifically, the court rejected the taxpayer's argument that IRC Section 312(l) supported its contention that COD income of an insolvent second-tier subsidiary should be included in its earnings and profits for purposes of calculating a first-tier subsidiary's basis in the second-tier subsidiary's stock even though the COD income was not included in the consolidated group's income. The taxpayer argued that since IRC Section 312(l) had not been enacted during the tax years at issue it should be allowed to benefit from the ambiguity in the consolidated regulations created by the absence of that section.

The court noted that unlike the taxpayer in Woods, the petitioner here was not relying on any express authority within the Code or regulations. The court stated that the taxpayer could not base its position on IRC Section 312(l) since that statute had not been passed until after the tax years at issue. Furthermore, the court stated that IRC Section 312(l) could only be read against the backdrop of the Bankruptcy Tax Act of 1980, of which it was a part. Since other provisions of this legislation would have resulted in offsetting negative tax consequences to the taxpayer, IRC § 312(l) could not be interpreted independent of these other provisions. The court also noted that the taxpayer's position violated the overall purpose of Treasury Regulation Section 1.1502-32 because that section clearly envisioned increases of stock basis only in situations where the subsidiary's earnings and profits increased. Since there was no statutory authority for such an increase at the time the COD income was realized, the court disallowed the taxpayer's earnings and profits calculation.

As in Woods and CSI, the treatment of the ECTS transaction appears to be clearly mandated in the Code and the regulations (*i.e.*, any loss recognized by ECT on the disposition of the preferred stock should not be a "duplicated loss" based on the unambiguous language provided in the regulations). Furthermore, unlike the situation in Wyman-Gordon, the treatment of the ECTS transaction does not rest on an ambiguous inconsistency within the regulations nor does it rely on any pending or possible legislation. Thus, existing judicial precedent should favor ECT's interpretation of the regulation in the absence of other clear authority.

Anti-Stuffing Rule of Treasury Regulation Section 1.1502-20(e)

Another factor to consider is whether the broad anti-avoidance or more specific anti-stuffing provisions contained in the loss disallowance regulations might cause the otherwise recognizable loss on the sale of the preferred stock to be disallowed. Like other anti-avoidance provisions in the consolidated regulations, Treasury Regulation Section 1.1502-20(e) states that adjustments are to be made when taxpayers act to avoid the general purpose of the loss disallowance regulations. The anti-stuffing rule operates similarly and states that if a transfer of any asset is followed within 2 years by a direct or indirect disposition of a subsidiary's stock with a view to avoid what otherwise would have been a disallowed loss on the stock of that subsidiary, the stock basis of the subsidiary will be reduced, immediately before the disposition, in order to cause recognition of gain in an amount equal to the loss disallowance. Treasury Regulation Section 1.1502-20(e)(2).

First, it is doubtful that the anti-avoidance provisions should apply since:

a) There is a legitimate business purpose behind the sale of the preferred stock (*i.e.*, to offer an additional incentive to the employees to manage liabilities related to the credit reserves and FPRM contract liabilities);
b) The treatment of the loss is consistent with the specific provisions contained in the regulations, and
c) The ECTS transaction is not at all similar to the examples used in the regulations to illustrate abusive avoidance transactions.

Second, the anti-stuffing rule should not apply since the contribution of the intercompany notes and the subsequent sale of the preferred shares is not being done to somehow avoid what otherwise would have been a disallowed loss but for the transfer of the assets. The basic anti-stuffing example involves a situation where a built-in gain asset is contributed to a subsidiary which otherwise would be sold at a loss. The contribution of the built-in gain asset reduces or eliminates the loss on the stock sale and thus acts to avoid the application of the loss disallowance regulations. In ECTS' situation, the notes which are contributed are not built-in gain assets, and the contribution does not act to net gain with an otherwise disallowed loss. Instead, the notes are contributed to provide funds for the operations of ECTS, an existing subsidiary, in its undertaking of the credit reserve and FPRM contract liability management business. It is unlikely that the anti-stuffing rules were meant to apply to capital contributions made for a corporation's operations. Therefore, the anti-stuffing rule should not apply to the ECTS transaction.

Intercompany Transaction Regulations of Treasury Regulation Section 1.1502-13

Background and Basic Operating Rules

The Intercompany Transaction Regulations generally provide rules for taking into account items of income, deduction, gain, and loss of members from intercompany transactions. The purpose of these regulations 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)." Treasury Regulation Section 1.1502-13(a)(1). The regulations attempt to achieve this objective by adopting a single-entity approach to transactions between members of a group in which an "intercompany transaction" is treated as though the transaction occurred between divisions of a single entity. In this way, the basic operating rules of the regulations affect the timing, character, source, and other attributes of intercompany income, expense, gain and/or loss and their corresponding items. Treasury Regulation Section 1.1502-13(a)(2).

An "intercompany transaction" is defined as "a transaction between corporations that are members of the same consolidated group immediately after the transaction." Treasury Regulation Section 1.1502-13(b)(1)(i). As discussed in more detail below, the basic operational rules in the regulations are the matching rule and the acceleration rule.

The transaction described in Appendix A involves two basic steps: (1) ECT's contribution of assets subject to certain liabilities to ECTS in exchange for voting preferred shares, and (2) the sale of the preferred shares to individuals that are engaged in the liability management function. To determine whether the basic operational rules of the regulations affect either step in the transaction, it is necessary to first determine the tax consequences of the various elements of each step under separate return rules.

In the first step, ECT contributes intercompany notes receivable ("security") from another member of the consolidated group to ECTS subject to certain contingent liabilities of ECT in exchange for voting preferred shares of ECTS. This step of the transaction should qualify as a tax-free exchange under IRC Section 351. Since ECTS receives solely preferred stock in the exchange, IRC Section 351 provides that no gain or loss will be recognized by ECT in the transaction. In addition, under IRC Section 358, ECT's basis in the preferred shares is equal to ECT's basis in the security and will not be reduced by the contingent liabilities that are assumed. In the second step, ECT sells the preferred shares to a third party for an amount of cash equal to the fair market value of the shares, which is generally equal to the excess of the face amount of the security over the expected cost of satisfying the contingent liabilities. As a result, ECT realizes a capital loss on the sale of the stock generally equal to the amount of the contingent liabilities. After the sale of the preferred shares, ECTS remains a member of the consolidated group and uses the proceeds of the security to fund its future credit and FPRM contract expenses. The basis for these conclusions regarding the separate return tax consequences are set out in detail in Appendices B and C.

To analyze whether the basic operational rules of the Intercompany Transaction Regulations modify these conclusions, one must first determine whether either step in the transaction is an intercompany transaction. Since ECT's transfer of the security to ECTS is a transaction between two corporations that are members of the same consolidated group immediately after the transaction, this step is an intercompany transaction. This conclusion is confirmed by Example 3 in section 1.1502-13(c)(7)(ii) of the regulations. This example provides that:

> Example 3. Intercompany section 351 Transfer. (a) Facts. S holds land with a $70 basis and a $100 fair market value for sale to customers in the ordinary course of business. On January 1 of Year 1, S transfers the land to B in exchange for all of the stock of B in a transaction to which IRC Section 351 applies. S has no gain or loss under section 351(a), and its basis in the B stock is $70 under IRC Section 358. Under IRC Section 362, B's basis in the land is $70. B holds the land for investment. On July 1 of Year 3, B sells the land to X for $100. Assume that if S and B were divisions of a single corporation, B's gain from the sale would be ordinary income because of S's activities.
>
> (b) Timing and Attributes. S's transfer to B is an intercompany transaction. S is treated as transferring the land in exchange for B's stock even though, as divisions, S could not own stock of B. S has no intercompany item, but B's $30 gain from its sale of the land to X is a "corresponding item" because the land was acquired in an intercompany transaction. B's $30 gain is ordinary income that is taken into account under B's method of accounting.

This example also illustrates the application of the basic operational rules to an intra-group IRC Section 351 transaction. As in the example, if ECT receives no boot in the transfer of property to ECTS in an IRC Section 351 transaction, ECT will have no "intercompany items" with respect to that transaction. Without intercompany items, the basic operational rules of the Intercompany Transaction Regulations will have no effect on the tax consequences to ECT from the ECTS transaction because the two operational rules apply to ECT only to the extent it has intercompany items (see Treasury Regulation Section 1.1502-13(c) and Treasury Regulation Section 1.1502-13(d)). Therefore, although ECT's contribution of the security to ECTS is an intercompany transaction, the basic operational rules of the Intercompany Transaction Regulations do not alter ECT's tax consequences relating to such transfer. The next step of the transaction, ECT's sale of its preferred shares to third parties, is not an intercompany transaction because it is not between two members of the same consolidated group. Therefore, the basic operational rules of the Intercompany Transaction Regulations do not affect ECT's tax treatment on the sale of the preferred shares to managers of the credit reserve and FPRM contract liabilities. Consequently, the basic operational rules are inapplicable and the Intercompany Transaction Regulations will not affect ECT's tax consequences unless the anti-avoidance rule described below applies.

The Anti-Avoidance Rule

In General

The Intercompany Transaction Regulations contain a general anti-avoidance rule that provides that: "if a transaction is engaged in or structured with a principal purpose to avoid the purposes of the section (including treatment as an intercompany transaction), adjustments must be made to carry out the purposes of the section.[1] As described above, section 1.1502-13(a)(1) of the regulations provides that the purposes of the section are "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)." The preamble of the regulations states that the Treasury and the Service believed that the anti-avoidance rule is necessary to prevent transactions that are designed to achieve results that are inconsistent with the purposes of the regulations. The preamble goes on to say that routine intercompany transactions undertaken for legitimate business reasons will be unaffected by the anti-avoidance rules. The application of the anti-avoidance rule is illustrated by four examples:

The SRLY Example

The first example deals with a situation where one member has a gain asset and another member has net operating loss carryforwards ("NOLs") from separate return limitation year rules ("SRLYs") that are subject to limitation under Treasury Regulation Section 1.1502-21(c). In the example, the member owning the gain asset, while remaining in existence, shifts its gain to the member with the SRLY NOL. Under the anti-avoidance rules, however, the SRLY member is precluded from using its SRLY loss to offset the gain.[2]

The specific facts of the example are as follows. S owns land with a $10 basis and $100 value. B has SRLY NOLs. Pursuant to a plan to absorb the losses without limitation by the SRLY rules, S transfers the land to an unrelated partnership in exchange for a 10% interest in the capital and profits of the partnership. The partnership does not have an IRC Section 754 election in effect. S sells its partnership interest to B for $100. In the following year, the partnership sells the land to X for $100. Because the partnership does not have an IRC Section 754 election in effect, its $10 basis in the land does not reflect B's $100 basis in the partnership interest. Under IRC Section 704(c), the partnership's $90 built-in gain is allocated to B, and B's basis in the partnership interest increases to $190. In a later year, B sells the partnership interest to a nonmember for $100. As a result, the hoped-for result is that B can use its SRLY NOLs to offset the gain from the partnership's sale of the asset (S and B would also have offsetting gain and loss

[1] Treasury Regulation Section 1.1502-13(h)(1).

[2] Treasury Regulation Section 1.1502-13(h)(2), *Example* 1.

on the partnership interest). The regulations provide that, under the anti-avoidance rule, the partnership's $90 built-in gain allocated to B will not increase B's SRLY limitation.

A few observations about this example are important. First, an intercompany transaction was used as part of the transaction (*i.e.*, S's sale of the partnership interest to B) that resulted in a reduction of consolidated tax liability. Second, the hoped-for result in this situation could not have been achieved without filing consolidated returns because a necessary element of the result is the ability to move the gain inherent in the land from S to B while deferring S's gain and offsetting it with B's loss on the sale of the partnership interest. If S and B were not joining in filing a consolidated return, S's gain would not have been deferred and B's loss could not have been used to offset S's gain. Finally, the result in the example overrides another provision of the consolidated return rules (*i.e.*, the SRLY rules) rather than a statutory provision.

The Transitory Intercompany Transaction Example

In the second anti-avoidance example, the Service disregards a transitory intercompany transaction that is consummated for a principal purpose of invoking provisions of the Intercompany Transaction Regulations that would generate a tax deduction. The facts of the example are as follows:

P historically has owned 70% of X's stock and the remaining 30% is owned by unrelated shareholders. S has borrowed $100 from X. The P group has substantial net operating loss carryovers, and the fair market value of S's note falls to $70 due to an increase in prevailing market interest rates. X is not permitted under IRC Section 166(a)(2) to take into account a $30 loss with respect to the note. Pursuant to a plan to permit X to take into account its $30 loss without disposing of the note, P acquires an additional 10% of X's stock, causing X to become a member, and P subsequently resells the 10% interest. In this situation, Treasury Regulation Section 1.1502-13(g)(4) would ordinarily permit X to take into account its $30 loss as a result of the note becoming an intercompany obligation, and would cause S to take into account $30 of discharge of indebtedness income. The example, however, concludes that the transitory status of S's indebtedness to X as an intercompany obligation is structured with a principal purpose to accelerate the recognition of X's loss and, therefore, S's note is treated as not becoming an intercompany obligation.

Like the previous example, an intercompany transaction was used as part of the transaction (*i.e.*, the deemed satisfaction and reissuance of X's note when it enters S's group). Here, however, the result is an acceleration (*i.e.*, only the timing) of X's deduction, not the consolidated group's tax liability. In fact, the consolidated group suffers a reduction in its NOLs. Like the SRLY Example, however, the hoped-for result in this situation could not have been achieved without filing consolidated returns because a necessary element of the result is use of the deemed satisfaction-reissuance rule in section 1.1502-13(g)(4) of the regulations. Finally, the result in the example

overrides a provision of the Intercompany Transaction Regulations, not a statutory provision.

Corporate Mixing Bowl Example

The third example involves the use of the consolidated return regulations to dispose of an asset without recognizing gain. The facts of the example are as follows:

M1 and M2 are subsidiaries of P. M1 operates a business on land it leases from M2, and the land is M2's only asset. P intends to dispose of the M1 business, as well as the land owned by M2. P's basis in the M1 stock is equal to the stock's fair market value. M2's land has a value of $20 and a basis of $0 and P has a $0 basis in the stock of M2. In Year 1, with a principal purpose of avoiding gain from the sale of the land, M1 and M2 form corporation T. M1 contributes cash in exchange for 80 percent of the T stock and M2 contributes the land in exchange for the remaining 20 percent of the stock. In Year 3, T liquidates, distributing $20 cash to M2 and the land (plus $60 cash) to M1. Under Treasury Regulation Section 1.1502-34, IRC Section 332 protects both M1 and M2 from gain. In addition, under IRC Section 337, T recognizes no gain or loss from its liquidating distribution of the land to M1 (since M1 owns 80 percent of the stock of T). In Year 4, P sells all of the stock of M1 (which now includes the land) to X, an unrelated party, and liquidates M2. The example concludes that because a principal purpose of the formation and liquidation of T was to avoid gain from the sale of M2's land, M2 must take into account $20 of gain when the M1 stock is sold to X.

In this situation, several intercompany transactions were used as part of the transaction (*i.e.*, formation of T and liquidation of T) to reduce consolidated tax liability. However, the effect of this series of transactions is to avoid what in substance would have been an intercompany transaction -- the sale of the land from M2 to M1. Second, the hoped-for result in this situation could not have been achieved without filing consolidated returns because a necessary element of the result is the aggregation of members' interest in a liquidating corporation for purposes of applying IRC Section 332. See Treasury Regulation Section 1.1502-34. Finally, although the result in the example might be viewed as overriding a statutory provision (*i.e.*, IRC Sections 1001 and 1012), the result seems to be based not on overruling the Code but treating the series of transactions according to their economic substance -- an intercompany sale of the land from M2 to M1.

Partnership Mixing Bowl Example

The fourth example of the anti-avoidance rule involves a situation where a partnership involving members of a consolidated group is used to shift basis from land to an IRC Section 197 amortizable intangible. The facts of the example are as follows:

M1 owns a self-created intangible asset with a $0 basis and a fair market value of $100. M2 owns land with a basis of $100 and a fair market value of $100. In Year 1, with a

principal purpose of creating basis in the intangible asset (which would be eligible for amortization under IRC Section 197), M1 and M2 form partnership PRS; M1 contributes the intangible asset and M2 contributes the land. X, an unrelated person, contributes cash to PRS in exchange for a substantial interest in the partnership. PRS uses the contributed assets in legitimate business activities. Five years and six months later, PRS liquidates, distributing the land to M1, the intangible to M2, and cash to X. The group reports no gain under IRC Sections 707(a)(2)(B) and 737(a) and claims that M2's basis in the intangible asset is $100 under IRC Section 732 and that the asset is eligible for amortization under IRC Section 197. The example concludes that a principal purpose of the formation and liquidation of PRS was to create additional amortization without an offsetting increase in consolidated taxable income by avoiding treatment as an intercompany transaction and, therefore, "appropriate adjustments must be made."

In this situation, no intercompany transactions were involved. However, the effect of the series of transactions was to avoid what in substance would have been an intercompany transaction – the exchange of M2's land for M1's intangible asset. The hoped-for result in this situation is the deferral of consolidated taxable income. Second, unlike all of the other examples illustrating the application of this provision, the hoped-for result in this situation could have been achieved without filing consolidated returns. Finally, the result in the example might be viewed as overriding two statutory provisions (*i.e.*, IRC Sections 707 and 737). However, the result seems to be based in substantial part on treating the series of transactions according to their economic substance – an intercompany exchange of land for an intangible asset.

Sale and Leaseback Example

The final example of the anti-avoidance rule is the only favorable example in this section. The facts are as follows:

S operates a factory with a $70 basis and $100 value, and has loss carryovers from SRLYs. Pursuant to a plan to take into account the $30 unrealized gain while continuing to operate the factory, S sells the factory to X for $100 and leases it back on a long-term basis. In the transaction, a substantial interest in the factory is transferred to X. The sale and leaseback are not recharacterized under general principles of federal income tax law. As a result of S's sale to X, the $30 gain is taken into account and increases S's SRLY limitation. The example concludes that, although S's sale was pursuant to a plan to accelerate the $30 gain, it is not subject to adjustment under the anti-avoidance rule because the sale is not treated as engaged in or structured with a principal purpose to avoid the purposes of the intercompany transaction regulations.

Application of Anti-Avoidance Rule to ECTS Transaction

Principles to be Derived From the Examples

The above-described examples illustrate several limiting principles that the Service will use in applying this anti-avoidance rule. The first principle seems to be that the anti-abuse rule may be applied where an intercompany transaction is part of the overall transaction (*e.g.*, the SRLY Example) or where the substance of the transaction involves an intercompany transaction (*e.g.*, Corporate and Partnership Mixing Bowl Examples). In addition, the anti-abuse rule may apply where the transaction is structured as an intercompany transaction but in substance is not an intercompany transaction (*e.g.*, the Transitory Intercompany Transaction Example). The ECTS transaction would not escape the anti-abuse rule under this principle because the intercompany transaction in this situation (*i.e.*, the IRC Section 351 transfer to ECTS) is a necessary element to the tax loss realized by ECT.

The second principle is that the anti-abuse rule may be applied where consolidated taxable income is avoided (*e.g.*, the SRLY and Corporate Mixing Bowl Examples) or deferred (*e.g.*, the Transitory Intercompany Transaction and Partnership Mixing Bowl Examples). Therefore, the ECTS transaction, would not escape the anti-abuse rule under this principle.

The third principle is that the anti-abuse rule would seem to apply only in situations where either consolidated return rules are used (*e.g.*, the SRLY, Corporate Mixing Bowl, and Transitory Intercompany Transaction Examples) or avoided (*e.g.*, the Partnership Mixing Bowl Example involves a situation where a partnership is used to avoid treatment as an intercompany transaction) to achieve an untoward tax advantage. In the ECTS transaction, consolidated return rules are not used to achieve a tax benefit; the tax consequences of this transaction are not dependent on the Intercompany Transaction Regulations or any other consolidated return regulations. The results are dictated by statutory rules of Subchapter C of the Code (*e.g.*, IRC Sections 351, 358, 361, 362). In addition, consolidated return rules are not avoided in the ECTS transaction; such rules are applied according to their express terms. Furthermore, the transaction is not properly viewed as, in substance, anything different than its form. In other words, the tax consequences that obtain in the ECTS transaction (*i.e.*, ECT's loss on the sale of the preferred shares) would be the same if the corporations did not file a consolidated return. Therefore, based on the use of this principle, the ECTS transaction would not be subject to the anti-avoidance rule of the Intercompany Transaction Regulations.

The fourth principle is that the anti-abuse rule will not alter tax consequences that are provided by the Internal Revenue Code. In particular, every example other than the Partnership Mixing Bowl Example involves a situation where the anti-abuse rule is overriding a consolidated return provision; the SRLY Example overrides the SRLY rules, the Transitory Intercompany Transaction Example overrides the deemed

satisfaction-reissuance rule in Treasury Regulation Section 1.1502-13(g)(4), the Corporate Mixing Bowl example overrides the stock aggregation rule in Treasury Regulation Section 1.1502-34. The only exception to this principle is the Partnership Mixing Bowl Example, which seems to overrule IRC Sections 707 and 737. However, this example is more properly viewed as recasting a series of transactions in accordance with their economic substance rather than overriding statutory provisions. Applying this principle to the ECTS transaction, the anti-avoidance rule should not apply because, as discussed above, the tax consequences of this transaction are governed by provisions of the Internal Revenue Code, not by the consolidated return regulations.

Additional Reasons Support the Taxpayer's Conclusions

Without deriving some limiting principles from the examples illustrating the application of the anti-avoidance rule, there is a substantial risk that the anti-avoidance rule will apply to the ECTS transaction. If so, the appropriate adjustment would almost certainly be a reduction in ECT's basis in its preferred shares prior to the sale of such shares.

The reason for this conclusion is that, in order for the literal language of the anti-avoidance rule to apply, the Service or a court need only find that a transaction (not necessarily an intercompany transaction) has a principal purpose of using an intercompany transaction to create, accelerate, avoid, or defer consolidated taxable income (or consolidated tax liability). Therefore, if a principal purpose of the ECTS transaction is to recognize a loss on the sale of the preferred shares and the anti-abuse rule applies according to its literal language, the ECTS transaction would be subject to "appropriate adjustments."

As discussed above, however, the examples described above illustrate that the Service does not intend to apply the anti-avoidance rule according to its literal language. This is also buttressed by the statement in the preamble that routine intercompany transactions undertaken for legitimate business reasons will be unaffected by the anti-avoidance rules. In addition, it is our understanding that government officials have reinforced this conclusion further by frequently suggesting that this rule does not affect standard SRLY planning techniques such as merging a member with SRLY losses into a profitable member.

It is important to note several additional arguments that support the conclusion that the anti-avoidance rule does not apply to the ECTS transaction. First, as described above, the ECTS transaction is motivated by numerous substantial business purposes. ECTS is capitalized with notes used to fund the credit reserve and FPRM contract management activity assumed by it. The consideration issued is stock in ECTS in order to provide the holders with highly negotiated equity and voting terms so that the holders are true owners and participants in the activity as opposed to passive investors or mere employees. As a result, we would argue that a reduction or deferral of consolidated tax liability is not a principal purpose of the ECTS transaction. At this time, however, there

is no guidance on the meaning of "a principal purpose." Therefore, it is unclear whether this argument would be successful.

Second, it can also be argued that, if the ECTS transaction is not affected by the anti-avoidance provisions in the loss disallowance rules (Treasury Regulation Section 1.1502-20(e)), the anti-avoidance rule in the Intercompany Transaction Regulations should be inapplicable. It is a well settled principle of statutory and regulatory interpretation that the specific must control over the general. In this situation, the anti-avoidance rule in the loss disallowance rules is more specific to the ECTS transaction than the anti-avoidance rule in the Intercompany Transaction Regulations. As discussed above, however, we believe that the loss disallowance rules should not disallow ECT's loss on the sale of the preferred shares. This conclusion is based in part on the fact that the loss disallowance rules are applied in full to the ECTS transaction and the loss that ECT incurs is allowed under the express terms of those rules (*i.e.*, the formula in section 1.1502-20(c) of the regulations). Therefore, the loss disallowance rules and their purposes are not avoided in the ECTS transaction but rather are applied to their full extent. As a result, the anti-avoidance rule in the Intercompany Transaction Regulations should not disallow a loss on the sale of stock of a member if such loss would be allowed by the loss disallowance rules. In other words, the loss disallowance rules provide the circumstances where the Service believes that consolidated groups should be permitted and denied losses on the sale of stock in members and the anti-avoidance rule in the Intercompany Transaction Regulations should not alter that treatment.

Finally, to the extent that the Service attempts to apply the anti-avoidance rules in the Intercompany Transaction Regulations without the limiting principles described above, such application will exceed the Service's authority under IRC Section 1502 and would be declared invalid by the courts. There are several situations in which the courts have recently declared the Service's legislative regulations invalid. In addition, the courts have declared consolidated return regulations invalid in a number of circumstances. These situations are analogous to the present situation and would provide ECT with substantial arguments that the application of the anti-avoidance rule to the ECTS transaction is an invalid exercise of the Service's regulatory authority.

A recent court decision is worthy of note. In RLC Industries v. Commissioner, 95-2 USTC ¶50,328 (9th Cir., 1995), the court declared invalid section 1.611-3(d)(5) of the regulations. This provision was promulgated pursuant to legislative regulatory power to provide rules for determining a reasonable allowance for the depletion of timber. In exercising this authority, the Service issued regulations that defined the units or blocks that were to be used to calculate depletion deductions. In addition, the Service provided in its regulations that: "For good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts." The court declared this regulation invalid because such regulation was inconsistent with the rulemaking authority granted

the Service in IRC Section 611 in that the regulation attempted to vest in the Service the overriding power to decide the reasonableness of a particular taxpayer's timber depletion allowance and "eviscerate[d] the fundamental distinction that is deeply embedded in administrative law between quasi-legislative and quasi-judicial power." Because the court found the regulation to be an attempt to vest quasi-judicial power in the Service and the regulatory authority to vest only quasi-legislative power in the Service, the court found the regulation to go beyond the Service's authority as it was granted in IRC Section 611.

In some ways, the anti-abuse rule in the Intercompany Transaction Regulations is similar to the regulations promulgated under IRC Section 611; both attempt to retain for the Service the ability to change the tax consequences of a transaction on a case-by-case basis. This is properly viewed as quasi-judicial power that not granted the Service in IRC Section 611 or IRC Section 1502 (compare IRC Section 166(a)(2)).

Applying this reasoning to our situation, IRC Section 1502 does not grant the Service the authority to overrule statutory provisions. Since the tax consequences of the ECTS transaction are dependent solely on the statutory rules governing IRC Section 351 transactions, if the Service applies the anti-abuse rule according to its literal language and thereby overrides statutory provisions, the Service has exceed its authority as granted in IRC Section 1502 ("to prescribe regulations as may be necessary in order that the tax liability of any affiliated group of corporations making a consolidated return . . . . may be returned, determined . . . .)

Finally, the courts have also declared certain consolidated return regulations invalid in situations where the Service went beyond its statutory mandate. See for example, American Standard, Inc v. U.S., 602 F.2d 256 (Ct. Cl., 1979) ("[T]he statute does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed.") and Comm'r v. General Machinery Corporation, 95 F.2d 759 (6th Cir., 1938) (taxpayers are not required to surrender any part of the statutory privilege as a condition to filing a consolidated return).

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For the reasons described above, it is more likely than not that, in the ECTS transaction, the loss claimed by the consolidated group on the sale of the preferred shares will not be disallowed by the Intercompany Transaction Regulations.

Summary

Based on the arguments discussed above, a loss on the sale of the preferred stock of ECTS by ECT should, more likely than not, not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1)(iii), not be disallowed under the anti-avoidance or anti-stuffing rules of Treasury Regulation Section 1.1502-20(e), and not be disallowed under the intercompany transaction rules of Treasury Regulation Section 1.1502-13.

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ACQUISITION MADE TO EVADE OR AVOID INCOME TAX

ECT's contribution of the intercompany notes to ECTS in exchange for all of the voting preferred stock of ECTS should, more likely than not, not constitute an acquisition made to evade or avoid income tax within the meaning of IRC Section 269.

ECT will transfer $267.32 million of intercompany notes receivable, subject to a contractual assumption of $267.28 million of ECT's credit reserve and FPRM contract obligations. In exchange, ECT will receive 100 percent of the voting preferred stock in ECTS.

This transaction raises the issue whether ECT's contribution of the intercompany notes to ECTS in exchange for all of the voting preferred stock of ECTS is an acquisition made to evade or avoid income tax within the meaning of IRC Section 269.

IRC Section 269(a) states:

> (a) In general – If–
>
> (1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or
>
> (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transfer corporation,
>
> and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

ECTS was "acquired" as that term is used in IRC Section 269(a)(1) when ECT subscribed to all of the common stock of its predecessor, EGGI. The principal purpose of acquiring EGGI/ECTS at that time was not tax avoidance. For IRC Section 269(a)(1) to apply, the principal purpose of the acquisition must be the evasion or avoidance of federal income tax by securing the benefit of a deduction, credit or allowance which the acquiring corporation would

not otherwise enjoy. ECT's principal purpose in acquiring ECTS is determined at the time ECTS was formed and ECT received all of its common stock, not when ECT received the voting preferred stock. The voting preferred stock will represent less than 20 percent of the vote and value of ECTS. Therefore, ECT will not acquire control of ECTS within the meaning of IRC Section 269(a)(1) when it obtains the voting preferred stock, since ECT controlled ECTS from its inception and continued to control ECTS at all times thereafter.

In The Challenger Corporation v. Commissioner, 23 TCM 2096 (1964), the taxpayer transferred property to two dormant corporations that it controlled. The Commissioner argued that the revival of dormant corporations was the equivalent of the "acquisition" of the corporation under IRC Section 269(a)(1) and that the taxpayer should not be entitled to multiple surtax exemptions. The court disagreed with the Commissioner and stated:

> Section 269(a)(1) requires acquisition of "control," not acquisition of the corporation. Congress undertook to define "control" for these purposes in terms of stock ownership. [citation omitted]. The revival of a dormant corporation does not constitute the acquisition of ownership of stock.

IRC Section 269 is essentially a reenactment of Section 129 of the Internal Revenue Code of 1939, added by Section 128 of the Revenue Act of 1943. The Senate Finance Committee Report stated (S. Rep. No. 627, 78th Cong., 1st Sess., 1943, p. 60):

> Control once acquired could not be again acquired, unless the group was in some way broken. A mere shift in the form of control -- from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect -- cannot, therefore, amount to acquisition of control within the meaning of (Section 269).

ECT acquired control of ECTS when it subscribed to all of the common stock of its predecessor, EGGI. It acquired EGGI/ECTS for nontax purposes. ECT controlled EGGI/ECTS at its formation and that control has continued unbroken at all times since. Most importantly, EGGI/ECTS has continued to be an ongoing operating business since its inception in 1985. Therefore, it is clear under the rationale of The Challenger Corporation case that when ECT exchanged the intercompany notes, subject to the credit reserve and FPRM contract obligations for all the voting preferred stock of ECTS, it was not acquiring control of ECTS under IRC Section 269(a)(1).

Even if ECT acquired control of ECTS under IRC Section 269(a)(1) at the time it acquired all the voting preferred stock of ECTS, the principal purpose of the acquisition was not the evasion or avoidance of federal income tax.

IRC Section 269 provides for the disallowance of deductions and other tax benefits when tax avoidance is the principal purpose for acquisition of control of a corporation or for certain transfers from one corporation to another. A corporation's principal purpose in acquiring

another corporation's stock or assets is tax avoidance if it "exceeds the importance of any other purpose." Treasury Regulation Section 1.269-3(a).

As stated above, ECT has represented that the principal purpose of ECTS was not the evasion or avoidance of income tax. The business purposes for which ECTS was formed include, but are not limited to:

- to consolidate ECT's selected credit reserve and FPRM contract liability management activities in one subsidiary,

- to better control the administrative costs and expected losses associated with in-the-money contracts, and

- to offer management and certain employees associated with the credit reserve and FPRM contract management function an incentive to control these costs and to share in the cost savings.

IRC Section 269(a)(2) is not applicable to this transaction. IRC Section 269(a)(2) only applies to the acquisition of property by the transferee corporation (*i.e.*, ECTS) where the principal purpose is to secure a deduction, etc., by the transferee corporation which it would not otherwise enjoy. Here, the loss at issue is a loss by the transferor (ECT) and not the transferee (ECTS).

Treasury Regulation Section 1.269-3(c) clarifies that IRC Section 269(a)(2) only applies to the transferee corporation. IRC Section 269(a)(2) applies in transactions where there is a transfer of built-in loss property for the purpose of recognizing the loss at the transferee corporation, and transactions where there is a transfer of built-in gain property to a transferee with losses otherwise unavailable to the transferor so that the transferee may recognize the gain and utilize its losses. ECT's contribution of the intercompany notes is not similar to either of these transactions, and IRC Section 269(a)(2) does not apply.

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Based on the arguments discussed above, ECT's contribution of the intercompany notes to ECTS in exchange for all of the voting preferred stock of ECTS should, more likely than not, not be an acquisition made to evade or avoid income tax within the meaning of IRC Section 269.

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