V. TAX OPINION LETTERS

RELATING TO

PROJECT TERESA

KING & SPALDING

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

DIRECT DIAL:
(202) 626-2908

**PRIVILEGED AND CONFIDENTIAL
SUBJECT TO ATTORNEY-CLIENT PRIVILEGE
AND WORK-PRODUCT DOCTRINE**

MEMORANDUM

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

FROM: William S. McKee
Susan Jewett

DATE: February 20, 1997

RE: Deferred Tax Liability Accounting Transaction

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

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I. Assumed Facts

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

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

191 PEACHTREE STREET
ATLANTA, GA 30303-1763
TELEPHONE: 404/572-4600
FACSIMILE: 404/572-5100

120 WEST 45TH STREET
NEW YORK, NY 10036-4003
TELEPHONE: 212/556-2100
FACSIMILE: 212/556-2222

1100 LOUISIANA STREET, SUITE 3300
HOUSTON, TX 77002-5219
TELEPHONE: 713/751-3200
FACSIMILE: 713/751-3290

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

aggregate amount of the Purchase Price plus any distributions made or deemed made by Enron Sub II to its shareholders during such year.

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

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

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in which an Enron Sub III Redemption occurs will exceed the aggregate amount of any distributions, other than an Enron Sub III Redemption, made or deemed made by Enron Sub III to its shareholders during such year.

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

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

the dividend resulting from the Purchase, the Holdco Redemption, or the Enron Sub III Redemption.

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

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

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

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

II. Tax Consequences Summary

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

A. Affiliation

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

B. Purchase

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

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

C. Formation of Holdco and Enron Sub III

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

D. Holdco Redemption

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

E. Enron Sub III Redemption

We believe that the payments by Enron Sub III in redemption of the Enron Sub III common and preferred stock should be treated as distributions subject to section 301 and as dividends under section 301(c)(1). We believe that the adjusted basis of the Enron Sub III preferred stock retained by Partnership should be increased by an amount equal to Partnership's adjusted basis in the Enron Sub III preferred stock redeemed by Enron Sub III and that the adjusted basis of SPVCo's interest in Partnership should be increased by its distributive share of the dividend attributable to the redemption of Enron Sub III preferred stock from Partnership. We believe that section 1059 should not be applicable to reduce Partnership's basis in the retained Enron Sub III preferred stock, to reduce SPVCo's basis in its interest in Partnership, or to trigger

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

III. Analysis

A. Deconsolidated Status of SPVCo

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

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

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

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

The Service has also respected the use of heavy voting stock to break affiliation. In Private Letter Ruling 6710242620B (Oct. 24, 1967), the taxpayer wanted to deconsolidate a subsidiary using a class of common stock having the power to elect 1/3 of the board of directors of the corporation but representing less than 3.5 percent of the consideration paid for all of the corporation's outstanding stock. The letter ruling concludes, without mentioning the

disproportionality between the voting power and value of the stock, that ownership of the entire class of stock outside the group would be sufficient to terminate affiliated status.[3]

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

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

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

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

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

Section 957(a) provides that a foreign corporation is a CFC if more than 50 percent of the total combined voting power of the corporation is owned by United States shareholders. (Section 957(a) was amended in 1986 to add, as an alternative basis for classification as a CFC, ownership

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

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

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

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

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

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

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

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

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

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

B. Affiliation of Enron Sub III

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

The term "includible corporation" means any corporation except (1) corporations exempt from tax under section 501, (2) insurance companies subject to taxation under section 801, (3) foreign corporations, (4) corporations with respect to which an election under section 936 is in effect for the taxable year, (5) regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1 of the Internal Revenue Code of 1986, and (6) a DISC (as defined in section 992(a)(1)). Section 1504(b). Enron Sub III is a for profit Delaware corporation that will not be an insurance company subject to taxation under section 801, a

regulated investment company or a real estate investment trust subject to tax under subchapter M of chapter 1 of the Code, or a DISC (as defined in section 992(a)(1)). No election under section 936 will be made with respect to Enron Sub III. Accordingly, we believe Enron Sub III is an includible corporation.

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

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

The yield on the preferred stock of Enron Sub III does not vary with either the profitability of the issuing corporation or the appreciation of its assets. Terms that do not vary the return on the preferred stock with the profits of the issuing corporation may not be sufficient to establish an absence of participation in corporate growth, however, if the facts and circumstances indicate that the preferred stock in effect participates in corporate growth. See H.R. Rep. No. 98-861, at 817 (1984) ("preferred stock carrying a dividend rate materially in excess of a market

rate when issued would not be ignored"). An argument might be made that the preferred stock nevertheless participates in corporate growth if the capitalization or operations of the corporation were such that corporate growth would be required in order for the issuing corporation to satisfy its obligations with respect to the preferred stock.[5]

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

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

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

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

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

C. Purchase

1. Section 304

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

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

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

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

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

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

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

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

2. Consequences of Dividend Treatment

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

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

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

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

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

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

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

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

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

3. Consolidated Return Regulations

a. Inapplicability of Section 304 Within a Consolidated Group

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

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

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

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

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

b. Intercompany Transaction Rules

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

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

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

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

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

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

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

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

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

c. Earnings and Profits Rules

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

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rules (the "earnings and profits rules") for adjusting the earnings and profits of members of the group where one member owns stock of another member.[12]

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

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

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

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

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

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

d. Investment Adjustment Rules

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

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

or made a contribution to Enron Sub II in connection with the Purchase for purposes of applying the investment adjustment rules (or other applicable basis rules of the Code).[13]

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

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

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

4. Dividends Received Deduction

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

a. Receipt of a Dividend from a Domestic Corporation

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

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

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

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

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

b. Section 246(c)

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

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

holding period requirement of section 246(c) if the partnership itself were otherwise entitled to the dividends received deduction.[15]

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

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

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

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

c. Section 246(b)

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

d. Section 246A

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

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

corporation in a section 304 transaction. Rev. Rul. 92-86, 1992-2 C.B. 199. Accordingly, we believe that the section 304 dividend should be treated as paid to Partnership by Enron Sub II.

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

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

e. Percentage

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

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

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

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

5. Section 1059

Section 1059 provides for the reduction (but not below zero) of a corporation's basis in stock by the amount of the dividends received deduction allowable with respect to certain "extraordinary" dividends received with respect to such stock. Extraordinary dividends that trigger the application of section 1059 include (i) a dividend received by a corporation with respect to a share of stock that equals or exceeds a threshold percentage of the corporation's

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

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

a. Pro Rata Redemption

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

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

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

b. Two-Year Holding Period

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

c. Threshold Percentage

The Service might argue that the relevant holding period for Partnership is the shorter of the period for which it has constructively owned Enron Sub II stock and Enron's holding period in the Enron Sub II stock. We believe that the period of constructive ownership has no relevance to the purposes of section 304 and 1059. Accordingly, we believe such an argument should be

rejected by a court. If such an argument were, nevertheless, accepted, then in the case of a Purchase that occurs within two years of the formation of Partnership, the characterization of a dividend as extraordinary would become significant.[21]

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

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

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

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

D. Formation of Holdco and Enron Sub III

1. Application of Section 351

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

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

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

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

2. Earnings and Profits Rules

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

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

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

believe that the transfer by Enron Sub III of Regulated stock to Holdco should affect the "tier up" of X percent of Regulated's earnings and profits to Enron Sub III.

3. Earnings and Profits Anti-avoidance Rule

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

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

E. Holdco Redemption

1. Dividend Treatment

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

Enron Sub III owns all of the preferred stock of Holdco. Under the constructive ownership rules of section 318, Enron Sub III owns all of the stock owned by Enron. Enron

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

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

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

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

3. Consolidated Return Adjustments

In addition to the above effects under sections 312 and 302, the consolidated return regulations provide for earnings and profits adjustments and investment adjustments in connection with the dividend. Treas. Reg. §§ 1.1502-32, -33. Under the consolidated return regulations, the

dividend should be excluded from Enron Sub III's income to the extent that Enron Sub III has a corresponding negative basis adjustment under the investment adjustment rules. Treas. Reg. §§ 1.1502-13(f)(2)(ii).

a. Investment Adjustment Rules

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

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

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

class of common stock, the net remainder adjustment is generally allocated equally to each share within the class. Treas. Reg. § 1.1502-32(c)(2)(i).

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

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

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

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

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

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

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

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

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

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

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

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

4. Anti-avoidance Rules

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

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

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

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

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

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

The attempt to deduce a more detailed purpose for the earnings and profits adjustments as applied to redemptions by looking at the detailed rules is equally disappointing, since the detailed rules appear to provide diametrically opposed results in the case of a redemption depending on

whether the redemption dividend relates to preferred or common stock. A redemption dividend that relates to common stock would appear to require a corresponding allocation of earnings and profits pro rata to each share of common stock or, in the case of more than one class of common stock, to the various classes of common stock based on the manner in which each class shares in the economic benefits or burdens associated with the earnings and profits. In contrast, a redemption dividend that relates to preferred stock appears to require a corresponding allocation of earnings and profits to the preferred stock, without regard to the manner in which various classes of stock share in the economic benefits or burdens associated with the earnings and profits.

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

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

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

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

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

F. Enron Sub III Redemption

1. Dividend Treatment

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

Under section 301(c)(1) and section 316, a distribution is treated as a dividend to the extent of the earnings and profits of the distributing corporation. Given current and accumulated earnings and profits of Enron Sub III, determined without regard to any Holdco Redemptions and

without regard to any Enron Sub III Redemptions, for the taxable year in which the Enron Sub III Redemption occurs in excess of the aggregate amount of any distributions, other than an Enron Sub III Redemption, made or deemed made by Enron Sub III to its shareholders during such year, the full amount of the redemption should be treated as a dividend from Enron Sub III to each redeemed shareholder.

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

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

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

3. Consolidated Return Adjustments

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

The investment adjustment rules contain an anti-avoidance rule which calls for adjustments to be made to carry out the purpose of the investment adjustment rules if a person acts "with a principal purpose which is contrary to the purpose of [the investment adjustment rules], to avoid the effect of [the investment adjustment rules], or to apply [the investment adjustment rules] to

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

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

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

circumstances, we believe that neither the investment adjustment anti-avoidance rule nor the intercompany transaction anti-avoidance rule should be applicable to an Enron Sub III Redemption.[27]

4. Intercompany Transaction Rules

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

5. Dividends Received Deduction

a. Section 243

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

b. Section 246

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

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

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

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

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

c. Section 246(b)

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

d. Section 246A

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

6. Section 1059

a. Pro Rata Redemption

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

b. Two-Year Holding Period

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

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

c. Threshold Percentage

In the case of an Enron Sub III Redemption that occurs within two years of Partnership's acquisition of the Enron Sub III preferred stock, the characterization of a dividend as extraordinary will be significant. In general, the term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds 10 percent (5 percent in the case of stock which is preferred as to dividends) of the taxpayer's

adjusted basis in such share of stock when aggregated with all other dividends received within an 85-day period, or exceeds 20 percent of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends having ex-dividend dates within an 365-day period. Section 1059(c).

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

d. Disqualified Preferred Stock

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

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

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

(C) such stock is otherwise structured --

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

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

Section 1059(f)(2).

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

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

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

G. Partnership Anti-abuse Rule

Under the partnership anti-abuse rule:

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

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

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

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

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

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

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

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

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

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

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

The analysis of transactions that invoke specific provisions of subchapter K (e.g., section 732(c)) to create a tax benefit that would not be available in the absence of Partnership is more difficult. The anti-abuse rule includes a list of factors that may be indicative of the proscribed effect. The first negative factor is that the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. Treas. Reg. § 1.701-2(c)(1). This factor is apparently applied

as if all transactions occur. See Treas. Reg. § 1.701-2(d) *Example 6, Example 7, Example 8*. Assuming transactions that result in a reduction of the partners' aggregate federal tax liability as compared to direct ownership of the assets (e.g., transactions that invoke section 732(c) to convert a capital deduction into a more beneficial ordinary deduction), we believe there is a risk that the Service would argue that the transaction produces results that are inconsistent with the intent of subchapter K.

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

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

a mechanical rule that alters its application based on the presence or absence of tax motivation or the magnitude of tax benefits should not be considered a reasonable interpretation.

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

The examples in the abuse-of-subchapter K rule suggest that the rule is also intended to expand upon judicial doctrines, primarily by requiring that the tax motivation for a transaction be taken into account in applying those doctrines. Generally, the courts have not taken tax motivation into account in determining whether a transaction is a sham, a transaction has a substantial business purpose, the step transaction is applicable, or the substance of a transaction matches its form. See, e.g., Knetsch v. United States, 364 U.S. 361, 365 (1960); Gregory v. Helvering, 293 U.S. 465, 469 (1935). But cf. Sheldon v. Commissioner, 94 T.C. 738 (1990). In contrast to the virtual unanimity in the courts with respect to the role of tax avoidance motivation under these doctrines, some controversy has arisen in recent years with respect to the issue of the role of tax motives in the determination of whether the profit motive requirement of various Code provisions (e.g., sections 162, 165(c)(2), 183, and 212) has been satisfied. While the test is often described as requiring a primary purpose of realizing a profit, the cases generally have considered

the relative weight of profit motive only in comparison to personal motives. See Portland Golf Club v. Commissioner, 497 U.S. 154 n.16 (1990); Snyder v. Commissioner, 674 F.2d 1359 (10th Cir. 1982). In commercial transactions, where personal motives are not at issue, in some cases the courts have analyzed the facts of the transaction to determine whether a profit motive existed. In general, the finding of a profit motive has been sufficient for the courts to hold in favor of the taxpayer without further analysis. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Levy v. Commissioner, 91 T.C. 838 (1988). There have, however, been some tax shelter cases in which the courts have expanded their inquiry to consider the primacy of the profit motive as compared to the tax motive. See, e.g., Estate of Baron v. Commissioner, 83 T.C. 542 (1984), aff'd, 798 F.2d 65 (2d Cir. 1986); Fox v. Commissioner, 82 T.C. 1001 (1984). It remains to be seen whether tax motivation will play a significant role in the determination of whether a profit motive requirement within a particular Code provision is satisfied.

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

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

H. Substance Over Form Doctrine

The tax consequences of a transaction are generally based on the substance of the transaction. Where the form reflects the substance, the tax consequences of the form are generally recognized. Where the form of a transaction does not reflect its substance, however, a

variety of judicial approaches have been used to determine the tax consequences of the transaction. These approaches include refusing to recognize a participant in a transaction as a separate taxable entity and disregarding a transaction as a sham.

1. Separate Taxable Entity

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

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

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

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

2. Sham

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

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

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

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

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

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

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

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

Transactions involving the transfer, distribution, or exchange of the debt and equity securities of a corporate issuer to or by a related corporation or unincorporated entity are respected notwithstanding the circular ownership resulting from such transactions. In Peter Pan Seafoods, Inc. v. United States, 417 F.2d 670 (9th Cir. 1969), it was held that cancellation of

indebtedness income did not arise when a newly formed corporation, 85 percent of whose stock was held by shareholders of the corporate obligor, purchased debt of the corporate obligor at a discount. The acquiring corporation was formed for the purpose of acquiring the debt and in order to avoid the adverse cancellation of indebtedness income consequences that would result from the corporate obligor's acquisition of its own debt. The Commissioner argued that the notes were in substance acquired by the obligor.

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

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

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

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

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

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

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

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

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

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

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

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

entity and pay principal and interest back with loans from related entity; no evidence that loans could have benefited the taxpayer economically).[36]

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

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

I. Section 269

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

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

Enron acquired control of SPVCo;

Enron acquired control of Forco;

Enron acquired control of Enron GP;

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

Enron Sub III and Holdco acquired control of Regulated; and

Enron and Enron Sub III acquired control of Holdco.

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

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

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

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

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

J. Application of Section 482

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

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

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

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

(202) 626-2908

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<~~DRAFT~~> May <~~6~~> **14**, 1997

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

Re: Enron Leasing Partners, L.P.

Dear Dave:

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

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

I. STATEMENT OF FACTS

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

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

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

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

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

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

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

II. DOCUMENTS EXAMINED

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Three letters, dated March 27, 1997, from Thomas Finley to Richard A. Causey, relating to the engagement by Enron of Bankers Trust to provide certain services.
<[~~Guaranty, dated as of April 14, 1997, by Enron for and in favor of Brazos, relating to lessee's obligations under the Lease Agreement ("Parent Guaranty").~~]

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

[~~OPI Indemnity, effective as of April 14, 1997, by OPI for and infavor of the general partners of Partnership, relating to lessee's obligations under the Lease Agreement.~~]>
In our examination of documents and in our reliance upon them in issuing this opinion, we have assumed, with your consent, that all documents submitted to us as photocopies faithfully reproduce the originals, that the originals are authentic, that all documents submitted to us have been duly executed and validly signed to the extent required in substantially the same form as they have been provided to us, that each executed document constitutes the legal, valid, binding and enforceable agreement of the signatory parties, that all representations and statements set forth in the documents are true and correct, and that all obligations, covenants, conditions or terms imposed on the parties by any of the documents have been or will be performed or satisfied in accordance with their terms. We have further assumed that, for our examination in connection with this opinion, you have disclosed to us all of the documents that are relevant to the transactions that are the subject of this opinion and that there are no undocumented agreements related to these transactions that modify or alter the effect of any documents listed above or that create any additional obligations or rights among the parties to those documents. We are not aware of any documents related to these transactions that would alter our opinions as set forth below.

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

III. REPRESENTATIONS AND ASSUMPTIONS

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

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

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

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

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

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

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

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

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

7. On the date the Liquids preferred stock was issued, (i) the annual dividend rate for the stock was no less than the rate that would be required by an investor that owned no common stock of Liquids and that was unrelated to Liquids, (ii) the annual dividend rate for the stock was not materially in excess of the then prevailing market rate for preferred stock having similar terms and issued by a corporation having a credit rating similar to that which Liquids would have had on the date of issuance if it were rated, (iii) all terms of the stock were consistent with commercial practices generally prevailing at that time and were terms that could reasonably be expected to be agreed upon in negotiations between unrelated parties having adverse interests, and (iv) the stock had a fair market value, to an investor that owned no common stock of Liquids and that was unrelated to Liquids, equal to its issue price.

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

9. The fair market value of the assets of Liquids will at all times exceed the face amount of all outstanding debt plus any accrued but unpaid interest plus the liquidation value (including accrued but unpaid dividends) of its preferred stock. All dividends on the Liquids preferred stock will be paid currently. The aggregate current earnings and profits and net cash flow of Liquids for each year will each exceed the annual dividend on the preferred stock.

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

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

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

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

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

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

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

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

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

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

7. The terms of the Partnership Agreement are commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree.

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

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

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

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

11. Each of Enron, Houston Pipe, Liquids, OPI, and Enron GP will at all times represent itself to third parties as a separate entity in all transactions, observe all corporate and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Partnership will at all <time> **times** represent itself to third parties as a separate entity in all transactions, observe all partnership and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. **Each of the entities listed in the preceding two sentences holds significant assets. In addition, each of Enron, Houston Pipe, Liquids, and OPI has been in existence for a substantial period of time and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons.**

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

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

IV. OPINIONS

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

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

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

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

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

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

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

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

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

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

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

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V. LEGAL ANALYSIS

A. Deconsolidated Status of OPI

In order for OPI to be an affiliate of Enron under section 1504 of the consolidated return rules, members of the Enron affiliated group (within the meaning of section 1504) must own stock possessing at least 80 percent of the total voting power and 80 percent of the total value of the stock of OPI. Section 1504(a). Enron owns approximately 98 percent of the value, but only 75 percent of the voting power, of the OPI shares. PCI owns approximately 0.9 percent of the value and approximately 23.8 percent of the voting power of the OPI shares. EN-BT owns approximately 1.1 percent of the value and approximately 1.2 percent of the voting power of the OPI shares. Accordingly, if PCI's ownership of 23.8 percent of the voting power of OPI is respected, OPI will not be an affiliate of Enron.

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

Pre-1984 authority indicates that the IRS did not consider disproportionality between the voting rights and the value of shares of stock, by itself, to be a reason to disregard the voting power of such shares in determining affiliated status. The IRS has repeatedly respected the use of ~~<heavy voting-shares>~~ **stock with disproportionately high voting power as compared to value ("disproportionately high vote" stock)** to create affiliated status. In Technical Advice Memorandum 8030007 (Apr. 14, 1980), the taxpayer wanted to create affiliated status through its ownership of a class of common stock that initially represented approximately 80 percent of the number of, 73.5 percent of the consideration paid for, and 96 percent of the vote of all outstanding shares of the corporation, and later represented approximately 40 percent of the number of, approximately 20 percent of the consideration paid for, and slightly in excess of 80 percent of the voting power of all outstanding shares of the corporation. Finding that the voting power accorded the stock existed for a substantial period of time and, during such period, actually reflected the

relative rights of the shareholders, the Technical Advice Memorandum concludes that the disproportionate allocation of voting rights was not a sham and that ownership of the stock was sufficient to establish affiliation, despite the facts that the disproportionate voting rights were given to the stock for the purpose of establishing affiliation and were intended to be eliminated after ~~<6>~~ **six** years. <u>See also</u> Priv. Ltr. Rul. 8139089 (June 30, 1981) (affiliated status respected based on ownership of common stock representing 100 percent of the voting power and 60 percent of the equity value of a corporation); Priv. Ltr. Rul. 7401231710B (Jan. 23, 1974)[3] (affiliated status respected based on ownership of common stock representing 80 percent of the voting power and 50 percent of the value of a corporation).

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

The IRS has also respected the use of ~~<heavy voting>~~ **disproportionately high vote** stock to break affiliation. In Private Letter Ruling 9714002 (Dec. 6, 1996), the IRS ruled that a subsidiary could not be included in the parent's consolidated return for the period during which, by reason of a change in the voting rights of the outstanding preferred stock, the preferred stock of the subsidiary had 26 percent of the total number of votes of all stock of the corporation, despite the fact that the value of common stock held by the parent represented at least 80 percent of the value of the subsidiary's stock at all times. The IRS specifically rejected any application of section 1504(a)(5)(F) based on the fact that no regulations have been issued under that section and that it is not self-executing. In Private Letter Ruling 6710242620B (Oct. 24, 1967),[4] the taxpayer wanted to deconsolidate a subsidiary using a class of common stock having the power to elect ~~<1/3>~~ **<u>one-third</u>** of the board of directors of the corporation but representing less than 3.5 percent of the consideration paid for all of the corporation's outstanding stock. The letter ruling concludes, without mentioning

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[3] **<u>Reprinted in Fred W. Peel, Jr., Consolidated Tax Returns (3d ed. 1977).</u>**

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

the disproportionality between the voting power and value of the stock, that ownership of the entire class of stock outside the group would be sufficient to terminate affiliated status.[5]

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

Consistent with the above authorities, we believe that the determination of whether the purported ownership of voting shares of a corporation should be respected for purposes of establishing or preventing affiliation should be based on an analysis of all facts and circumstances as they bear on the reality of the ownership and voting power of each shareholder. We believe that

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

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

Authorities dealing with the voting power test contained in the definition of a controlled foreign corporation ("CFC") provide some indication of the factors that the IRS and the courts might consider relevant in determining the reality of a shareholder's purported ownership and voting power. While the purposes of the CFC rules and the consolidation rules are quite different, we believe the CFC authorities can be useful in analyzing fact situations in which the taxpayer is attempting to avoid consolidation. The antiabuse considerations underlying enactment of the CFC rules are quite different from the considerations underlying enactment of the consolidated return rules, which are generally considered to create a taxpayer-favorable privilege. Consistent with these differing purposes, the authorities tend to interpret the voting control requirement in the CFC rules in favor of finding control, thereby imposing the limitations of CFC status on the tax avoidance opportunities available to a taxpayer, but tend to interpret the voting control requirement in the consolidated return rules against finding control, thereby denying the privilege of filing a consolidated return. Accordingly, we believe that voting rights that would be recognized as sufficient to avoid control for purposes of determining CFC status should be sufficient to avoid control for purposes of determining affiliation. See Priv. Ltr. Rul. 9714002 (affiliation status is much more neutral than ~~<controlled foreign corporation>~~ **CFC** status).

Section 957(a) provides that a foreign corporation is a CFC if more than 50 percent of the total combined voting power of the corporation is owned by United States shareholders. (Section 957(a) was amended in 1986 to add, as an alternative basis for classification as a CFC, ownership of more than 50 percent of the total value of the stock of the corporation by United States shareholders.) The regulations under section 957 provide that, where United States shareholders own shares of one

or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person on whose behalf it is exercised, or, if not exercised, will be disregarded if the percentage of voting power of such class is substantially greater than its proportionate share of the corporate earnings, if the facts show that the shareholders of such class of stock do not exercise their voting rights independently or fail to exercise such voting rights, <u>and</u> if a principal purpose of the arrangement is to avoid the classification as a CFC. Treas. Reg. § 1.957-1(b)(2). Accordingly, disproportionality between vote and value or between vote and profit share does not appear to be a sufficient reason by itself to disregard the voting power of a class of stock. Rather, the facts and circumstances surrounding the manner in which the vote is exercised are critical to a determination to disregard such voting rights.

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

In <u>CCA</u>, the court found that a Swiss corporation was not a CFC where preferred stock carrying 50 percent of the voting rights in the corporation was sold to foreign persons. The fact that the preferred shareholders paid less for their stock than 50 percent of the net worth of the corporation[6] was not considered by the court to be sufficient, in light of other factors present in the case, to disregard the voting power of the preferred stock. **<u>CCA</u>,** 64 T.C. at 153. The other factors considered by the court were that there were no substantial restrictions placed on the preferred stock other than a requirement for approval of transfers that was equally applicable to the common stock, no provision was made for the U.S. ~~<shareholders>~~ **shareholder** to acquire the preferred stock, the board of directors was equally divided between representatives of the common ~~<shareholders>~~ **shareholder** and the preferred shareholders, there were no provisions for breaking deadlocks, the board of directors had significant powers, any two members of the board of directors could act jointly to represent the corporation vis-a-vis the outside world, the preferred shareholders were not related to the U.S. ~~<shareholders>~~ **shareholder**, representatives of the preferred shareholders took an active part in shareholder and director meetings, and the U.S. shareholder retained no "significant strings" which could have been used to require the preferred shareholders to vote with it. The court found the facts in <u>CCA</u> to be in sharp contrast to those in <u>Kraus</u>, <u>Garlock</u>, and <u>Weiskopf</u> in which U.S. shareholders were found to have retained dominion and control, despite the ownership by foreign persons of shares representing 50 percent of the voting power of the corporation.

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

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

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

In Weiskopf, a newly formed UK corporation (Ininco) issued preferred ordinary shares in exchange for £25,000 to another UK corporation (Romney), and issued to a U.S. corporation deferred ordinary shares in exchange for £2,500 and second preferred shares in exchange for £17,500. The preferred ordinary shares elected 50 percent of the board of directors and received a dividend of 12.5 percent per year. The deferred ordinary shares elected the remaining 50 percent of the board of directors and shared the profits of the corporation, after the payment of the dividend on the preferred ordinary shares, with the second preferred shares. While the facts are not entirely clear, it appears that the UK tax exemption of Ininco resulted in Ininco having very substantial net earnings,

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with the result that the 12.5 percent return on the preferred ordinary shares represented much less than 50 percent of the annual earnings of Ininco. Weiskopf, 64 T.C. at 96. Two and one-half years after its formation, the preferred ordinary shares of Ininco were sold for par value (£25,000) and the remaining shares were sold for approximately £810,000. Again, the opinion focuses on a factual analysis to determine the reality of the control exercised by Romney. The court concluded that, as in Garlock, the arrangement was such that the preferred shareholder would have no interest in disturbing the U.S. ~~<shareholders>~~**shareholder's** control and that the U.S. ~~<shareholders>~~ **shareholder** retained complete dominion and control of Ininco. The factors mentioned by the court in reaching its conclusion were the above market rate of return being paid on the preferred shares, the limitation of the preferred shareholder to a return of its investment upon disposing of its stock, the dependence of Ininco on the U.S. shareholder as its source of supply for Ininco's product line, the unrealistic provision for resolving a deadlock, the disproportionality between vote and profit share, and the control the U.S. shareholder demonstrated at the time of the sale of the stock of Ininco.

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

We believe that PCI's voting power in OPI should be respected because we believe the relevant facts and circumstances indicate that PCI's ownership of its shares and its voting rights under the documents should be considered to be real. First and foremost are the facts that Enron will not exercise any control or influence over PCI in the exercise of its voting rights in OPI and PCI will exercise its voting rights in OPI for the benefit of itself and its Affiliates, and not on behalf of or for the benefit of Enron and its Affiliates. In addition, the two classes of preferred stock of OPI, in the aggregate, have an economic interest in ~~<2>~~ **two** percent of the profits of OPI above the base return provided to the shareholders. It appears reasonable to believe that PCI would want to protect its approximately 45 percent interest in this ~~<2>~~ **two** percent ~~<upside>~~ **profit share** through the exercise

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

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

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

~~<For purposes of section 1504(a),>~~ **Section 1504(a)(4) provides that** the term "stock" does not include stock that (A) is not entitled to vote; (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; (C) has redemption and liquidation rights which do not exceed the issue price (except for a reasonable redemption or liquidation premium); and (D) is not convertible into another class of stock. ~~<Section 1504(a)(4).>~~ The Liquids preferred stock is, by its terms, not entitled to vote, limited and preferred as to dividends, and not convertible into any other class of stock. Moreover, we believe that the facts do not indicate that the preferred stock

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

of Liquids has any beneficial interest in or control over the voting power of the common stock of Liquids. The issue price of Liquids preferred stock is not less than its redemption price and its liquidation value (except for a reasonable redemption or liquidation premium).

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

The yield on the preferred stock of Liquids does not vary with either the profitability of the issuing corporation or the appreciation of its assets. Terms that do not vary the return on the preferred stock with the profits of the issuing corporation may not be sufficient to establish an absence of participation in corporate growth, however, if the facts and circumstances indicate that the preferred stock in effect participates in corporate growth. See H.R. Rep. No. 98-861, at 817 (1984) ("preferred stock carrying a dividend rate materially in excess of a market rate when issued would not be ignored"). An argument might be made that the preferred stock nevertheless participates in corporate growth if the capitalization or operations of the corporation were such that corporate growth would be required in order for the issuing corporation to satisfy its obligations with respect to the preferred stock.[8]

In the section 382 context, the IRS has ruled that preferred stock does not offer a potential significant participation in the growth of a corporation solely because of its dividend rate where the current earnings of the corporation are sufficient to permit the corporation to pay dividends at the highest rate with respect to the stock. **See** Priv. Ltr. Rul. 8945055 (Aug. 16, 1989). The IRS has

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[8] See Michael L. Schler, Money Market Preferred Stock: Making the Punishment Fit the Crime, 46 Tax Notes 935, 939 (1990) (insubstantial common stock capitalization might mean that the preferred stock bears the ~~<downside>~~ **"downside"** risk of the corporate assets ~~<and thus may not constitute>~~**, violating the spirit of** section 1504(a)(4) ~~<stock}>~~).

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

On the date of issue, the annual dividend rate for the preferred stock of Liquids was not materially in excess of the prevailing market rate for preferred stock having similar terms and issued by a corporation having a credit rating similar to that which the issuing corporation would have on the date of issuance if it were rated. The preferred stock of Liquids represented approximately 67 percent of the equity capital of Liquids on the date it was issued. The fair market value of the assets of Liquids will at all times exceed the face amount of such corporation's outstanding debt plus any accrued but unpaid interest plus the liquidation value (including accrued but unpaid dividends) of its preferred stock. All dividends on the Liquids preferred stock will be paid currently. The current earnings and profits and net cash flow of Liquids for each year will each exceed the annual dividend on its preferred stock.

We have found no authority addressing the effect, if any, under section 1504(a)(4) of having a substantial portion of a corporation's capital represented by preferred stock. We understand that the IRS has refused to rule on this issue, suggesting that the IRS might challenge the treatment of such preferred stock.[9] We believe that any such challenge would be based on the participation test, and we further believe that the facts described do not provide any basis for a court to conclude that the preferred stock of Liquids participates in corporate growth to any significant extent. Accordingly, we believe the preferred stock of Liquids is described in section 1504(a)(4).

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

C. <u>Classification of Partnership</u>

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

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

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

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

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

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

An entity that otherwise qualifies as a partnership for federal income tax purposes may nevertheless be subject to taxation as if it were a corporation if it is a publicly traded partnership within the meaning of section 7704. For taxable years of a partnership beginning after December 31, 1995, publicly traded status can be avoided if interests in the partnership are not traded on an established securities market, are offered and sold within the United States and are not registered under the Securities Act of 1933, and if not more than 100 persons own, directly or indirectly through a partnership, a grantor trust, or an S corporation, interests in the partnership. Treas. Reg. <§>§§ 1.7704-1(a)(1)(i), -1(h). None of the interests in Partnership are traded on an established securities market. All of the interests in Partnership were offered and sold within the United States and were issued in transactions that were not required to be registered under the Securities Act of 1933. Less than 100 persons own, directly or indirectly through partnerships, grantor trusts, or S corporations, an interest in Partnership.

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

D. Contributions to OPI and Liquids

1. Section 351

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

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

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

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

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

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

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

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

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

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

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

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

2. Section 357(c)

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

3. Basis Effects

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

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

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

4. Earnings and Profits Effects

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

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

The earnings and profits rules contain a provision that deals with a change in location of a subsidiary within the group. Treas. Reg. § 1.1502-33(f)(2). Under this rule, if the location of a member changes within a group, "appropriate adjustments" must be made to the earnings and profits of the members to prevent the earnings and profits from being eliminated. For example, if P transfers all the stock of S to another member in a section 351 transaction, the transferee's earnings and profits are adjusted immediately after the transfer to reflect the earnings and profits of S immediately before the transfer. Id. Accordingly, we believe the transfer by Enron of all of the common stock of Operations to Liquids should cause all of the earnings and profits of Operations to "tier up" to Liquids.

The earnings and profits rules contain an anti-avoidance rule that provides for adjustments as necessary to carry out the purposes of the rules if any person acts with a principal purpose contrary to the purpose of the rules, to avoid the effect of the rules, or to apply the rules to avoid the effect

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of any other provision of the consolidated return regulations. ~~<Treasury Regulation>~~ **<u>Treas. Reg.</u>** § 1.1502-33(g). The primary earnings and profits effect of the transfer of Operations to Liquids is the duplication of all of Operation's earnings and profits in Liquids.

We believe that the statement of the purpose of the earnings and profits rules (to treat a parent and a subsidiary as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent) is consistent with this effect. The rules cause the earnings and profits of Operations to "tier up" to Liquids, which is a higher-tier member in the Enron group as a result of the contribution of the Operations stock to Liquids. Reflecting the earnings and profits of Operations in Liquids is consistent with treating the Enron consolidated group as a single entity. Accordingly, we do not believe that the earnings and profits anti-avoidance rule should be applicable to the contribution of Operations to Liquids.

E. <u>OPI Contribution to Partnership</u>

1. <u>In General</u>

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

2. <u>Section 707</u>

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

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

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

VI. CONCLUSION

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

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

Sincerely,

KING & SPALDING

By: ______________________
William S. McKee

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

KING & SPALDING

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

DIRECT DIAL:
(202) 626-2908

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July 29, 1997

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

Re: Stock Purchase

Dear Dave:

You have requested our opinion with respect to certain federal income tax consequences of the purchase by Enron Pipeline Company ("Enron Pipeline") of preferred stock of Enron Liquids Holding Corp. ("Liquids") from Enron Leasing Partners, L.P. ("Partnership").

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

I. STATEMENT OF FACTS

Enron directly owns all of the common stock, which is all of the outstanding stock, of each of Enron Pipeline, Enron Capital & Trade Resources Corp. ("ECTR"), Enron Power Corp., and Enron Cayman Leasing, Ltd. ("Enron Cayman"). Enron Power Corp. owns all of the common stock, which is all of the outstanding stock, of Enron Development Corp. ("EDC"). Enron owns all of the

191 PEACHTREE STREET
ATLANTA, GA 30303-1763
TELEPHONE: 404/572-4600
FACSIMILE: 404/572-5100

120 WEST 45TH STREET
NEW YORK, NY 10036-4003
TELEPHONE: 212/556-2100
FACSIMILE: 212/556-2222

1100 LOUISIANA STREET, SUITE 3300
HOUSTON, TX 77002-5219
TELEPHONE: 713/751-3200
FACSIMILE: 713/751-3290

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outstanding common stock of Organizational Partner, Inc. ("OPI"). All of the outstanding shares of Series A preferred stock of OPI are owned by Potomac Capital Investment Corporation ("PCI") and all of the outstanding shares of Series B preferred stock of OPI are owned by EN-BT Delaware, Inc. ("EN-BT"). The common stock of Liquids is owned 80 percent by Enron and 20 percent by OPI. The preferred stock of Liquids is owned by Partnership. OPI is a limited partner in Partnership with a 98 percent interest in capital and profits. EN-BT is a limited partner in Partnership with a one percent interest in capital and profits. Enron Property Management Corp. ("Enron GP"), a wholly-owned subsidiary of Enron Cayman, is the general partner of Partnership with a one percent interest in capital and profits.

As of April 28, 1997 there was outstanding an intercompany indebtedness from ECTR to Enron in an amount in excess of $600 million. This indebtedness was incurred for working capital advances made by Enron to ECTR prior to April 28, 1997 and for obligations of ECTR to third parties that were satisfied on behalf of ECTR by Enron prior to April 28, 1997. As of April 28, 1997, there was outstanding an intercompany indebtedness from EDC to Enron in an amount in excess of $400 million. This indebtedness was incurred for working capital advances made by Enron to EDC prior to April 28, 1997 and for obligations of EDC to third parties that were satisfied on behalf of EDC by Enron prior to April 28, 1997.

On April 29, 1997, ECTR issued to Enron a $600 million note (the "$600 Million ECTR Note") and EDC issued to Enron a $400 million note (the "EDC Note"), in each case reflecting a portion of the existing intercompany debt between the issuer and Enron. At the time of the issuance of the $600 Million ECTR Note, ECTR's assets, liabilities, and anticipated cash flows were such that it would have been commercially reasonable for an unrelated person to lend ECTR $600 million on terms substantially the same as those of the $600 Million ECTR Note. At the time of the issuance of the EDC Note, EDC's assets, liabilities, and anticipated cash flows were such that it would have been commercially reasonable for an unrelated person to lend EDC $400 million on terms substantially the same as those of the EDC Note. On April 29, 1997, Enron contributed the $600 Million ECTR Note and the EDC Note to Enron Pipeline. On May 14, 1997, ECTR issued two notes, one in the principal amount of $198 million (the "$198 Million ECTR Note") and one in the principal amount of $402 million (the "$402 Million ECTR Note"), in amendment and restatement of the $600 Million ECTR Note. Payment by ECTR to Enron Pipeline of interest on the $600 Million ECTR Note for the period from April 29, 1997 to May 14, 1997 was reflected in intercompany accounts in accordance with the usual and customary procedures followed by Enron and its wholly-owned subsidiaries with respect to intercompany debts.

On May 14, 1997, Enron Pipeline purchased 1,980 shares of Liquids preferred stock from Partnership (the "Purchase") in exchange for $198 million (the "Purchase Price") in the form of the $198 Million ECTR Note. At that time, Enron guaranteed the $198 Million ECTR Note.

II. DOCUMENTS EXAMINED

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

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

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

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

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

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

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

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

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

Promissory Note of ECTR, dated April 29, 1997, in the amount of $600 million.

Promissory Note of ECTR, dated May 14, 1997, in the amount of $198 million.

Promissory Note of ECTR, dated May 14, 1997, in the amount of $402 million.

Promissory Note of EDC, dated April 29, 1997, in the amount of $400 million.

Contribution Agreement, dated as of April 29, 1997, by and between Enron and Enron Pipeline ("Enron/Enron Pipeline Contribution Agreement").

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Stock Purchase Agreement, dated as of May 14, 1997, between Partnership and Enron Pipeline ("Purchase Agreement").

Guaranty of Obligations, dated as of May 14, 1997, by Enron in favor of Partnership, relating to the $198 Million ECTR Note.

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

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

III. ASSUMPTIONS

In rendering this opinion, we have relied upon the facts as set forth in the Statement of Facts in Section I above, which you have represented to us are true to the best of your knowledge and belief. In addition, you have consented to our reliance, in rendering this opinion, on the following assumptions:

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

2. The predominant purpose of Enron and its Affiliates for participating in the Purchase was to generate income for financial accounting purposes. The accounting treatment of the Purchase

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

provides Enron and its Affiliates with significant and material benefits. Partnership and the Purchase were structured to achieve this purpose without increasing or decreasing, on a present value basis (determined using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period), the aggregate federal income tax liability of the Enron consolidated group or those Affiliates of Enron that are included on Enron's consolidated financial statements.

3. Neither OPI's nor Partnership's holding period with respect to the stock of Liquids has at any time been subject to reduction under section 246(c)(4).[2] Enron's holding period with respect to the stock of Enron Pipeline has not at any time been subject to reduction under section 246(c)(4).

4. On the date of the Purchase, the terms of the Partnership Agreement were commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree. The Purchase Price was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of the purchased shares of Liquids preferred stock on the date of the Purchase.

5. The terms of any transactions, including any loan, lease, license, or fee for services, between any of OPI, Enron GP, Partnership and members of the Enron consolidated group[3] are commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree.

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

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

[3] As used in this letter, the term "consolidated group" has the same meaning as in the consolidated return regulations. Treas. Reg. § 1.1502-1(h) (a consolidated group is an affiliated group of corporations filing consolidated returns for the tax year). References to the "Enron consolidated group" are to the consolidated group of which Enron is the parent.

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for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Each of the entities listed in the preceding two sentences holds assets having a fair market value of at least $10 million. In addition, each of Enron, Enron Pipeline, ECTR, EDC, Liquids, and OPI has been in existence for at least two years and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons.

7. It is anticipated that Partnership will remain in place for at least five years. While additional stock of Liquids held by Partnership may be sold or redeemed over time, it is anticipated that at least 40 percent of the preferred stock of Liquids will be retained by Partnership for at least two years after March 27, 1997.

8. Enron Pipeline's current and accumulated earnings and profits for the taxable year ending December 31, 1997 will exceed the aggregate amount of the Purchase Price plus any distributions made or deemed made by Enron Pipeline to its shareholders during such year.

9. Enron Pipeline will not, during any 85 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all dividends resulting from such purchases ("Purchase Dividends") were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 85 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 85 day period is greater than 10 percent of the shareholder's basis in such share.

10. Enron Pipeline will not, during any 365 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all Purchase Dividends were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 365 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 365 day period is greater than 20 percent of the shareholder's basis in such share.

11. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using a discount rate that is less than or equal to the after-tax

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weighted average cost of capital of the Enron consolidated group during the relevant period) on the date of the Purchase of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer will equal or exceed the present value (computed using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period) on the date of the Purchase of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Purchase.

12. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the recapitalization of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, the operations and investments of OPI and Partnership, and the Purchase. These transactions are considered to produce a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, if the sum of the present values (computed using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period), on March 20, 1997, of the hypothetical federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, determined as if the transactions had not occurred, exceeds the sum of the present values (computed using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period), on March 20, 1997, of the actual federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates.

13. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Purchase on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any.

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

15. No member of the Enron consolidated group will dispose of any stock of Liquids or Enron Pipeline except to another member of the Enron consolidated group. Neither Enron nor any

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Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Purchase.

16. OPI will have taxable income from nondividend sources that exceeds its deductible expenses.

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

IV. OPINION

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

1. Enron's adjusted basis in the stock of Enron Pipeline should be increased by the aggregate amount of Enron's adjusted basis in the ECTR Note and the EDC Note immediately before Enron's contribution of those notes to Enron Pipeline.

2. Under section 304, the payment by Enron Pipeline to Partnership for the Purchase of the Liquids preferred stock should be treated as a distribution (the "Deemed Distribution") in redemption of the stock of Enron Pipeline for purposes of sections 302 and 303.

3. The Deemed Distribution should be treated as a distribution subject to section 301 and as a dividend under section 301(c)(1).

4. The adjusted basis of the Liquids preferred stock retained by Partnership should be increased by an amount equal to Partnership's adjusted basis in the Liquids stock sold to Enron Pipeline.

5. The adjusted basis of OPI's interest in Partnership should be increased by its distributive share of the Deemed Distribution.

6. OPI should be treated, for purposes of section 243, as having received its distributive share of the Deemed Distribution from Enron Pipeline and should be treated as having satisfied the holding period requirement of section 246(c).

7. Section 246(b) should not limit OPI's section 243 deduction with respect to its distributive share of the Deemed Distribution.

8. It is more likely than not that OPI will be treated as owning 20 percent or more of the stock of Enron Pipeline for purposes of section 243(c)(2).

9. Section 1059 should not be applicable to reduce Partnership's basis in the retained Liquids preferred stock, to reduce OPI's basis in its interest in Partnership, or to trigger gain on the Deemed Distribution.

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

V. LEGAL ANALYSIS

A. Basis of Enron Pipeline Stock

Pursuant to the Enron/Enron Pipeline Contribution Agreement, Enron transferred the $600 Million ECTR Note and the EDC Note to Enron Pipeline on April 29, 1997. Enron did not receive any stock in exchange for its contribution of these assets to Enron Pipeline. Given Enron's ownership of 100 percent of the common stock of Enron Pipeline, the issuance of additional shares of common stock to Enron would have been meaningless. See Commissioner v. Morgan, 288 F.2d 676 (3d Cir. 1961); King v. United States, 79 F.2d 453 (4th Cir. 1935). Under such circumstances, we believe that the federal income tax consequences of the contribution by Enron to Enron Pipeline should be determined as if Enron had received stock of Enron Pipeline in exchange for the contributed assets. See Lessinger v. Commissioner, 85 T.C. 824 (1985), rev'd on other issues, 872 F.2d 519 (2d Cir. 1989); Rev. Rul. 64-155, 1964-1 C.B. 138.

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

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the contribution, Enron owned all of the stock of Enron Pipeline. Accordingly, we believe the contribution by Enron to Enron Pipeline should be treated as a transfer described in section 351.

In general, the basis of stock received by a transferor in a section 351 transaction equals the basis of the property exchanged for such stock, decreased by the amount of any liabilities transferred to the issuing corporation. Sections 358(a)(1), 358(d); Treas. Reg. § 1.358-2(b)(2). In general, the basis of property received by a corporation in exchange for its stock in a section 351 transaction equals the basis of the property in the hands of the transferor immediately before the exchange. Section 362(a).

Accordingly, we believe that (1) Enron's adjusted basis in the common stock of Enron Pipeline should be increased by an amount equal to Enron's aggregate adjusted bases in the $600 Million ECTR Note and the EDC Note immediately before Enron's contribution of those assets to Enron Pipeline and (2) Enron Pipeline's adjusted basis in each of the $600 Million ECTR Note and the EDC Note immediately after the contribution should equal Enron's adjusted basis in each of those assets immediately before the contribution.[4]

B. The Deemed Distribution

1. In General

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

Enron owns all of the outstanding stock of Enron Pipeline. Enron owns in excess of 50 percent of the value of all of the shares of OPI. OPI is a partner in Partnership. Applying the constructive ownership rules of sections 304(c) and 318, Partnership constructively owns all of the outstanding stock of Enron Pipeline that is directly owned by Enron. Sections 304(c)(3), 318(a)(3)(A), 318(a)(3)(C). Similarly, Partnership constructively owns all of the stock of Liquids that is directly owned (whether before or after the Purchase) by Enron, Enron Pipeline, or OPI. Sections 304(c)(3), 318(a)(2)(C), 318(a)(3)(A), 318(a)(3)(C). Accordingly, we believe that

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[4] We believe that the tax consequences should be the same if the transfer were treated as a contribution to capital rather than an exchange for stock. See Sections 118, 362, 1012; Rev. Rul. 83-73, 1983-1 C.B. 84.

Partnership owns, directly or constructively, all of the stock of both Enron Pipeline and Liquids, and therefore controls both of those corporations for purposes of section 304. Absent the application of a rule that overrides section 304, we believe the acquisition of stock of Liquids by Enron Pipeline from Partnership should be subject to section 304(a)(1) and the property transferred from Enron Pipeline to Partnership should be treated as a distribution (the "Deemed Distribution") in redemption of stock of Enron Pipeline.[5]

The determination of whether the Deemed Distribution in redemption of stock of Enron Pipeline is treated as a capital transaction under section 302(b) or as a distribution subject to section 301 is made by reference to the stock of Liquids. Section 304(b)(1). Applying the relevant constructive ownership rules, Enron Pipeline's, Enron's, and OPI's direct ownership of Liquids stock should be attributed to Partnership, with the result that Partnership should be treated as owning all of the stock of Liquids both before and after the Purchase for purposes of applying section 302(b). Sections 304(b)(1), 318(a)(2)(C), 318(a)(3)(A), 318(a)(3)(C). Because Partnership's ownership of Liquids is not diminished by the Purchase, we believe the transaction should be treated as subject to section 301. See Sections 302(b), 302(d); United States v. Davis, 397 U.S. 301 (1970).

Under section 301(c)(1) and section 316, the Deemed Distribution will be treated as a dividend to the extent of the earnings and profits of the distributing corporation. Under section 304, the determination of whether the Deemed Distribution is a dividend is made as if the Deemed Distribution were made by Enron Pipeline to the extent of its earnings and profits, and then by Liquids to the extent of its earnings and profits. Section 304(b)(2). Given current and accumulated earnings and profits of Enron Pipeline for the 1997 taxable year in excess of the aggregate amount of the Purchase Price plus all other actual or deemed distributions by Enron Pipeline in 1997, the full amount of the Purchase Price should be treated as a dividend from Enron Pipeline.

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

2. Consequences of Dividend Treatment

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

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

If Partnership were an actual shareholder of Enron Pipeline, we believe Partnership's basis in its Enron Pipeline stock should be increased by an amount equal to its basis in the Liquids stock deemed contributed to Enron Pipeline. Treas. Reg. § 1.304-2(a). In the absence of any direct ownership of Enron Pipeline stock, it is not entirely clear what happens to the basis of the transferred Liquids stock. See Coyle v. United States, 415 F.2d 488, 493 (4th Cir. 1968) (in dicta, the court noted that increasing the basis of the constructively held stock of the acquiring corporation or increasing the basis of the directly held stock of the issuing corporation would be reasonable solutions to the potential basis allocation problem created by the taxpayer's lack of any direct ownership of the acquiring corporation in a section 304 transaction). Where the transferor retains shares of the transferred corporation, the IRS has adopted the position that the basis of the transferred shares attaches to the basis of the retained shares. Rev. Rul. 71-563, 1971-2 C.B. 175. But cf. Priv. Ltr. Rul. 8710035 (Dec. 9, 1986), revoked by Priv. Ltr. Rul. 9437004 (June 10, 1994) (basis of transferred issuing corporation stock disappears where seller had only constructive ownership of stock of purchaser; no mention of potential for adding basis to the single share of issuing corporation stock retained by the seller). Given the rejection of alternative approaches by either the IRS or the

courts,[6] we believe that Partnership should increase its basis in the retained shares of Liquids stock by the amount of its basis in the Liquids stock deemed contributed to Enron Pipeline in the section 304 transaction.[7]

Finally, we believe that each partner's distributive share of Partnership's dividend income from the Purchase should increase the basis of such partner's interest in Partnership without reduction for

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

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

[7] Legislation has been proposed that would amend section 304(a)(1) to treat Enron Pipeline's purchase of Liquids stock as if Partnership had transferred the Liquids stock to Enron Pipeline in exchange for stock of Enron Pipeline in a section 351(a) transaction and Enron Pipeline had then redeemed the stock issued in the exchange. The effective date of this amendment, as proposed, would be for distributions and acquisitions after June 8, 1997. The fictional issuance of stock created by this amendment may be inconsistent with the positions taken by the IRS in Revenue Ruling 70-496 and Revenue Ruling 71-563. While the Treasury Department explanations of similar proposals by the President state that the amendment would "clarify" the treatment of a section 304 transaction, the committee reports on the pending legislation make no reference to the provision being a clarification. We do not believe that a statement in a Treasury Department explanation of Presidential proposals is effective to revoke outstanding revenue rulings. Accordingly, we do not believe that current law, including the published positions of the IRS, has been changed by the proposal of this legislation.

any dividends received deduction that may be allowable to such partner. Section 705(a)(1)(A) and (B); Treas. Reg. § 1.705-1(a)(2)(ii) (a partner's basis is increased by tax-exempt receipts of the partnership).

3. Substance Over Form Doctrine

The above analysis is based on the form of the Purchase. If the form of the Purchase were not respected, the tax consequences could be different. For the reasons set forth below, we believe that the substance over form doctrine should not apply to adversely affect the conclusions reached in this opinion.

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

a. Separate Taxable Entity

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the Supreme Court established the test for determining whether a corporation will be recognized as a separate taxable entity, stating that "so long as [the purpose for forming the corporation] is the equivalent of a business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Id. at 439. The level of activity necessary to constitute the "carrying on of business" within the meaning of the Moline Properties test appears to be quite minimal.[8] In practice, it seems to require little more than the observance of bookkeeping formalities, maintenance of separate bank accounts, having employees, executing contracts where appropriate, and representing the corporation to third parties as an independent organization. The separate entity tests set forth in Moline Properties have been applied to partnerships. Campbell County State Bank, Inc. v. Commissioner, 37 T.C. 430, 441-42 (1961) (acq.), rev'd on another issue, 311 F.2d 374 (8th Cir. 1963).

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

Each of Enron, Enron Pipeline, ECTR, EDC, Liquids, OPI, and Enron GP will at all times represent itself to third parties as a separate entity in all transactions, observe all corporate and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Partnership will at all time represent itself to third parties as a separate entity in all transactions, observe all partnership and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Each of the entities listed in the preceding two sentences holds assets having a fair market value of at least $10 million. In addition, each of Enron, Enron Pipeline, ECTR, EDC, Liquids, and OPI has been in existence for at least two years and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons. OPI and Enron GP entered into a substantial joint venture (Partnership) with an unrelated person (EN-BT). Partnership has entered into financial transactions with unrelated parties. Transactions with third parties are generally considered sufficient business activity to satisfy the Moline Properties test. For example, obtaining a loan from third parties has been found to be sufficient business activity to prevent taxpayers from disavowing the separate status of a corporation that admittedly served no business purpose. See Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945). Based on the above facts, we believe that each corporation described above and Partnership should be respected as a separate entity for federal income tax purposes.

b. Sham

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

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

Transactions between parent and subsidiary corporations and among other related persons are subject to a heightened level of scrutiny by the IRS and are often the focus of sham transaction attacks. While transactions among related corporations often are suspect, they are not *per se* subject to recharacterization under the sham transaction doctrine. Indeed, the consolidated return regulations promulgated under section 1502 set forth myriad rules prescribing the treatment to be accorded transactions among members of a consolidated group. Such transactions may result in items of income, deduction, gain, or loss being eliminated, deferred, or disallowed, but such items are not disregarded on the basis that they arise from sham transactions.

In order to fail the business purpose portion of the sham test in Rice's Toyota World, a taxpayer can have no motive other than tax purposes. The predominant purpose for the Purchase is to generate income for financial accounting purposes. This effect of the Purchase provides Enron and its Affiliates with significant and material benefits. The formation and capitalization of Partnership and the Purchase were structured to achieve the desired accounting benefits without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements.

Improving a company's balance sheet has been recognized as a valid business purpose. See Lyon, 435 U.S. at 577-78 (effect of debt on company's balance sheet has "distinct element of economic reality"); Newman v. Commissioner, 902 F.2d 159, 163 (2d Cir. 1990) (business purposes in entering into operating agreement rather than lease for balance sheet purposes); Priv. Ltr. Rul. 9017061 (Jan. 31, 1990) (improvement of balance sheet for company's lenders is business purpose for section 355); Tech. Adv. Mem. 8803001 (Sept. 29, 1987) (movement of assets from non-member to member corporation of affiliated group to improve consolidated balance sheet is business purpose for section 368(a)(1)(C)), revoked by Tech. Adv. Mem. 8941004 (July 11, 1989) (based on insufficiency of facts submitted at time of examination). While the accounting benefits in the instant case are derivative of the tax consequences of the Purchase, we believe that the purpose to obtain accounting benefits without either increasing or decreasing tax liability on a present value basis should be sufficient to satisfy the business purpose portion of the sham test in Rice's Toyota World.

The economic substance test depends upon all of the facts and circumstances. Following the Purchase, 1,980 shares of Liquids preferred stock is held by Enron Pipeline and Partnership holds the $198 Million ECTR Note. The economics to Partnership and its partners, including EN-BT will reflect this change in the assets owned by Partnership. We believe that this shift in investments should be sufficient to satisfy the economic substance portion of the test.

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c. Transitory Ownership

The IRS might argue, given the short period of time that Partnership owned the Liquids preferred stock that was acquired by Enron Pipeline in the Purchase, that Partnership's ownership of such shares should be disregarded. Presumably, in order to account for the actual positions of the parties, such an argument would rely on a recharacterization of the transactions relating to the recapitalizations of Liquids and OPI on March 21, 1997, the capitalization of Partnership on March 27, 1997, and the Purchase as follows: (1) an acquisition by Enron of the Liquids preferred stock from Liquids in exchange for the note of Houston Pipe Line Company, dated as of March 21, 1997 (the "Houston Pipe Note"); (2) a sale by Enron of 1,980 shares of Liquids preferred stock to Enron Pipeline for the $198 Million ECTR Note; (3) a contribution by Enron of the $198 Million ECTR Note and the remaining shares of Liquids preferred stock to OPI; and (4) a contribution of the $198 Million ECTR Note and the Liquids preferred stock by OPI to Partnership.

We believe an attempt to recharacterize the transactions in such a manner should not succeed. Such a recharacterization would reorder, but not reduce the number of, the steps relative to the transaction as actually structured. Where two different routes are equally consistent with the substance of the transactions, produce the equivalent end result, and have the same number of steps, the courts have generally rejected attempts to substitute hypothetically equivalent steps for the steps actually taken in the absence of an inconsistency between the tax consequences of the form of the transaction and the policy underlying the applicable statutory provision. See Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989), and cases cited therein. Moreover, in the instant case, a reordering of the steps would not duplicate the economics of the transactions as structured, because the ownership of all of the Liquids preferred shares by Partnership gave EN-BT (as a partner in Partnership) and EN-BT and PCI (as shareholders of OPI) an interest in the benefits and burdens of ownership of all of that stock, albeit for a short period of time.

The IRS has taken the position that a reordering of steps is appropriate under some circumstances. See Rev. Rul. 91-47, 1991-2 C.B. 16 (substance of transaction, which would be reflected in reordered steps, controls to prevent avoidance and carry out the clear policy underlying enactment of section 108(e)(4)); Rev. Rul. 87-66, 1987-2 C.B. 168 (contribution of foreign corporation's stock to a domestic corporation followed by liquidation of the foreign corporation treated as transfer of foreign corporation's assets to domestic corporation followed by liquidation of foreign corporation for purposes of applying section 897 to transactions; in a letter to a lawyer who criticized the ruling, then Associate Chief Counsel D. Kevin Dolan defended the effects of the resequencing based on the policy of Congress to impose recognition unless there is basis preservation in the interest subject to taxation under section 897(a)); Priv. Ltr. Rul. 8823056 (Mar. 10, 1988) (reordering of successive section 351 steps, apparently at the request of, or possibly without the

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objection of, the taxpayer); Priv. Ltr. Rul. 8351136 (Sept. 23, 1983) (same). Thus it appears that, where there is a policy justification for resequencing steps, or where the taxpayer consents to the resequencing, the IRS considers the creation of steps that never took place to be permissible.

In the instant case, respecting the steps as actually undertaken does not appear to violate any clear principle of tax policy. Gain or loss, if any, to Enron on a sale of Liquids stock to Enron Pipeline would be deferred under the consolidated return regulations, and would remain deferred following a contribution of the $198 Million ECTR Note by Enron to OPI. Treas. Reg. §§ 1.1502-13, -80(b). In contrast, the Purchase generates a tax liability on the resulting section 304 dividend and increased bases in the Liquids stock retained by Partnership and in the interests of the partners in Partnership. As discussed below, we do not believe these results, under the facts of the instant case, should be considered to be inconsistent with the principles established in the consolidated return regulations, with the principles of subchapter K, or with the objectives of section 1059. Accordingly, we believe the transactions as structured should not be considered to violate any clear tax policy principles and should not be resequenced to produce a different tax result from that of the actual transactions.

4. Consolidated Return Regulations

The consolidated return regulations, in some circumstances, may alter what would otherwise be the tax consequences of a transaction where the transaction involves one or more members of a consolidated group. For the reasons set forth below, we believe that the consolidated return regulations should not apply to adversely affect the conclusions reached in this opinion.

a. Inapplicability of Section 304 Within a Consolidated Group

Treasury Regulation § 1.1502-80(b) provides that section 304 does not apply to the acquisition of a corporation's stock in an intercompany transaction occurring on or after July 24, 1991. A sale of Liquids stock from Enron to Enron Pipeline would be an intercompany transaction and therefore would not be subject to section 304. A sale between Partnership and Enron Pipeline, however, is not an intercompany transaction because Partnership is not a member of the Enron consolidated group.[9] We do not believe the principles underlying Treasury Regulation § 1.1502-80(b) have any application to transactions that actually occur between persons who are not members of the same consolidated group.

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[9] Even if Partnership were treated, under Treasury Regulation § 1.701-2(e), as an aggregate rather than an entity for purposes of applying Treasury Regulation § 1.1502-80(b), Treasury Regulation § 1.1502-80(b) should not be applicable because none of OPI, Enron GP, and EN-BT should be a member of the Enron consolidated group.

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The rule of Treasury Regulation § 1.1502-80(b) was adopted as "the simplest way to implement the purposes of section 304(b)(4) for a consolidated group. . . ." T.D. 8402, 1992-1 C.B. 302, 303. Section 304(b)(4) requires that "proper adjustments" be made to the adjusted basis of stock of a member of an affiliated group that is held by the group, and to the earnings and profits of members of the group, to the extent necessary to carry out the purposes of the section. Section 304(b)(4) was adopted to prevent the use of section 304 transactions within an affiliated group to shift built-in gain within the group, allowing the disposition of appreciated stock of a subsidiary outside the group without the payment of the corporate level tax on the appreciation. See H.R. Conf. Rep. No. 100-495, at 969-70 (1987); H.R. Rep. No. 100-391, pt. 2, at 1084 (1987). Where stock is never held by a member of the affiliated group, the concerns addressed by section 304(b)(4) would not appear to be present. Accordingly, we do not believe the issuance of the Liquids preferred stock to OPI and the contribution of such stock to Partnership followed by the sale of some of the Liquids preferred stock to Enron Pipeline subject to section 304 should be considered inconsistent with the principles underlying Treasury Regulation § 1.1502-80(b).

b. Intercompany Transaction Rules

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

The intercompany transaction anti-avoidance rule of Treasury Regulation § 1.1502-13(h) provides as follows: "If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section." The purpose of the intercompany transaction rules is "to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)." Treas. Reg. § 1.1502-13(a)(1). The examples under the intercompany transaction anti-avoidance rule provide the only available guidance on the types of transactions that have a principal purpose to avoid the purposes of the intercompany transaction rules. Treas. Reg. § 1.1502-13(h)(2). These examples suggest that a transaction may be considered to avoid the purposes of the intercompany transaction rules if it (i) invokes or avoids the effects of those rules, either by interposing an unnecessary intercompany transaction or by avoiding an equivalent and more direct intercompany transaction, for the purpose of altering the consolidated taxable income or consolidated tax liability of the group as

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compared to an equivalent alternative transaction (Examples 1, 3, 4) or (ii) is structured to affirmatively use the intercompany transaction rules for the purpose of altering the taxable income of a nonmember and the relationship between the transaction and consolidated taxable income or consolidated tax liability is artificially created (Example 2). See also Prop. Treas. Reg. § 1.1502-13(h)(2) *Example 2* (1994) (proposed example deleted in final regulations; would have applied anti-avoidance rule to transaction that did not involve an intercompany transaction and that did not avoid a more direct intercompany transaction).

Even if, despite the economic differences, the acquisition of the Liquids stock by OPI and Partnership followed by the sale of the Liquids stock to Enron Pipeline were viewed as an indirect route adopted to avoid an intercompany transaction in which Enron invests in the Liquids preferred stock, Enron Pipeline purchases a portion of such stock from Enron, and the $198 Million ECTR Note and the remaining Liquids preferred stock are contributed to OPI and then to Partnership, the transactions as structured do not, under the facts as we understand them, alter the consolidated taxable income or consolidated tax liability of the Enron consolidated group as compared to an intercompany sale between Enron and Enron Pipeline. Where no member of the Enron consolidated group disposes of stock of Liquids or Enron Pipeline outside the group and no action is taken to utilize high basis in the stock of Liquids or Enron Pipeline that may result from the Purchase, the taxable income and tax liability of the consolidated group should not be affected by the investment in the Liquids preferred stock and the Purchase of a portion of such stock by Enron Pipeline, without regard to whether it is Enron or OPI that makes the investment or whether it is Enron or Partnership that is the seller of the shares.

The issuance of preferred stock by Liquids in exchange for the Houston Pipe Note should not be a taxable event, whether the investment is made by Enron or OPI. Under the transactions as structured, the section 304 dividend by Enron Pipeline does not affect the group's taxable income or tax liability, and Enron Pipeline takes the Liquids stock with a carryover basis. Under the intercompany transaction alternative, Enron's gain or loss, if any, on the sale of Liquids stock directly to Enron Pipeline would be deferred under the intercompany transaction rules. No member of the Enron consolidated group will dispose of any stock of Liquids or Enron Pipeline except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. Although the reduction in Enron Pipeline's earnings and profits attributable to the section 304 dividend may prevent subsequent distributions by Enron Pipeline to Enron from constituting dividends, these dividends would be eliminated in the consolidated return, and thus would not affect taxable income. We believe that, under these facts, there should be no difference in the tax liability or taxable income of the Enron

consolidated group resulting from the Purchase and resulting from a hypothetical intercompany transaction in which Enron invests directly in Liquids preferred stock and then sells a portion of such stock to Enron Pipeline.

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

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

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

Treasury Regulation § 1.1502-33 contains rules (the "earnings and profits rules") for adjusting the earnings and profits of members of the group where one member owns stock of another member. These rules may require adjustments to the earnings and profits of members of the Enron consolidated group in connection with the Purchase. We have not analyzed the specific earnings and profits

adjustments that would be required under these rules. We have, however, considered whether the earnings and profits effects of the Purchase could trigger the application of the anti-avoidance rule contained in the earnings and profits rules.

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

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

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

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

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

Enron consolidated group. Accordingly, we believe the earnings and profits adjustments required by the transactions considered herein should not be considered to produce a result that is contrary to the purpose of the earnings and profits rules or that avoids the effect of the earnings and profits rules or any other provision of the consolidated return regulations.

d. Investment Adjustment Rules

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

As discussed above, the IRS has consistently taken the position that basis adjustments attributable to the deemed distributions and contributions resulting from a section 304 transaction are made with respect to stock held directly by the taxpayer receiving the deemed distribution or making the deemed contribution, but not with respect to stock that is held constructively by such taxpayer. See Rev. Rul. 71-563, 1971-2 C.B. 175; Rev. Rul. 70-496, 1970-2 C.B. 74. Based on this authority, we believe that distributions and contributions that are deemed to occur under section 304 with respect to stock that is constructively held by a taxpayer should not be treated as being made through the shareholder from whom ownership is attributed (the "direct" shareholder) for purposes of determining the federal tax effects of such deemed transactions on the direct shareholder. Accordingly, we believe Enron should not be treated as having either received a distribution from or made a contribution to Enron Pipeline in connection with the Purchase for purposes of applying the investment adjustment rules (or other applicable basis rules of the Code).

We have not analyzed the specific earnings and profits adjustments that would be required under the investment adjustment rules. We have, however, considered whether the basis effects of the Purchase could trigger the application of the anti-avoidance rule contained in the investment adjustment rules. This anti-avoidance rule calls for adjustments to be made to carry out the purpose of the investment adjustment rules if a person acts "with a principal purpose which is contrary to the purpose of [the investment adjustment rules], to avoid the effect of [the investment adjustment rules], or to apply [the investment adjustment rules] to avoid the effect of any other provision of the consolidated return regulations." Treas. Reg. § 1.1502-32(e)(1). The purpose of the investment

adjustment rules is to treat the shareholder/member and the subsidiary as a single entity so that consolidated taxable income reflects the group's income. Treas. Reg. § 1.1502-32(a)(1).

The examples under the investment adjustment anti-avoidance rule suggest that it is applicable where stock ownership or affiliated status is manipulated in order either to obtain the benefits of positive investment adjustments without bearing the burden of corresponding negative investment adjustments (Examples 1, 4, 5) or to shift basis among group members or among classes of stock, thereby reducing gain recognition on an anticipated sale (Examples 2, 3). Treas. Reg. § 1.1502-32(e)(2) *Examples 1-5*. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Purchase on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any. No member of the Enron consolidated group will dispose of any stock of Liquids or Enron Pipeline except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. Based on these facts, we believe that neither Enron nor any of its Affiliates should be considered to have a principal purpose which is contrary to the purposes of the investment adjustment rules, to avoid the effect of the investment adjustment rules, or to apply the investment adjustment rules to avoid the effect of any other provision of the consolidated return regulations.

C. Dividends Received Deduction

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

1. Receipt of Dividend from a Domestic Corporation

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

for purposes of section 243, as having received its distributive share of a partnership's dividend income directly from the source from which the partnership received the dividend.

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

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

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

2. <u>Section 246(c)</u>

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

Implicit in the provisions of section 702, which contemplate that a partner may be entitled to a dividends received deduction with respect to dividends received by a partnership, is that the holding period requirements of section 246(c)(1) can be satisfied with respect to stock that a corporation

owns indirectly through a partnership. It is unclear whether this holding period requirement should be applied at the partner or the partnership level. Treating a partnership as an entity, it would appear to be the holding period of the partnership in the stock that should be taken into account. Treating a partnership as an aggregate, it would appear that the holding period of the partner with respect to its interest in the partnership also should be taken into account. Cf. Treas. Reg. § 1.856-3(g) (real estate investment trust deemed to own its proportionate share of assets of partnership in which it is a partner; holding period with respect to sale of property by partnership is shorter of partnership's holding period in asset or partner's holding period in partnership interest); Priv. Ltr. Rul. 9615004 (Dec. 19, 1995) (extending aggregate treatment prescribed by statute for purposes of section 851(b)(2) to determine satisfaction by regulated investment company of section 854 requirements relating to sections 243, 246, and 246A; holds regulated investment company will be deemed to hold its proportionate share of assets of a partnership for the period that the partnership held the assets or for the period the regulated investment company has held its interest in the partnership, whichever is shorter).

In addition to the lack of certainty as to how the holding period requirement of section 246(c) is applied to a dividend received through a partnership, in the context of a section 304 transaction involving constructive ownership, the identity of the stock on which the dividend is paid is not clear. In the instant case, prior to the Purchase, Enron had a holding period in the common stock of Enron Pipeline and Liquids, OPI had a holding period in the common stock of Liquids, Partnership had a holding period in the preferred stock of Liquids, and each partner had a holding period in its interest in Partnership in excess of the 45 days required by section 246(c)(1). Accordingly, whether one looks to the holding period of the stock of the acquiring corporation (Enron Pipeline) or to the holding period of the stock of the issuing corporation (Liquids), whether one considers directly held stock or constructively held stock, and whether or not one takes into account the holding period of the partners in their partnership interests, we believe the holding period requirement of section 246(c)(1) should be satisfied.

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

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

3. Section 246(b)

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

4. Section 243(c)

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

With respect to the issue of whether a partner should be treated as owning stock owned by a partnership, the IRS has taken the position that ownership through a partnership is ownership for purposes of the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation. See Rev. Rul. 71-141, 1971-1 C.B. 211 (allowing section 902 credit to partners who hold 20 percent interests, indirectly through a partnership, in foreign corporation); T.D. 8708, 1997-10 I.R.B. 14 (amending Treasury Regulation § 1.902-1(a)(1) to change the definition of a domestic shareholder from one that "owns directly" the requisite stock to one that "owns" such stock). Based on this authority, we believe that it is more likely than not that, for purposes of section 243(c), OPI will be treated as owning 98 percent (its share of profits and capital) of any stock that Partnership is treated as owning.

With respect to the issue of whether constructively held stock will be taken into account in determining ownership of the payor corporation in a section 304 transaction, we again look to the statement in the legislative history of the 1984 amendment to section 304 that any dividends received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made

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directly by the acquiring corporation (to the extent of its earnings and profits) The IRS has cited this legislative history in ruling that a section 304(a)(1) dividend qualifies for the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation, even though the transferor corporation did not own directly any stock in the acquiring corporation. Rev. Rul. 92-86, 1992-2 C.B. 199. Of particular importance is the fact that section 902, like section 246(c), does not invoke the constructive ownership provisions of section 318. See First Chicago Corporation v. Commissioner, 96 T.C. 421 (1991) (corporation not allowed to aggregate its ownership with that of its affiliated members so as to meet the requisite ownership of section 902); Rev. Rul. 85-3, 1985-1 C.B. 222 (section 902 does not allow indirect ownership through subsidiaries to satisfy the section 902 ownership requirement). Nevertheless, Revenue Ruling 92-86 explicitly holds that the transferor corporation's constructive ownership as determined under section 304(c) is counted for purposes of determining the existence and amount of direct ownership under section 902. Based on the legislative history of section 304 and the IRS's position in Revenue Ruling 92-86, we believe that Partnership should be treated as "owning" the stock of Enron Pipeline that it constructively owns for purposes of section 304.

D. Section 1059

Section 1059 provides for the reduction (but not below zero) of a corporation's basis in stock by the amount of the dividends received deduction allowable with respect to certain "extraordinary" dividends received with respect to such stock. Extraordinary dividends that trigger the application of section 1059 include (i) a dividend that equals or exceeds 10 percent of the corporation's adjusted basis in the stock of the payor and that is received on stock that the corporation has not held for more than two years before the dividend announcement date or (ii) any amount treated as a dividend in the case of any redemption of stock which is non pro rata as to all shareholders. Sections 1059(a)(1), 1059(e)(1). The reduction occurs immediately before any sale or disposition of the stock. Section 1059(d)(1). Any excess of the dividends received deduction over the basis of the stock is treated as gain upon disposition of the stock. Section 1059(a)(2). The IRS takes the position, and we assume for purposes of this discussion, that a partnership is treated as an aggregate for purposes of applying section 1059, with each partner treated as owning its share of the stock owned by the partnership. Treas. Reg. § 1.701-2(f) *Example 2*. The discussion refers to Partnership and the application of section 1059 to Partnership, with the understanding that the dividends received deduction that causes a portion of the dividend to be nontaxable is that of its partners.

While Treasury has been given broad regulatory authority by section 1059(g), to date there have been no regulations or other administrative authorities addressing the application of section 1059 to a section 304 transaction. The difficulties in determining whether section 1059 should be applied in the instant case arise from the fact that Partnership does not own directly any stock of the payor of the dividend, Enron Pipeline. Section 1059 assumes that the recipient of a dividend owns stock

of the payor with a basis and holding period that can be referenced to determine whether the dividend is extraordinary and with a basis that could be reduced if the dividend is extraordinary.

Pending legislation includes a proposal that would treat a section 304(a)(1) transaction as if (1) the seller had transferred the stock of the issuing corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation then redeemed the shares it was treated as issuing. Under this fiction, the acquiring corporation is treated for all purposes (including basis determinations and the application of section 1059) as redeeming the stock issued to the selling corporation. The legislation also proposes to amend section 1059 so that a section 304 dividend would be treated as an extraordinary dividend (without regard to the holding period of the stock of the payor or the amount of the dividend) and that only the basis of the transferred shares would be taken into account for purposes of section 1059.

The committee reports relating to the proposed legislation explain that the concerns addressed by section 304:

> are most relevant where the shareholder is an individual. Different concerns may be present if the shareholder is a corporation, due in part to the presence of the dividends received deduction. . . . [I]n some situations where the selling corporation does not own any stock of the acquiring corporation before or after the transaction (except by attribution), it is possible that current law may lead to inappropriate results.
>
> As one example, in certain related party sales, the selling corporation may take the position that its basis in any shares of stock it may have retained (or possibly any shares of the acquiring corporation it may own) need not be reduced by the amount of the dividends received deduction. This can result in an inappropriate shifting of basis.

H.R. Rep. No. 105-148, at 465 (1997); S. Rep. No. 105-33, at 143 (1997).

We believe that the proposed legislation reflects (1) a change in view of the proper application of the policies of section 304 in the context of corporate sellers, (2) a change in view of the proper manner for applying section 1059 in the context of a section 304 transaction, and (3) a change in the view of appropriate shares to look to in making basis adjustments under section 1059. We believe that the law relating to the interaction of sections 304 and 1059 prior to the effective date of the pending proposals, if and when they are enacted, should be determined by reference to the policies of sections 304 and 1059 as reflected in their past legislative histories, and should not be influenced by the changes of view reflected in the proposed legislation. Furthermore, in the absence of any direct ownership by the seller of stock of the acquiring corporation in a section 304 transaction, we

believe that it is questionable whether section 1059 is applicable. Nevertheless, in the absence of any clear authority on the issue of whether section 1059 can be applied in such a situation, we have analyzed the issue of how the extraordinary dividend determination might be made if section 1059 were applicable.

1. Pro Rata Redemption

A threshold question in the case of a redemption of stock is whether the redemption is pro rata as to all shareholders. No guidance has been issued on the meaning of "pro rata" for these purposes. The application of section 304, and the resulting deemed redemption of stock of Enron Pipeline from Partnership, is based on Partnership's constructive ownership of all of the stock of Enron Pipeline. Where the only ownership by a taxpayer of stock of the redeeming corporation is constructive, we believe the "non pro rata" test of section 1059(e) should be applied by reference to this same constructive ownership.

In other contexts, a redemption from a shareholder that owns 100 percent of the stock of a corporation by attribution is treated as being pro rata. See United States v. Davis, 397 U.S. 301 (1970) (application of attribution rules make 25 percent shareholder a 100 percent shareholder; treated as "sole shareholder" for purposes of section 302; Congress clearly mandated that pro rata distributions be treated under rules of section 301 rather than under section 302; redemption was essentially equivalent to a dividend); Rev. Rul. 81-289, 1981-2 C.B. 82 (describing the distribution in Davis as "precisely pro rata"). Based on Partnership's constructive ownership of 100 percent of all of the stock of Enron Pipeline, we believe Partnership should be viewed as the sole shareholder of Enron Pipeline for purposes of testing whether a deemed redemption from Partnership of stock of Enron Pipeline is "pro rata as to all shareholders." Accordingly, we believe the deemed redemption of Enron Pipeline stock from Partnership should be treated as pro rata for purposes of section 1059(e).

2. Two-Year Holding Period

Where a redemption is pro rata, a second threshold question for application of section 1059 is whether the stock with respect to which the dividend is received has been held by the corporation for more than two years. For this purpose, the holding period of stock is determined under rules similar to the rules of sections 246(c)(3) and 246(c)(4). Section 1059(d)(3). For the reasons discussed below, we believe it is the holding period in the Enron Pipeline stock that should be relevant in applying section 1059. Accordingly, we believe that to the extent that, on the date of the Purchase, Enron had a holding period in excess of two years with respect to the stock of Enron Pipeline, section 1059 should not be applicable.

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Enron Pipeline is the corporation that is treated as redeeming its stock under section 304(a)(1) and as the payor of the section 304 dividend under section 304(b)(2)(A). The legislative history of section 1059 states that "if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to stock of the shareholder which is not redeemed." H.R. Conf. Rep. No. 98-861, at 817 (1984). Accordingly, we believe the stock with respect to which the Deemed Distribution is made should be stock of Enron Pipeline that is owned by Partnership and that remains outstanding after the transaction. Where a taxpayer does not directly own any stock of the redeeming corporation, we believe that the holding period test of section 1059 should be applied by looking to the holding period of stock that is constructively held by the taxpayer.

We believe that looking to the holding period of the Enron Pipeline stock in applying the threshold rules of section 1059 is consistent with the purpose of section 304 to ensure that Code provisions relating to dividend treatment of direct redemptions are not circumvented through the use of indirect redemptions. It is the common ownership by Enron of Enron Pipeline and Liquids that results in the application of section 304, and it is the earnings and profits of Enron Pipeline that support the dividend characterization of the deemed redemption. Under these facts, we believe that the direct redemption, the tax consequences of which section 304 is intended to mimic, should be considered to be a redemption by Enron Pipeline of its stock from Enron. If Enron Pipeline had redeemed a portion of its stock directly from Enron, section 1059 would not have been applicable to the extent that Enron's holding period in the stock of Enron Pipeline exceeded two years. Similarly, in a purchase by Enron Pipeline of Liquids stock directly from Enron, we believe it would be the holding period in the stock of Enron Pipeline that would be considered relevant for purposes of determining whether section 1059 would be applicable to such a transaction.

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

stock, the literal language of section 1059 should yield to the underlying purpose of the statute to prevent tax arbitrage and section 1059 should be applicable.

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

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

Initially X, a corporation unrelated to Parent, owns all 100 outstanding shares of Acquiring;

At the beginning of Year 1, Parent purchases 75 shares of the stock of Acquiring from X for their fair market value of $75;[10]

During Years 1 through 3, Acquiring accumulates $20 of earnings and profits and the fair market value of Parent's 75 shares of Acquiring's stock increases to $90;

At the end of Year 3, Parent purchases 75 shares of the 100 outstanding shares of Issuing from an unrelated party for their fair market value of $75.

At the beginning of Year 4, Acquiring does one of the following three things:

(i) pays a dividend of $20 pro rata to Parent and X;

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

(ii) redeems $20 worth of its stock pro rata from Parent and X; or

(iii) purchases 15 shares of Issuing stock from Parent for their fair market value of $15 (i.e., the value of the Issuing stock has not changed since the purchase by Parent).

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

The economics of the third transaction above (the paradigm section 304 transaction) are different from those of the direct dividend and the direct redemptions. In the paradigm section 304 transaction, the overall value of Acquiring and the relative interests of Parent and X in Acquiring are unchanged. There is no net reduction in the value of Parent's 75 shares of Acquiring, but the basis of those shares is increased by the deemed capital contribution of the Issuing shares with a $15 basis. As a result, Parent holds 75 shares of Acquiring with a value and basis of $90. As with the direct dividend and the direct redemption transactions discussed above, the paradigm section 304 transaction does not create any potential tax loss for Parent where the value of the earnings and profits on which the dividend characterization of the section 304 deemed redemption is based is not reflected in Parent's basis before the transaction. Consistent with the absence of any potential for tax arbitrage at which section 1059 is directed, the threshold requirement of section 1059 of a holding period of two years or less would not be met based on Parent's two-year holding period in its 75 shares of Acquiring stock.[11]

Given that none of what might be considered economically equivalent transactions (a direct dividend distribution from Enron Pipeline to Enron, a direct redemption of Enron Pipeline stock from Enron, and the dividend portion of a section 304 transaction in which Enron Pipeline purchases stock of Liquids from Enron (with no affiliation among the parties)) would be subject to section 1059 to the extent that Enron had a holding period of more than two years in the Enron Pipeline stock, and that none of those transactions appears to violate the spirit of section 1059, we believe a court should not consider the holding period of tne retained Liquids stock to be relevant to the application of

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[11] Some redemption from X might be required to avoid section 1059(e)(1)(B), which overrides the two-year threshold requirement in the case of non pro rata redemptions. It is unclear how one would determine whether a section 304 deemed redemption is pro rata for purposes of section 1059(e).

section 1059 to the Purchase. Rather, we believe a court should recognize that the distortions between basis and value created in the retained Liquids stock are attributable to the fictions created by section 304 and section 318 in which there is a deemed capital contribution to a corporation in which the contributor has no direct ownership.[12]

Congress viewed acquisitions of stock in anticipation of the payment of an extraordinary dividend as the acquisition of two assets: the right to distributions to be made with respect to the stock and the underlying stock itself. In such cases, Congress concluded that it was appropriate to reduce the basis of the underlying stock to reflect the value of the distribution that was not taxed to a corporate distributee. See H.R. Rep. No. 98-432, pt. 2, at 1186 (1984); S. Prt. No. 98-169, vol. I, at 172 (1984).

Congress used objective rather than subjective criteria to identify transactions that were appropriately treated as "two asset" acquisitions (i.e., those acquisitions in which a portion of the basis of the shareholder is attributable to the value of an anticipated distribution). The statute provides a dual test for its application, requiring both a holding period of two years or less as of the dividend announcement date (presumably as an indication that the dividend might have been

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[12] In the event that, contrary to our conclusion above, a court were to accept the IRS's argument that it is appropriate to apply section 1059 to the Purchase, two approaches to a liberal application of section 1059 might be suggested by the IRS, consistent with the positions it has adopted in Revenue Rulings 70-496 and 71-563. The IRS might argue that section 1059 should be applied to reduce the basis of the Liquids stock retained by Partnership (which was increased by the basis of the Liquids stock transferred to Enron Pipeline) with a corresponding reduction in the bases of the partners' interests in Partnership. Alternatively, the IRS might argue that, while basis reductions cannot be made in constructively held stock, the section 1059 consequences of an extraordinary dividend could be visited on the constructive owner/dividend recipient by treating the nontaxed portion of an extraordinary dividend as an amount that did not reduce basis by reason of the limitation on reducing basis below zero. Section 1059(a)(2).

Of these two approaches, we believe the reduction of basis in the retained Liquids stock should be more appealing to a court, because it does not require the application of any further fictions. If and when the Liquids stock is disposed of, the basis adjustment would be triggered. The section 1059(a)(2) approach, under existing law, would require expansion of the nonliteral interpretation of section 1059 and the fictions of section 304 to identify a disposition of stock that would trigger gain under section 1059(a)(2). While the IRS might argue that the fictionally redeemed stock of Enron Pipeline is owned by Partnership (with a zero basis) and is disposed of in the section 304 deemed redemption, such an approach would be inconsistent with the view of the courts that the fictions created by section 304 "do not change the reality that . . . stock is not actually redeemed." Broadview Lumber Co., 561 F.2d at 702 (quoting Webb v. Commissioner, 67 T.C. 293, 307 (1976), aff'd, 572 F.2d 135 (5th Cir. 1978)). Moreover, we believe a court should consider triggering gain recognition at the time of the section 304 transaction, based on a deemed disposition of fictional stock having a zero basis, as being inconsistent with the purposes of section 1059. Section 1059 was enacted to deal with the potential for tax arbitrage based on the differing treatment of dividend income and capital losses on the sale of stock. No loss could ever be recognized on the deemed disposition of fictional zero basis stock.

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anticipated at the time of the acquisition and thus reflected as a separate asset in the acquisition transaction) and a dividend in excess of a specified percentage of the basis in the stock (presumably to exclude regular dividends, the tax arbitrage potential of which is addressed by section 246(c)). Subject to certain express statutory exceptions, where the objective two-year holding period requirement is not met, the statute does not apply, regardless of whether the shareholder in fact anticipated an extraordinary dividend or whether the value of an extraordinary dividend is in fact reflected in the shareholder's basis in the stock. In effect, there is an irrebuttable presumption that the distortion between basis and economics created by a dividend distribution and addressed by section 1059 is not present where a shareholder has a holding period in excess of two years as of the dividend announcement date.

We believe the holding period threshold in section 1059 serves as an objective substitute for an inquiry into whether an extraordinary dividend distribution is made with respect to stock having a basis that reflects the value of the earnings and profits that fund the extraordinary dividend. We believe that it is consistent with the purposes of section 1059 to look to the holding period in the stock of the corporation having the earnings and profits that fund a dividend to determine whether the two-year threshold of section 1059 is satisfied. Accordingly, we believe that to the extent that, on the date of the Purchase, Enron had a holding period of more than two years with respect to the stock of Enron Pipeline, section 1059 should not be applicable to the Purchase.

3. Threshold Percentage

The IRS might argue that the relevant holding period for Partnership is the shorter of the period for which it has constructively owned Enron Pipeline stock and Enron's holding period in the Enron Pipeline stock. We believe that the period of constructive ownership by Partnership of Enron Pipeline stock should not be considered relevant for the purposes of applying section 1059. Accordingly, we believe such an argument should be rejected by a court. If such an argument were, nevertheless, accepted, or if Enron did not have a holding period in excess of two years in the stock (or some portion of the stock) of Enron Pipeline on the date of the Purchase, then the characterization of the dividend resulting from the Purchase as extraordinary would become significant.

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

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Enron Pipeline will not, during any 85 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all Purchase Dividends were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 85 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 85 day period is greater than 10 percent of the shareholder's basis in such share. Enron Pipeline will not, during any 365 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all Purchase Dividends were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 365 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 365 day period is greater than 20 percent of the shareholder's basis in such share. Based on these facts, we believe a dividend attributable to the Purchase and deemed made with respect to stock of Enron Pipeline should not be treated as exceeding the threshold percentage.[13]

E. <u>Section 269</u>

Under certain circumstances, section 269 may alter what would otherwise be the tax consequences of a transaction. For the reasons set forth below, we believe section 269 should not apply to adversely affect the conclusions reached in this opinion.

Section 269 applies to the acquisition of control of a corporation or the acquisition of property from a corporation (other than a subsidiary or a sister corporation) with a carryover basis when the principal purpose of such acquisition is the "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which . . . would not otherwise [be]

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[13] The IRS might argue that the threshold tests of section 1059 should be applied by reference to the retained stock of the issuing corporation (Liquids) where that is the only stock that the dividend recipient (Partnership) owns directly. In support of such a position, the IRS might point to the fact that the determination of whether the redemption is a sale or exchange is made by reference to the ownership of stock of the issuing corporation, without regard to the identity of the corporation that is deemed to have made the redemption or to have paid the dividend, and that the basis attributable to the deemed capital contribution of the redeemed shares to the acquiring corporation attaches to the retained shares of the issuing corporation, in the absence of any direct ownership of stock of the acquiring corporation. As discussed in the text, we believe that the threshold test of section 1059 should be applied by reference to the stock of the acquiring corporation (Enron Pipeline), where such corporation is treated as making the redemption under section 304(a)(1) and as having made the section 301 distribution under section 304(b)(2)(A). In the event that, contrary to our views, a court were to apply the threshold tests of section 1059 by reference to the stock of the issuing corporation (Liquids), the dividend attributable to the Purchase would exceed the 5 percent/85 day threshold percentage requirement of section 1059 relating to dividends on preferred stock.

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enjoy[ed]." For this purpose, control is defined as 50 percent of vote or value. The following acquisitions of control or carryover basis property (from a corporation other than a subsidiary or a sister corporation) occurred in connection with the formation of Partnership and the Purchase:

Enron acquired control of Enron Cayman;

Enron and Enron Cayman acquired control of Enron GP;

Partnership and OPI acquired control of Liquids;

Liquids acquired control of Enron Operations Corp.;

OPI acquired the Houston Pipe Note and real estate from Enron; and

Enron Pipeline acquired the $600 Million ECTR Note and the EDC Note from Enron.

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

Obtaining the desired accounting benefits does not depend on any of the acquisitions of control described above. It might be argued that the acquisition of the $600 Million ECTR Note and the EDC Note by Enron Pipeline potentially allows Enron to obtain the benefit of a deduction on the ultimate disposition of the Liquids stock retained by Partnership if section 1059 would have been applicable to the Purchase in the absence of such contributions. The carryover basis in those notes, however, is irrelevant to the application of section 1059. The basis increase in Enron's stock of Enron Pipeline, which may have relevance to the application of the section 1059 threshold percentage test, could have been achieved by a contribution of cash. We believe that the availability of an alternative means to obtain the same results suggests that the benefits are "otherwise available" to Enron.

Even if the required deduction, credit, or other allowance could be identified, it is necessary to show that tax avoidance or evasion by obtaining the benefit of such item was the principal purpose for an acquisition of control. The predominant purpose for the formation of Partnership and the

Purchase was to generate income for financial accounting purposes. Additional purposes for the formation of Partnership included risk shifting and raising minority equity capital. While the accounting benefits are derivative of the tax consequences of the Purchase, the formation of Partnership and the Purchase were structured to achieve these purposes without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements. We believe that these facts present a strong case for refuting any claim that the principal purpose of any of these transactions was the evasion or avoidance of tax.

Accordingly, we believe that section 269 should not be applicable to any of these acquisitions.

F. Partnership Anti-abuse Rule

The IRS, in regulations promulgated under section 701, has stated that it has the power, under certain circumstances, to alter what would otherwise be the tax consequences of transactions involving partnerships. Treas. Reg. § 1.701-2 (the "partnership anti-abuse rule"). For the reasons set forth below, we believe the regulations under section 701 should not apply to adversely affect the conclusions reached in this opinion.

Under the partnership anti-abuse rule:

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

Treas. Reg. § 1.701-2(b).

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

The maximum scope of a transaction for these purposes would include a particular step that produces a tax benefit (the "goal step") and all other steps ("related steps") that would not have been done if the goal step were not done. In the instant case, the goal step would be creating the potential for deductions with respect to tax basis in excess of the book value of assets ("excess basis"). The related steps would be all elements of the creation of the structure, including the recapitalization of OPI and Liquids and the formation and capitalization of Enron GP and Partnership. Under this view of what constitutes the transaction, two of the partners of Partnership (Enron GP and EN-BT) would not exist if the transaction were not done. Moreover, the assets held by OPI would not have been owned by OPI if the transaction were not done. It seems reasonable to believe that the tax liability of a partner that does not exist or that would not have held its assets in the absence of the transaction would be determined by looking to the tax liability of the persons that initially owned the assets that were actually transferred to the partner. Under this view, the baseline would be the present value of the aggregate tax liability of the Enron consolidated group and the consolidated group of which EN-BT is a member (the "EN-BT consolidated group") if no steps were taken to recapitalize OPI or Liquids or to form and capitalize Partnership, Enron GP, and EN-BT.

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

A more limited view of what constitutes a "transaction" would include the goal step and those other steps ("enabling steps") that are required in order to make the goal step possible. In the instant case, the enabling steps would be the steps required to create the excess basis (e.g., the Purchase) and any steps taken to utilize that basis (e.g., section 732(c) distributions). Under this view, the baseline would be the tax liability of the partners if all transactions except the Purchase occurred. (In the absence of excess basis attributable to the Purchase, the effects of any steps taken to utilize such excess basis should become neutral.) The effects on the Enron consolidated group of the recapitalization of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, and investments by OPI and Partnership would be the same in the baseline as in the actual transaction, and accordingly would be irrelevant under this view. The change in tax liabilities as compared to the baseline would be attributable to the transaction increasing the income of the partners by the amount of the dividend income in excess of the dividends received deduction and decreasing the income of

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the partners by the amount of the deductions attributable to excess basis. The timing of these effects would be affected by the time at which the partners trigger deductions attributable to the excess basis.

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

In the absence of any authority indicating which of these approaches is most appropriate, we have considered the potential application of the partnership anti-abuse rule under each approach. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the recapitalization of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, any investments by OPI and Partnership, and the Purchase. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Purchase on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any. Accordingly, we believe that under either the maximum or a limited view of the meaning of the term "transaction" in the partnership anti-abuse regulation, the regulation should not be applicable.

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

The tax reduction effects of a transaction that triggers a deduction attributable to the Purchase could be duplicated without the use of a partnership (although the accounting benefits of the transaction could not be duplicated without a partnership). We believe that tax results that could be

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achieved without the use of a partnership should not be considered to be inconsistent with the intent of subchapter K.

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

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

The IRS might argue that the mechanical rules of subchapter K should not be applied literally based on general factors rather than particular examples, and in particular based on a substantial tax avoidance purpose at the time the partnership is formed, or on the magnitude of the tax benefits created by its application. Absent clearly expressed legislative intent to the contrary, the unambiguous language of a statute is controlling under all but rare and exceptional circumstances. See Crooks v. Harrelson, 282 U.S. 55, 60 (1930). If the intent of Congress in drafting a rule (e.g., to allocate basis in proportion to the relative bases of the distributed property under section 732(c))

is clear, the regulation cannot change that rule. If the statute is silent or ambiguous, then the regulation may fill the gap with a reasonable interpretation. See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-43 (1984); see also National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 476-77 (1979). We believe the intent of Congress to have the mechanical rules of subchapter K apply without regard to tax motivations is clear. In view of this Congressional intent, we believe a regulatory interpretation of a mechanical rule that alters its application based on the presence or absence of tax motivation or the magnitude of tax benefits should not be considered a reasonable interpretation.

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

The examples in the abuse-of-subchapter K rule suggest that the rule is also intended to expand upon judicial doctrines, primarily by requiring that the tax motivation for a transaction be taken into account in applying those doctrines. Generally, the courts have not taken tax motivation into account in determining whether a transaction is a sham, a transaction has a substantial business purpose, the step transaction doctrine is applicable, or the substance of a transaction matches its form. See, e.g., Knetsch v. United States, 364 U.S. 361, 365 (1960); Gregory v. Helvering, 293 U.S. 465,

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469 (1935). But cf. Sheldon v. Commissioner, 94 T.C. 738 (1990). In contrast to the virtual unanimity in the courts with respect to the role of tax avoidance motivation under these doctrines, some controversy has arisen in recent years with respect to the issue of the role of tax motives in the determination of whether the profit motive requirement of various Code provisions (e.g., sections 162, 165(c)(2), 183, and 212) has been satisfied. While the test is often described as requiring a primary purpose of realizing a profit, the cases generally have considered the relative weight of profit motive only in comparison to personal motives. See Portland Golf Club v. Commissioner, 497 U.S. 154 n.16 (1990); Snyder v. United States, 674 F.2d 1359 (10th Cir. 1982). In commercial transactions, where personal motives are not at issue, in some cases the courts have analyzed the facts of the transaction to determine whether a profit motive existed. In general, the finding of a profit motive has been sufficient for the courts to hold in favor of the taxpayer without further analysis. See, e.g., Lyon v. United States, 435 U.S. 561 (1978); Levy v. Commissioner, 91 T.C. 838 (1988). There have, however, been some tax shelter cases in which the courts have expanded their inquiry to consider the primacy of the profit motive as compared to the tax motive. See, e.g., Estate of Baron v. Commissioner, 83 T.C. 542 (1984), aff'd, 798 F.2d 65 (2d Cir. 1986); Fox v. Commissioner, 82 T.C. 1001 (1984). It remains to be seen whether tax motivation will play a significant role in the determination of whether a profit motive requirement within a particular Code provision is satisfied.

It has long been settled case law that tax motivation does not affect the qualification of an organization as a partnership. See Culbertson, 337 U.S. 733. Furthermore, to date there has been no decision applying a "primarily for profit" requirement to the definition of partnerships or to any provision of subchapter K. But see Brannen v. Commissioner, 78 T.C. 471 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984) (dissent by J. Whitaker, suggesting that profit motive identical to that required under section 162 would be required for a partnership to be recognized for tax purposes). Sixty years of case law consistently denies any relevance of a tax avoidance motivation in applying the substance over form doctrine and in determining whether there is a valid business purpose for a transaction. Moreover, case law and legislation consistently have denied relevance to tax avoidance motivation in determining whether an organization is a partnership for tax purposes. Finally, there have been repeated reenactments of the entire Code in the context of that case law. Based on this legal history, we believe that the partnership anti-abuse rule should not be considered a reasonable interpretation of the statute to the extent that it requires that what would otherwise be the tax consequences of a transaction be modified based on the presence of a tax motivation for a partnership transaction.

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

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believe that a court should find the regulation to be invalid to the extent that it alters the clear rules of subchapter K based on the presence of a tax motivation.

G. Application of Section 482

Section 482 gives the IRS the authority, under certain circumstances, to alter what would otherwise be the tax consequences of a transaction. For the reasons set forth below, we believe section 482 should not apply to adversely affect the conclusions reached in this opinion.

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

The threshold requirement for application of section 482 is that a transaction does not reflect arm's-length dealing between the parties. See Simon J. Murphy Co. v. Commissioner, 231 F.2d 639, 644-45 (6th Cir. 1956) (describing limits of predecessor of section 482, court stated that allocation not permitted where related parties deal with each other at arm's length; in case before court, failure of return to clearly reflect income was inherent in accrual method, not due to control over related parties); Haag v. Commissioner, 88 T.C. 604, 615 (1987), aff'd, 855 F.2d 855 (8th Cir. 1988) (to determine whether a reallocation is necessary to clearly reflect income or to prevent the evasion of taxes, court must decide whether the agreement reflected arm's-length dealing); Van Dale Corp. v. Commissioner, 59 T.C. 390, 398 (1972) (unless the tax benefit stems from less than arm's-length dealings, the threshold point for applying section 482 is simply not reached); Seminole Flavor Co. v. Commissioner, 4 T.C. 1215, 1229-31 (1945) (nonacq.) (court rejected government's argument that contract was for purpose of evading tax based on finding that terms of contract were arm's length); Treas. Reg. § 1.482-1(b)(1) (purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer; standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer); Tech. Adv. Mem. 7927009 (Mar. 22, 1979) (conditioning application of section 482 on finding that control relationship was utilized to effect the transaction at bargain sale price). Given EN-BT's interest in Partnership, and terms of the Purchase Agreement that were, at the time the transaction was entered into, commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree, we believe that section 482 should not be applicable to reallocate the section 304 dividend or the basis adjustments resulting from the Purchase among the entities.

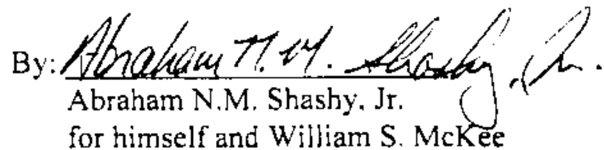
VI. CONCLUSION

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

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

Sincerely,

KING & SPALDING

By: 
Abraham N.M. Shashy, Jr.
for himself and William S. McKee

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KING & SPALDING

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

DIRECT DIAL:

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October 2, 2000

Enron Corp.
1400 Smith Street
Houston, TX 77002-7361

Re: Redemption of Stock of Enron Liquids Holding Corp.

Ladies and Gentlemen:

In our capacity as special tax counsel, you have requested our opinion with respect to certain federal income tax consequences of the March 31, 1998 acquisition by Enron Liquids Holding Corp. ("Liquids") of its stock from its shareholders (the "Redemption").

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

In rendering this opinion, we have relied upon the certificate of incorporation of Liquids, as amended by certificates of amendment filed on December 23, 1992, March 21, 1997, and March 31, 1998 (the "Liquids Certificate"), the representations and assumptions set forth in your letter to us, dated September 27, 2000, a copy of which is attached, and the additional information that we have obtained through consultation with officers, employees, or legal representatives of Organizational Partner, Inc. ("OPI"), Enron Property Management Corp. ("Enron GP"), Enron Leasing Partners, L.P. ("Partnership"), and members of the consolidated

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191 PEACHTREE STREET
ATLANTA, GA 30303-1763
TELEPHONE: 404/572-4600
FACSIMILE: 404/572-5100

1185 AVENUE OF THE AMERICAS
NEW YORK, NY 10036-4003
TELEPHONE: 212/556-2100
FACSIMILE: 212/556-2222

1100 LOUISIANA STREET, SUITE 3300
HOUSTON, TX 77002-5219
TELEPHONE: 713/751-3200
FACSIMILE: 713/751-3290

group, within the meaning of Treasury Regulation § 1.1502-1(h),[1] of which Enron is the parent (the "Enron consolidated group").

I. OPINION

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

1. The amounts received by Liquids shareholders in the Redemption should be treated as dividend distributions ("Redemption Dividends") from Liquids.

2. The adjusted basis of the Liquids preferred stock retained by Partnership should be increased by an amount equal to Partnership's adjusted basis in the Liquids preferred stock transferred to Liquids in the Redemption.

3. The adjusted basis of OPI's interest in Partnership should be increased by its distributive share of the Redemption Dividends received by Partnership.

4. Section 1059 should not be applicable to reduce Partnership's basis in the retained Liquids preferred stock, to reduce OPI's basis in its interest in Partnership, or to trigger gain to Partnership with respect to any portion of the Redemption Dividends received by Partnership.

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

II. LEGAL ANALYSIS

A. Dividend Treatment

Liquids acquired shares of its stock from its shareholders in exchange for property in the Redemption. For purposes of the relevant sections of the Code, stock is treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is canceled, retired, or held as treasury stock. Section

[1] All references to sections are to the Internal Revenue Code of 1986 (the "Code"), as amended and in effect as of the date of this letter, unless otherwise noted. All references to regulations are to U.S. Treasury Department regulations, as most recently adopted, amended, or proposed, as the case may be, as of the date of this letter, unless otherwise noted.

317(b). A distribution in redemption of stock from a shareholder is treated as a sale or exchange of stock if the redemption is not essentially equivalent to a dividend, is substantially disproportionate with respect to the shareholder, or is in complete redemption of all of the stock of the corporation owned by the shareholder. Sections 302(a), 302(b).

We believe that a pro rata redemption from all shareholders cannot satisfy any of these conditions. In the Redemption, 3.25 percent of each class of stock held by each shareholder was acquired by Liquids in exchange for cash or notes. While the pro rata nature of a redemption might be determined by reference to a number of factors, we believe that a redemption of the identical percentage of each class of stock of a corporation should be considered pro rata with respect to all such factors. Accordingly, we believe the Redemption should be treated as pro rata and as a distribution of property to which section 301 applies. Section 302(d).

Under section 301(c)(1) and section 316, a distribution is treated as a dividend to the extent of the earnings and profits of the distributing corporation. Liquids' current and accumulated earnings and profits for the taxable year ended December 31, 1998 exceeded the aggregate amount of the promissory notes and cash transferred by Liquids to Enron, Enron Pipeline Company ("Pipeline"), OPI, and Partnership in exchange for stock on March 31, 1998 plus any other distributions made or deemed made by Liquids to its shareholders during such taxable year. Accordingly, we believe that the full amount of the Redemption proceeds received by each shareholder should be treated as a dividend from Liquids to such shareholder.

Regulations under section 7701(l) permit the Commissioner to recharacterize an arrangement in which a corporation has outstanding fast-pay stock as an arrangement between shareholders of the corporation if a principal purpose for the structure of the arrangement is the avoidance of any tax imposed by the Code. Treas. Reg. § 1.7701-3(c). Such a recharacterization could be applied for taxable years ending after February 26, 1997. Treas. Reg. § 1.7701-3(g). Stock is fast-pay stock if it is structured so that dividends paid by the corporation with respect to the stock are economically a return of the holder's investment. Treas. Reg. § 1.7701-3(b)(2)(i). Stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of section 302(d) unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement. Treas. Reg. § 1.7701-3(b)(2)(ii).

The predominant purpose of Enron and its Affiliates[2] for participating in the Redemption was to generate income for financial accounting purposes. The accounting treatment of the Redemption provided Enron and its Affiliates with significant and material benefits. Partnership and the Redemption were structured to achieve this accounting benefit without increasing or decreasing, on a present value basis (computed using a discount rate that is less than or equal to the lesser of the applicable federal rate as defined in section 1274(d) or the after-tax weighted average cost of capital of the Enron consolidated group (the "Discount Rate") during the relevant

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

period), the aggregate federal income tax liability of the Enron consolidated group and those Affiliates of Enron that are included in Enron's consolidated financial statements.

Neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a transaction in which Partnership is treated for federal income tax purposes as receiving a dividend in connection with a redemption, purchase, or other acquisition of Liquids stock from Partnership by Enron or an Affiliate of Enron (a "Dividend Transaction"). A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer equals or exceeds the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Dividend Transaction.

Neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT Delaware, Inc. ("EN-BT"), Potomac Capital Investment Corporation ("PCI"), and their Affiliates, in the aggregate, from the 1997 restructuring of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, the operations and investments of OPI and Partnership, and any Dividend Transactions. These transactions are considered to produce a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, if the sum of the present values (computed using the Discount Rate during the relevant period), on March 20, 1997, of the hypothetical federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates. determined as if the transactions had not occurred, exceeds the sum of the present values (computed using the Discount Rate during the relevant period), on March 20, 1997, of the actual federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates.

None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Redemption on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any. The Redemption (i) has not altered and will not alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Redemption) by members of the Enron consolidated group to nonmembers of the Enron consolidated group that are treated as having been made out of earnings and profits and (ii) has not resulted and will not result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Redemption on the earnings and profits of members of the Enron consolidated group.

No member of the Enron consolidated group has disposed or will dispose of any stock of Liquids on or after March 30, 1998 except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron has taken or will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Redemption.

Based on these facts, we believe that Dividend Transactions, and the Redemption in particular, should not be considered to have a principal purpose of tax avoidance. Accordingly, we believe that the Redemption should not cause stock of Liquids to be recharacterized under the fast-pay stock regulations as an arrangement between shareholders of Liquids even if such stock were determined to be fast-pay stock.

B. Basis Effects

Under section 302, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Treas. Reg. § 1.302-2(c). The examples in Treasury Regulation § 1.302-2(c) suggest that the "proper adjustment" is to increase the basis of stock retained by the taxpayer by the amount of the taxpayer's basis in the redeemed stock. See Treas. Reg. § 1.302-2(c) *Example (1)*, *Example (3)*. Accordingly, we believe the proper adjustment in the case of the Redemption should be to increase the basis of the remaining Liquids stock held by a shareholder by the amount of the basis of the Liquids stock that is redeemed from that shareholder.

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

C. Section 1059

Under certain circumstances, a corporation must reduce its basis in a share of stock with respect to which it receives an extraordinary dividend by the amount of the dividends received deduction attributable thereto, and must recognize gain to the extent of any excess of such dividends received deduction over such basis. Section 1059(a).

1. Pro Rata Redemptions

Dividends attributable to a redemption which is not pro rata as to all shareholders trigger application of these rules. Section 1059(e). The Redemption involved the acquisition from each shareholder of identical percentages of Liquids common and preferred stock. Such a redemption has no effect on the relative interests of any shareholder. We believe the Redemption should be considered pro rata for purposes of section 1059(e).

2. Extraordinary Dividends

Extraordinary dividends received with respect to a share of stock that has not been held for more than two years before the dividend announcement date also trigger application of the basis reduction and gain recognition rules of section 1059. The Redemption occurred within two years of Partnership's acquisition of the Liquids preferred stock. Accordingly, we believe that if the Redemption is properly characterized as an extraordinary dividend, the basis reduction and gain recognition rules of section 1059 would be applicable.

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

The statute does not specify the date on which a taxpayer's basis is determined for purposes of applying the Quarterly Test or the Annual Test. The statute provides that, under some circumstances, the taxpayer may elect to apply the Quarterly Test and the Annual Test by substituting the fair market value of a share of stock as of the day before the ex-dividend date for the adjusted basis of the share. Section 1059(c)(4). In addition, the statute provides that any reduction of basis is treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates. Section 1059(d)(1). Accordingly, we believe that the adjusted basis that should be used in applying the Quarterly Test or the Annual Test is the adjusted basis as of the day before the ex-dividend date for the particular dividend being tested.[3]

It is not entirely clear, in the case of a redemption of stock, how one identifies the exact shares with respect to which the resulting dividend is treated as paid. Based on the information that we have relied on, we believe that the maximum amount of dividends that might be aggregated with respect to all preferred stock of Liquids for any 85 day period that included March 31, 1998 (a "Relevant 85 Day Period") should not exceed $47,968,750 (the amount of the notes and the cash transferred to Enron, Pipeline, and Partnership on March 31, 1998, excluding the amount of the note issued to Enron in exchange for common stock of Liquids) and that the basis of the 7,759.35 shares of Liquids preferred retained by Partnership was at least $967,500,000 on March 30, 1998. Five percent of $967,500,000 is $48,375,000, an amount which exceeds the maximum amount of dividends described in the preceding sentence as being

[3] Note that if an aggregation of a current dividend with future dividends results in the aggregate amount failing either the Quarterly Test or the Annual Test, it is unclear when the resulting basis reduction occurs. If it were to occur immediately before the first dividend included in the aggregate amount, then it might cause other aggregations over different quarterly periods to fail to satisfy the Quarterly Test because there is no specific exclusion of basis adjustments required by section 1059(a)(1) in applying the Quarterly Test.

aggregated with respect to all preferred stock of Liquids for any Relevant 85 Day Period. Accordingly, we believe that the aggregate amount of all dividends properly taken into account by Partnership for purposes of applying the Quarterly Test to the Redemption should not exceed five percent of the basis on the day before the Redemption of the Liquids preferred shares retained by Partnership following the Redemption and the Redemption should not be treated as an extraordinary dividend with respect to Partnership by reason of application of the Quarterly Test.

The sum of (i) the aggregate of all amounts that were declared and paid as dividends with ex-dividend dates within any 365 day period that included March 31, 1998 (a "Relevant 365 Day Period") on all shares of Liquids preferred stock in the aggregate plus (ii) the aggregate of all amounts ("Redemption Amounts") that were paid by Liquids in exchange for preferred stock acquired in transactions that occurred within, or were effective on a record date within, any Relevant 365 Day Period plus (iii) the aggregate of all amounts of any other distributions or deemed distributions with respect to the Liquids preferred stock in the aggregate that occurred within, or were effective on a record date within, any Relevant 365 Day Period (each such dividend, stock acquisition, distribution, or deemed distribution being a "Relevant Transaction") did not exceed 20 percent of Partnership's adjusted basis for federal income tax purposes, as of the day immediately preceding any Relevant Transaction, of those shares of Liquids preferred stock that were held by Partnership immediately after such Relevant Transaction. The aggregate of all per share amounts with respect to all Relevant Transactions did not exceed 20 percent of the Partnership's adjusted basis per share of Liquids preferred stock as of the day immediately preceding any Relevant Transaction. Accordingly, we believe that the Redemption should not be treated as an extraordinary dividend with respect to Partnership by reason of application of the Annual Test.

3. Disqualified Preferred Stock

Any dividend with respect to disqualified preferred stock triggers application of the basis reduction and gain recognition rules of section 1059. Section 1059(f)(1). Disqualified preferred stock means any stock which is preferred as to dividends if:

> (A) when issued, such stock has a dividend rate which declines (or can reasonably be expected to decline) in the future,
>
> (B) the issue price of such stock exceeds its liquidation rights or its stated redemption price, or
>
> (C) such stock is otherwise structured --
>
> > (i) to avoid the other provisions of [section 1059], and

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

Section 1059(f)(2).

The Liquids Certificate provides for preferred dividends to be paid on the Liquids preferred stock at a floating rate based on LIBOR. The spread over LIBOR is fixed in the Liquids Certificate and does not decline over time. The legislative history of section 1059(f) states that the provision is not intended to apply to dividends on floating rate or auction rate preferred stock whose dividend rate declines solely in response to changes in prevailing market conditions. Committee on Finance, 101st Cong., 1st Sess., Revenue Reconciliation Act of 1989, Explanation of Provisions Approved by the Committee on October 3, 1989, 64 (Comm. Print 1989). Accordingly, we believe the Liquids preferred stock should not be treated as described in section 1059(f)(2)(A).[4] Based on our review of the information that we have relied on, we believe that the issue price of the Liquids preferred stock does not exceed its liquidation rights or its stated redemption price. Accordingly, we believe the Liquids preferred stock should not be treated as described in section 1059(f)(2)(B).

Finally, neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a Dividend Transaction. A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer equals or exceeds the present value (computed using the Discount Rate during the relevant period) on the date of the

[4] If the dividends resulting from redemptions of Liquids preferred stock were taken into account, and if it were expected that there would be a larger amount of redemptions in earlier years than in later years, it might be argued that the dividend rate on the Liquids preferred stock could reasonably be expected to decline over time. The legislative history of section 1059(f) identifies the provision as requiring basis reduction for the nontaxed portion of dividends on self-liquidating stock and states the reason for change as follows: "Corporate stockholders may receive dividends eligible for the dividends received deduction in circumstances where the dividends more appropriately should be characterized as a return of capital. . . . The committee believes that basis reduction in such cases is appropriate to accurately reflect the true economic effect of these types of transactions." H.R. Rep. No. 101-247, at 63 (1989). Section 1059 includes very specific and detailed rules for dealing with a variety of transactions. In particular, section 1059(f)(2)(A) specifically addresses shares having declining dividend rates and section 1059(e)(1)(A) specifically addresses redemption transactions. In addition to its more specific provisions, the statute contains antiabuse type provisions of more general applicability. See Section 1059(f)(2)(C). We believe that redemptions should be analyzed only under the specific provisions applicable to redemptions and under the more general provisions of section 1059. We believe that application of the provision that specifically addresses stock with a declining interest rate should be limited to stock that, in form, provides for a declining interest rate and should not be applied based on the characterization for tax purposes of a redemption transaction as a dividend.

Dividend Transaction of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Dividend Transaction. We believe that section 1059(f)(2)(C), which requires that stock be "structured" to avoid the other provisions of section 1059 and to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock, should be interpreted as a subjective intent test. See Tech. Adv. Mem. 200023003 (Dec. 21, 1999). We further believe that the proscribed intent to reduce taxes should not be present where there is no net reduction in the economic burden, on a present value basis, of the taxpayer's tax liabilities. Cf. H.R. Rep. No. 98-432, pt. 2, at 1185-86 (1984) (legislative history describing intent to discourage corporations from buying stock shortly before ex-dividend date and selling shortly after and concern that the failure to apply a two asset analysis in cases of extraordinary distributions when the taxpayer's holding period in the stock is short leads to such transactions; focus on short holding periods suggests that Congress did not feel a need to address transactions in which there was a substantial deferral (i.e., a reduced present value) of the tax benefit of the deduction from a sale of the stock after the dividend payment). While the combination of the dividends received deduction and a loss on the disposition of the Liquids preferred stock may result in a reduction in the absolute dollars of tax paid, we believe that the absence of any anticipated reduction, on a present value basis, of the economic tax burden[5] from this combination supports a conclusion that there was no intent to reduce taxes within the meaning of section 1059(f)(2)(C). Accordingly, we believe the Liquids preferred stock should not be treated as described in section 1059(f)(2)(C).

4. Conclusion

We believe that the basis reduction and gain recognition rules of section 1059 should not be applicable to Partnership with respect to the Redemption.

[5] The Discount Rate is less than or equal to the lesser of the applicable federal rate or the after-tax weighted average cost of capital of the Enron consolidated group. If the relevant economic test of whether there has been a present value reduction of tax burdens is whether the government has suffered an economic detriment on a present value basis, we believe that the government's cost of funds should be considered the appropriate discount rate. We further believe that the applicable federal rate should be considered to reflect the government's cost of funds for these purposes. Moreover, we note that the applicable federal rate is the rate mandated by regulation for determining the present value of tax benefits and detriments for certain purposes. See Treas. Reg. §§ 1.860E-2(a)(4), 1.475(c)-2(c). If the relevant economic test of whether there has been a present value reduction of tax burdens is whether the taxpayer has obtained an economic benefit on a present value basis, we believe the taxpayer's cost of funds should be considered the appropriate discount rate. We further believe that the after-tax weighted average cost of capital of a consolidated group should be considered to reflect the taxpayer's cost of funds for these purposes. Given transactions that produce a tax detriment to the taxpayer initially, with a tax benefit later in time, the more conservative of the two discount rates (i.e., the rate more favorable to the government) would be the lesser of these two rates.

D. Substance Over Form Doctrine

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

1. Separate Taxable Entity

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the Supreme Court established the test for determining whether a corporation will be recognized as a separate taxable entity, stating that "so long as [the purpose for forming the corporation] is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Id. at 439. The separate entity tests set forth in Moline Properties have been applied to partnerships. Campbell County State Bank, Inc. v. Commissioner, 37 T.C. 430, 441-42 (1961), reversed on another issue, 311 F.2d 374 (8th Cir. 1963) (acq.). The level of activity necessary to constitute the "carrying on of business" within the meaning of the Moline Properties test appears to be quite minimal. Britt v. United States, 431 F.2d 227, 235 (5th Cir. 1970); Hospital Corp. of America v. Commissioner, 81 T.C. 520, 579 (1983) (nonacq. in part); Strong v. Commissioner, 66 T.C. 12, 24 (1976), aff'd without published opinion, 553 F.2d 94 (2d Cir. 1977). In practice, it seems to require little more than the observance of bookkeeping formalities, maintenance of separate bank accounts and books and records, having employees, executing contracts where appropriate, and representing the entity to third parties as an independent organization.

Each of Enron, Pipeline, Liquids, OPI, and Enron GP at all times has represented and will represent itself to third parties as a separate entity in all transactions, has observed and will observe all corporate and bookkeeping formalities, has maintained and will maintain separate bank accounts and books and records, has had and will have employees and/or has paid and will pay fees for services that would otherwise be rendered by employees, and has executed and will execute contracts in a manner consistent with its status as a separate entity. Partnership at all times has represented and will represent itself to third parties as a separate entity in all transactions, has observed and will observe all partnership and bookkeeping formalities, has maintained and will maintain separate bank accounts and books and records, has had and will have employees and/or has paid and will pay fees for services that would otherwise be rendered by employees, and has executed and will execute contracts in a manner consistent with its status as a separate entity. At all times during 1998, each of the entities described in the preceding two sentences held assets having a fair market value of at least $10 million. Prior to March 31, 1998, each of Enron, Pipeline, Liquids, and OPI had been in existence for at least two years and in 1998 each either was engaged in the active conduct of a trade or business or had engaged in financial or business transactions with unrelated persons. OPI and Enron GP entered into a substantial joint venture (Partnership) with unrelated persons (PCI and EN-BT). Transactions

with third parties are generally considered sufficient business activity to satisfy the Moline Properties test. For example, obtaining a loan from third parties has been found to be sufficient business activity to prevent taxpayers from disavowing the separate status of a corporation that admittedly served no business purpose. See Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945); but see ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000) (treating the Moline Properties test as unitary test in which the absence of a nontax business purpose is fatal). Based on the above facts, we believe that each corporation described above and Partnership should be respected as a separate entity for federal income tax purposes.

2. Sham

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

This quotation has led courts to focus on two elements in analyzing the substance of transactions: the objective economic substance of and the subjective business purposes for the transaction. If a tax-motivated transaction has neither of these elements, the transaction can be disregarded as a sham. See, e.g., ACM Partnership v. Commissioner, 73 T.C.M. 2189 (1997), aff'd 157 F.3d 231 (3d Cir. 1998), Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985); cf. ASA Investerings Partnership (treating the sham test as unitary test in which the absence of a nontax business purpose is fatal).

The predominant purpose of Enron and its Affiliates for participating in the Redemption was to generate income for financial accounting purposes. The accounting treatment of the Redemption provided Enron and its Affiliates with significant and material benefits. Partnership and the Redemption were structured to achieve this accounting benefit without increasing or decreasing, on a present value basis (computed using the Discount Rate), the aggregate federal income tax liability of the Enron consolidated group and those Affiliates of Enron that are included in Enron's consolidated financial statements.

Improving a company's balance sheet has been recognized as a valid business purpose. See Frank Lyon Co., 435 U.S. at 577-78 (effect of debt on company's balance sheet has "distinct element of economic reality"); Newman v. Commissioner, 902 F.2d 159, 163 (2d Cir. 1990) (business purposes in entering into operating agreement rather than lease for balance sheet purposes); Priv. Ltr. Rul. 9017061 (Jan. 31, 1990) (improvement of balance sheet for company's lenders is business purpose for section 355); Tech. Adv. Mem. 8803001 (Sept. 29, 1987),

(movement of assets from non-member to member corporation of affiliated group to improve consolidated balance sheet is business purpose for section 368(a)(1)(C)), revoked by Tech. Adv. Mem. 8941004 (July 11, 1989) (based on insufficiency of facts submitted at time of examination).

The economic substance test depends upon all of the facts and circumstances. With respect to the Redemption, the Liquids stock that was acquired in the Redemption was outstanding for at least one year prior to the Redemption. Dividends were paid on the preferred stock held by Partnership and were shared economically among the partners, OPI, Enron GP, and EN-BT. The economics attributable to the increase in value of the Liquids common stock over time, as reflected in the purchase price established for the Redemption, was shared by the common shareholders, including OPI and, indirectly through OPI, EN-BT and PCI.

We believe, based on the combination of business purpose for and economic substance of the Redemption and the absence of any present value economic benefit from the tax consequences of Dividend Transactions, that the Redemption should be respected in accordance with its form.

E. Partnership Anti-abuse Rule

Under the partnership anti-abuse rule:

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

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

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

The maximum scope of a transaction for these purposes would include a particular step that produces a tax benefit (the "goal step") and all other steps ("related steps") that would not have been done if the goal step were not done. In the instant case, the goal step would be generating accounting benefits by creating the potential for deductions with respect to tax basis in excess of the book value of assets ("excess basis"). The related steps would be all elements of

the establishment of the OPI/Partnership/Liquids investment structure. Under this view of what constitutes the transaction, Enron GP and EN-BT would not exist and OPI and Liquids would not have been recapitalized if the transaction had not been done. It seems reasonable to believe that the tax liability of a partner that does not exist or that would not have owned a substantial portion of its assets in the absence of the transaction would be determined by looking to the tax liability of the persons that own the assets that were transferred to the partner. Under this view, the baseline would be the present value of the aggregate tax liability of the Enron consolidated group, the shareholder of EN-BT, and PCI if no steps had been taken to set up the OPI/Partnership/Liquids structure.

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

A more limited view of what constitutes a "transaction" would include the goal step and those other steps ("enabling steps") that are required in order to make the goal step possible. In the instant case, the enabling steps would be the steps required to create the excess basis (e.g., the Redemption) and any steps taken to convert that basis into deductions. Under this view, the baseline would be the tax liability of the partners taking into account all steps involved in setting up the OPI/Partnership/Liquids structure but not taking into account the Redemption. The effects of the formation and capitalization of, and investments by, OPI and Partnership on the Enron consolidated group would be the same in the baseline as in the actual transaction, and accordingly would be irrelevant under this view. The change in tax liabilities as compared to the baseline would be attributable to the transaction increasing the income of the partners by the amount of the dividend income in excess of the dividends received deduction and decreasing the income of the partners by the amount of the deductions attributable to excess basis. The timing of these effects would be affected by the time at which the partners trigger deductions attributable to the excess basis.

A minimum view of what constitutes a "transaction" would treat each separate step as a transaction. In the instant case, under this view, each step (e.g., the restructuring of OPI or Liquids, the formation of Partnership, the Redemption, or a triggering of deductions attributable to excess basis) would be a transaction. The baseline could be the tax liability of the partners determined as if any one step was not done.

Based on our review of the information we have relied on, we believe that there should not be any present value tax benefit to the partners in the aggregate, to the Enron consolidated

group, or to any Affiliate of Enron when both dividend income and deductions attributable to the Redemption are taken into account. Similarly, we believe that there should not be any present value tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, taking into account all of the transactions described above. Finally, we believe that there should not be any present value tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the Redemption, when viewed in isolation. Accordingly, we believe that under any view of the meaning of the term "transaction" in the partnership anti-abuse regulation, the regulation should not be applicable to the Redemption.

III. RELIANCE

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

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

Very truly yours,

King & Spalding

EC2 000033827

Enron Corp.
P.O. Box 1188
Houston, TX 77251-1188
(713) 853-6161

PRIVILEGED AND CONFIDENTIAL
SUBJECT TO ATTORNEY-CLIENT PRIVILEGE

September 27, 2000

King & Spalding
1730 Pennsylvania Avenue, N.W.
Washington, D.C. 20006-4706

Ladies and Gentlemen:

In connection with your opinion (the "Opinion") relating to the acquisition by Enron Liquids Corp. ("Liquids") of its stock from its shareholders on March 31, 1998, we represent that the facts set forth below are true to the best of our knowledge and belief.

1. At all times during 1998, Enron Corp. ("Enron") directly owned all of the common stock, which was all of the outstanding stock, of each of Enron Pipeline Company ("Pipeline") and Enron Cayman Leasing, Ltd. ("Cayman").

2. At all times during 1998, (i) Enron owned all of the outstanding common stock of Organizational Partner, Inc. ("OPI"), (ii) Potomac Capital Investment Corporation ("PCI") owned all of the outstanding shares of Series A preferred stock of OPI, and (iii) EN-BT Delaware, Inc. ("EN-BT") owned all of the outstanding shares of Series B preferred stock of OPI.

3. Immediately before the March 31, 1998 acquisition of shares of Liquids (the "Redemption"), (i) the common stock of Liquids was owned 80 percent (13,583,085 shares) by Enron and 20 percent (3,395,771 shares) by OPI and (ii) the preferred stock of Liquids was owned 80.2 percent (8,020 shares) by Enron Leasing Partners, L.P. ("Partnership"), 10.45 percent (1,045 shares) by Pipeline, and 9.35 percent (935 shares) by Enron.

4. At all times during 1998, (i) OPI was a limited partner in Partnership with a 98 percent interest in capital and profits, (ii) EN-BT was a limited partner in Partnership with a one percent interest in capital and profits, and (iii) Enron Property Management Corp. ("Enron GP"), a wholly-owned subsidiary of Cayman, was the general partner of Partnership with a one percent interest in capital and profits.

5. On March 31, 1998, the following transactions were validly executed and effective in accordance with applicable state laws:

a. In exchange for 8.125 shares of Liquids common stock, Liquids issued to OPI a promissory note in the amount of $3,395,771.

b. In exchange for 260.65 shares of Liquids preferred stock, Liquids issued to Partnership a promissory note in the amount of $26,065,000 and transferred to Partnership cash in an amount equal to the accrued dividends on 260.65 shares of Liquids preferred stock.

c. In exchange for 33.9625 shares of Liquids preferred stock, Liquids issued to Pipeline a promissory note in the amount of $3,396,250 and transferred to Pipeline cash in an amount equal to the accrued dividends on 33.9625 shares of Liquids preferred stock.

d. In exchange for 30.3875 shares of Liquids preferred stock, Liquids issued to Enron a promissory note in the amount of $3,038,750 and transferred to Enron cash in an amount equal to the accrued dividends on 30.3875 shares of Liquids preferred stock.

e. In exchange for 32.5 shares of Liquids common stock, Liquids issued to Enron a promissory note in the amount of $13,583,085.

f. Liquids transferred to each of Enron, Pipeline, and Partnership cash in an amount equal to the accrued dividends that were payable on March 31, 1998 with respect to Liquids preferred shares held by such shareholder in excess of the shares involved in the exchanges described above.

6. At all times during 1998, each of Enron, Pipeline, Liquids, OPI, Enron GP, and Partnership held assets having a fair market value of at least $10 million. Prior to March 31, 1998, each of Enron, Pipeline, Liquids, and OPI had been in existence for at least two years and in 1998 each either was engaged in the active conduct of a trade or business or had engaged in financial or business transactions with unrelated persons.

7. At all times during 1998 and through the date of this letter, Partnership held in excess of 4,000 shares of preferred stock of Liquids.

8. Partnership's adjusted basis, for federal income tax purposes, in the 8,020 shares of Liquids preferred stock that it held immediately before the Redemption was at least $1 billion on March 30, 1998.

In addition to relying upon the representations set forth above, we consent to your assumption of the facts set forth below and your reliance on those assumptions:

1. Enron and its Affiliates[1] will at all times act in a manner that is consistent with the form of the transactions described in paragraph 5 above, as reflected in the documentation relating to those transactions.

2. The predominant purpose of Enron and its Affiliates for participating in the Redemption was to generate income for financial accounting purposes. The accounting treatment of the Redemption provided Enron and its Affiliates with significant and material benefits. Partnership and the Redemption were structured to achieve this accounting benefit without increasing or decreasing, on a present value basis (computed using a discount rate that is less than or equal to the lesser of the applicable federal rate as defined in section 1274(d)[2] or the after-tax weighted average cost of capital of the Enron consolidated group[3] (the "Discount Rate") during the relevant period), the aggregate federal income tax liability of the Enron consolidated group and those Affiliates of Enron that are included in Enron's consolidated financial statements.

3. The Liquids preferred stock was issued in exchange for consideration of $100,000 per share and $100,000 was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of a share of Liquids preferred stock on the date on which it was issued.

4. On the date of the Redemption, $100,000 plus accrued dividends was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of a share of Liquids preferred stock and $417,941.07772 was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of a share of Liquids common stock.

5. Each of Enron, Pipeline, Liquids, OPI, and Enron GP at all times has represented and will represent itself to third parties as a separate entity in all transactions, has observed and will observe all corporate and bookkeeping formalities, has maintained and will maintain separate bank accounts and books and records, has had and will have employees and/or has paid and will pay fees for services that would otherwise be rendered by employees, and has executed and will execute contracts in a manner consistent with its status as a separate entity. Partnership at all times has represented and will represent itself to third parties as a separate entity in all transactions, has observed and will observe all

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

2 All references to sections are to the Internal Revenue Code of 1986 (the "Code"), as amended and in effect as of the date of this letter, unless otherwise noted. All references to regulations are to U.S. Treasury Department regulations, as most recently adopted, amended, or proposed, as the case may be, as of the date of this letter, unless otherwise noted.

3 As used in this letter, the term "consolidated group" has the same meaning as in the consolidated return regulations. Treas. Reg. § 1.1502-1(h) (a consolidated group is an affiliated group of corporations filing consolidated returns for the tax year). References to the "Enron consolidated group" are to the consolidated group of which Enron is the common parent.

partnership and bookkeeping formalities, has maintained and will maintain separate bank accounts and books and records, has had and will have employees and/or has paid and will pay fees for services that would otherwise be rendered by employees, and has executed and will execute contracts in a manner consistent with its status as a separate entity.

6. At the time of the formation of Partnership, it was anticipated that Partnership would remain in existence for at least five years.

7. Liquids' current and accumulated earnings and profits for the taxable year ended December 31, 1998 exceeded the aggregate amount of the promissory notes and cash transferred by Liquids to Enron, Pipeline, OPI, and Partnership in exchange for stock on March 31, 1998 plus any other distributions made or deemed made by Liquids to its shareholders during such taxable year.

8. Liquids did not acquire any shares of Liquids stock, other than those shares acquired on March 31, 1998, in transactions that occurred within, or were effective on a record date within, any 85 day period that included March 31, 1998 (a "Relevant 85 Day Period").

9. The only dividend with respect to Liquids stock that had an ex-dividend date within any Relevant 85 Day Period was the preferred dividend paid on March 31, 1998.

10. Other than the Redemption and the preferred dividend paid on March 31, 1998, no distributions or deemed distributions with respect to Liquids stock occurred within, or were effective on a record date within, any Relevant 85 Day Period.

11. The sum of (i) the aggregate of all amounts that were declared and paid as dividends with ex-dividend dates within any 365 day period that included March 31, 1998 (a "Relevant 365 Day Period") on all shares of Liquids preferred stock in the aggregate plus (ii) the aggregate of all amounts ("Redemption Amounts") that were paid by Liquids in exchange for preferred stock acquired in transactions that occurred within, or were effective on a record date within, any Relevant 365 Day Period plus (iii) the aggregate of all amounts of any other distributions or deemed distributions with respect to the Liquids preferred stock in the aggregate that occurred within, or were effective on a record date within, any Relevant 365 Day Period (each such dividend, stock acquisition, distribution, or deemed distribution being a "Relevant Transaction") did not exceed 20 percent of Partnership's adjusted basis for federal income tax purposes, as of the day immediately preceding any Relevant Transaction, of those shares of Liquids preferred stock that were held by Partnership immediately after such Relevant Transaction.

12. The aggregate of all per share amounts with respect to all Relevant Transactions did not exceed 20 percent of the Partnership's adjusted basis per share of Liquids preferred stock as of the day immediately preceding any Relevant Transaction. For purposes of the preceding sentence, the per share amount of any Redemption Amount is such amount divided by the number of shares of Liquids preferred stock held by Partnership immediately after the payment of such amount.

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PRIVILEGED AND CONFIDENTIAL
SUBJECT TO ATTORNEY-CLIENT PRIVILEGE

13. Neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a transaction in which Partnership is treated for federal income tax purposes as receiving a dividend in connection with a redemption, purchase, or other acquisition of Liquids stock from Partnership by Enron or an Affiliate of Enron (a "Dividend Transaction"). A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer equals or exceeds the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Dividend Transaction.

14. Neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the 1997 restructuring of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, the operations and investments of OPI and Partnership, and any Dividend Transactions. These transactions are considered to produce a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, if the sum of the present values (computed using the Discount Rate during the relevant period), on March 20, 1997, of the hypothetical federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, determined as if the transactions had not occurred, exceeds the sum of the present values (computed using the Discount Rate during the relevant period), on March 20, 1997, of the actual federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates.

15. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Redemption on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any.

16. The Redemption (i) has not altered and will not alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Redemption) by members of the Enron consolidated group to nonmembers of the Enron consolidated group that are treated as having been made out of earnings and profits and (ii) has not resulted and will not result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Redemption on the earnings and profits of members of the Enron consolidated group.

17. No member of the Enron consolidated group has disposed or will dispose of any stock of Liquids on or after March 30, 1998 except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron has taken or will take any action to

obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Redemption.

18. We have disclosed to you all of the documents that are relevant to the transactions that are the subject of the Opinion and there are no undocumented agreements related to those transactions that modify or alter the effect of any of those documents or that create any additional obligations or rights in any parties to those documents.

For purposes of rendering the Opinion, we consent to your reliance on additional information that you have obtained through consultation with officers, employees, or legal representatives of OPI, Enron GP, Partnership, and members of the Enron consolidated group.

Very truly yours,
Enron Corp.

By R. D. Maxey
R. Davis Maxey
Vice President - Tax Planning

Vinson & Elkins
ATTORNEYS AT LAW

VINSON & ELKINS L.L.P
2300 FIRST CITY TOWER
1001 FANNIN STREET
HOUSTON, TEXAS 77002-6760
TELEPHONE (713) 758-2222
FAX (713) 758-2346

WRITER'S TELEPHONE
(713) 758-2222

WRITER'S FAX
(713) 758-2346

July 17, 1997

Enron Leasing Partners, L.P.
1400 Smith Street
Houston, Texas 77002

ATTORNEY-CLIENT PRIVILEGED

Ladies and Gentlemen:

We acted as special counsel to Enron Corp., then a Delaware corporation ("Enron"), Organizational Partner, Inc., a Delaware corporation ("OPI") and a 97 percent-owned subsidiary of Enron, and Enron Leasing Partners, L.P., a Delaware limited partnership ("Leasing Partners"), in connection with the transactions contemplated by (i) the Land and Facilities Lease Agreement (the "Lease"), dated as of April 14, 1997, between Brazos Office Holdings, L.P., a Delaware limited partnership ("Brazos"), and OPI, (ii) the Consent and Agreement (the "Lessee Consent"), of even date with the Lease, among OPI, Brazos and The Chase Manhattan Bank, a New York banking corporation, as agent (the "Agent") for the hereinafter defined Banks, (iii) the Parent Guaranty (the "Guaranty"), of even date with the Lease, executed by Enron, (iv) the Credit Agreement, of even date with the Lease, among Brazos, the lenders parties thereto (the "Banks") and the Agent (the "Credit Agreement"), (v) the Assignment and Assumption Agreement (the "Assignment"), of even date with the Lease, and (vi) the Sublease by and between Leasing Partners and Enron (the "Sublease"), of even date with the Lease. Unless otherwise noted, capitalized terms not otherwise defined herein have the meanings assigned to such terms in the Lease. You have requested our opinion with respect to certain federal income tax consequences of the transactions contemplated by the foregoing documents.

For the reasons set forth below, in our opinion Leasing Partners should be treated as the owner of the Building (as hereinafter defined) for federal income tax purposes.

FACTS

The Lease Transaction

On March 15, 1994. Enron renewed and restructured the lease financing covering an office building located at 1400 Smith Street. Houston, Texas (the "Building") with State Street Bank and

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Trust Company of Connecticut, National Association ("SSBTC"). SSBTC amended and restated the lease agreement (the "Prior Lease Agreement") covering the Building with Enron. SSBTC and Enron have terminated the Prior Lease Agreement. Upon termination of the Prior Lease Agreement, Enron had the right to reacquire the Building. Enron assigned its right to reacquire the Building to Brazos, which financed the acquisition of the Building through the Credit Agreement. Enron is not a member of the group of lenders providing financing under the Credit Agreement and has made no guarantees under the Credit Agreement. Brazos has a stated equity interest in the Building equal to 3 percent of the Acquisition Cost.

Pursuant to Section 5.01 of the Lease, Brazos leased the Building to OPI for an initial five-year term beginning April 14, 1997 and ending April 13, 2002. The Lease can be renewed at OPI's option for an initial renewal term of five years and thereafter for thirty Renewal Terms of one year, each in accordance with Section 11.03(a) of the Lease. If OPI chooses not to renew the Lease, or if OPI chooses to renew the Lease and Brazos is unable to obtain financing and equity contributions on terms acceptable to Brazos, its limited partners and OPI, Section 11.03(b) requires OPI either to purchase the Building for an amount of cash equal to the Acquisition Cost or arrange (at its own cost and expense) for the sale of the Building to a third party pursuant to Section 11.04 of the Lease.

Section 3.02(a) of the Lease provides that, for accounting and regulatory purposes, OPI and Brazos intend that the Lease be treated as an operating lease. For all other purposes of federal, state and local law, including income and *ad valorem* taxes and bankruptcy law, Section 3.02(b) of the Lease provides that OPI and Brazos intend that the Lease be treated as a financing transaction.[1] A Memorandum of Lease dated as of April 14, 1997 by and between Brazos and OPI was filed in the Office of the County Clerk of Harris County, Texas. In addition, two UCC financing statements relating to the Lease (the "Financing Statements") were filed in the UCC Records of Harris County, Texas and the Office of the Secretary of State of Texas, respectively.

OPI does not acquire record title to the Building as a result of the Lease. Under Section 11.01 of the Lease, after the third year of the Lease Term or at any time during any Renewal Term, OPI may terminate the Lease on any Basic Rent Payment Date and either purchase the Building for an amount of cash equal to the Acquisition Cost or arrange (at its own cost and expense) for the sale of the Building to a third party pursuant to Section 11.04 of the Lease. Under Section 11.02 of the

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[1] In this regard, Section 3.02(b) of the Lease provides that OPI and Brazos intend that (i) the Lease be treated as the repayment and security provisions of a loan by Brazos to OPI in the amount of the Acquisition Cost of the Building; (ii) all payments of Basic Rent, Additional Rent, proceeds of sale, and other amounts payable under the Lease be treated as payments of principal, interest and other amounts owing with respect to such loan, (iii) OPI be treated as entitled to all benefits of ownership of the Building and any part thereof; (iv) the Lease be treated as a mortgage and security agreement or other similar instrument from OPI, as mortgagor, to Brazos, as mortgagee, and as a security agreement in favor of Brazos as secured party encumbering the Building to secure such loan. Section 3.02(b) of the Lease further provides that the Agent and Assignees, collectively, shall have all the rights, powers and remedies of a mortgagee and secured party available under applicable law following a Potential Default or an Event of Default to take possession of and sell (whether by foreclosure, power of sale, or otherwise) the Building.

Lease, Brazos can terminate the Lease on any Basic Rent Payment Date in the event that certain circumstances arise in which Brazos incurs (or, in its reasonable judgment, in the future would incur) certain state or local taxes that are not indemnified pursuant to the Lease or in which the Lease (or related instruments) is deemed to require the payment or permit the collection of interest in excess of the Maximum Rate. In the event of a termination of the Lease by Brazos pursuant to Section 11.02 of the Lease, OPI is required either to purchase the Building for an amount of cash equal to the Acquisition Cost or arrange (at its own cost and expense) for the sale of the Building to a third party pursuant to Section 11.04 of the Lease.

Section 11.04(a)(i) of the Lease provides that if a sale of the Building to a third party results in sale proceeds greater than the Acquisition Cost, Brazos will pay to OPI the excess of the sale proceeds over the Acquisition Cost. If the sale proceeds are equal to or less than the Acquisition Cost, but greater than or equal to 25 percent of the Acquisition Cost, OPI is obligated under Section 11.04(a)(ii) of the Lease to pay to Brazos the excess of the Acquisition Cost over the sale proceeds. If the sale proceeds are less than 25 percent of the Acquisition Cost, OPI is obligated to pay Brazos, pursuant to Section 11.04(a)(iii) of the Lease, an amount equal to 75 percent of the Acquisition Cost plus an amount that Brazos determines in good faith to be the amount that the residual value of the Building was reduced in excess of that attributable to normal wear and tear, plus an amount that Brazos determines in good faith to be the amount the sale proceeds have been reduced due to certain Liens attaching to the Building that arise out of OPI's acts or failure to act.

Basic Rent under the Lease has two components: Basic Rent (Debt) and Basic Rent (Equity). In general, for any Basic Rent Payment Date (Debt), Basic Rent (Debt) equals the interest that would have been payable by Brazos under the Credit Agreement on such date if the Applicable Margin(s) (as defined in the Credit Agreement) were increased by the Brazos Margin (as specified in a letter dated February 24, 1997), provided that the interest rate under the Credit Agreement shall be deemed to be the Screen Rate.[2] Basic Rent (Equity) equals the product of the Equity Amount ($8,535,000) and a rate determined by formula. Under Section 6.03 of the Lease, OPI is required to pay Brazos, on demand, as Additional Rent, amounts required to reimburse Brazos for its costs and expenses (not previously included in Basic Rent) incurred in acquiring, financing and leasing the Building, as well as interest on any overdue amounts under the Lease.

Under Section 8.04 of the Lease, OPI may, at its expense, make additions and alterations to the Building so long as (i) no Event of Default has occurred and is continuing, (ii) the additions and alterations do not lessen the fair market value or impair the condition of the Building, (iii) the work is completed in a good and workmanlike manner in compliance with applicable Lease requirements (including insurance and legal requirements), (iv) no exterior walls or structural portion is demolished unless the structural integrity of the Building is maintained, and (v) the additions and

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[2]Special rules apply in the case of an Event of Default under the Credit Agreement when no Event of Default has occurred and is continuing under the Lease.

alterations do not result in any Lien (except Permitted Encumbrances). OPI must notify Brazos if the costs of such alterations and additions exceed $5,000,000. Additions and alterations to the Building that are made at OPI's expense and that are not removable from the Building without impairing the functioning or resale value of the Building become the property of Brazos at the termination of the Lease.

Under Section 8.03 of the Lease, OPI is required to make all required reports to taxing authorities and, in general, to pay all taxes, assessments, levies, fees and all other charges (governmental or otherwise) which are imposed or levied upon or assessed against the Building, the Lease, the leasehold estate created by the Lease, the amounts payable pursuant to the Lease, or which arise in respect of the ownership, operation, occupancy, possession or use of the Property (other than certain franchise, estate, inheritance, transfer, federal income or similar taxes of Brazos or any Assignee). Section 9.01 of the Lease requires OPI to maintain liability and property damage insurance with respect to the Building at OPI's sole cost and expense. Section 8.02 of the Lease provides that OPI shall pay all costs, expenses, fees and charges incurred in connection with the ownership, use or occupancy of the property during the Lease Term and any Renewal Term thereof and shall at all times, at its own expense, keep the Building in good operating order, repair, condition and appearance. Under Sections 8.02 and 13.01 of the Lease, OPI assumes all risk of loss of or damage to the Building.

Pursuant to the Guaranty, Enron guarantees OPI's payments to Brazos under the Lease.

The Assignment

Pursuant to the Assignment, OPI assigned all of its rights under the Lease to Leasing Partners as a contribution to Leasing Partners in exchange for a 97 percent limited partner interest in Leasing Partners. The general partner of Leasing Partners is Enron Property Management Corp., a Delaware corporation and a wholly-owned subsidiary of Enron Cayman Leasing Ltd., a Cayman company and a wholly-owned subsidiary of Enron; the general partner has a 1 percent general partner interest in Leasing Partners. The remaining 2 percent limited partner interest in Leasing Partners is owned by an unrelated institutional investor.

Leasing Partners assumed all of OPI's obligations under the Lease. Enron's obligations under the Guaranty survived the Assignment. The Assignment was recorded in the real property records in Harris County, Texas.

The Sublease

OPI subleased the Building to Enron under the Sublease. Section 2.01 of the Sublease provides that the term of the Sublease is ten years (the "Initial Term"). Enron has the right to renew the Sublease for ten additional one-year terms (the "Renewal Terms"). Section 15.01 of the Sublease

provides that, at the end of the Initial Term and the ten Renewal Terms, Enron can purchase the Building at its then-appraised fair market value.

Section 2.02 of the Sublease provides that, at the end of the first five years of the Initial Term, Enron can make a payment to OPI equal to $130,867,380, plus all other sums then due and owing under the Sublease (the "Cancellation Payment"), to terminate the Sublease. If Enron elects to make the Cancellation Payment and terminate the Sublease, Section 7.02 of the Sublease gives OPI the right to purchase any improvements made by Enron during the Sublease at the then fair market value of such improvements.

Base Rent under Section 3.01 of the Sublease is initially set at $25.8631 per square foot of rentable area in the Building ($32,716,821.50 per year), subject to adjustments provided in the Sublease. Under Section 5.01 of the Sublease, Enron is responsible for taxes, maintenance, utilities, insurance and other operating expenses of the Building.

Section 7.01 of the Sublease provides that, so long as no Default under the Sublease has occurred and is continuing, Enron can make additions and alterations to the Building, subject to limitations related to impairment of the Building's condition, quality of work and similar matters. Additions and alterations in excess of $5,000,000 must be approved by OPI, although the Sublease provides that OPI may not unreasonably withhold its approval.

Enron may assign its interest in the Sublease to Enron Property & Services Company, a Delaware corporation and a wholly-owned subsidiary of Enron.

REPRESENTATIONS

In connection with your request that we furnish this opinion, certain representations have been made with respect to the existence of certain facts. These constitute material representations relied upon by us as a basis for our opinion, and our opinion is conditioned upon the initial and continuing accuracy of these representations. Specifically, it has been represented that:

1. The rental payments under the Sublease approximate the fair rental value of the Building.

2. Leasing Partners has entered into the Sublease and the Assignment with the expectation of earning a profit.

3. The remaining economic useful life of the Building as of April 14, 1997 is at least 50 years.

4. The marginal federal income tax rates of OPI. Enron and the partners of Brazos are substantially identical.

5. Neither OPI nor Enron has any ownership interest in Brazos.

6. Leasing Partners and Enron will treat the Sublease as a true lease for accounting and all other purposes.

In addition to the facts and representations set forth above, our opinion is conditioned upon our understanding that the transactions will be carried out strictly in accordance with the documents described or referenced herein and that there are no other agreements, arrangements, or understandings other than those described or referenced herein.

LAW AND ANALYSIS

A. Authorities.

Rules for determining tax ownership of property are not provided in the Code[3] or related Treasury regulations. Instead, a body of court cases, revenue rulings and revenue procedures provide guidance for making a determination of tax ownership. All of the authorities are based on the proposition that the person claiming ownership must demonstrate sufficient attributes of ownership to be treated as the owner for federal income tax purposes, but none of the authorities sets forth a definitive standard for evaluating such attributes.

Nearly all of the authorities state that the substance of a transaction prevails over its form.[4] In examining the substance of a transaction, the analysis applied by various authorities can be divided into two parts: the presence or absence of economic substance in the transaction and the possession of the benefits and burdens of property ownership.

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[3]References herein to the Code are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.

[4]*See, e.g., Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939) (at taxpayer's behest, a transaction in which the taxpayer transferred title to real estate to a bank and received back a 99-year lease with options to renew and to purchase the property was held to be, in substance, a financing transaction for tax purposes); Rev. Rul. 68-590, 1968-2 C.B. 66 (IRS applied *Lazarus* in determining that an acquisition of land from a corporation by a political subdivision through financing provided by industrial revenue bonds, followed by a leaseback to the corporation that included an option to renew and repurchase so that the lease term, including renewal terms, was 99 years, amounted to a financing arrangement).

1. *Frank Lyon Co. v. U.S.*

The leading authority for determining the tax ownership of leased property in the context of a sale-leaseback transaction is *Frank Lyon Co. v. U.S.*[5] In *Lyon*, Worthen Bank and Trust Company of Little Rock ("Worthen") was not permitted to own and finance its own building, then under construction, through conventional sources because of objections from federal and state banking regulators. In lieu of conventional financing, the banking authorities approved a sale-leaseback transaction involving the building.

Worthen leased the land under the bank building to Frank Lyon Co. ("Lyon"), a closely-held corporation engaged in the distribution of home furnishings, for a term of approximately 76 years.[6] Worthen constructed the bank building and sold it, in sections, for approximately $7,640,000 to Lyon. Lyon invested $500,000 of its own funds and financed the balance with recourse, institutional first mortgage financing payable over 25 years. Worthen then leased the building from Lyon for a primary term of 25 years. The lease included options to extend to a total term of approximately 65 years. In the eleventh, fifteenth, twentieth and twenty-fifth years of the lease, Worthen had an option to purchase the building for a fixed purchase price equal to (a) $500,000 plus six percent compound interest over the lease term, plus (b) the amount of the then-unpaid balance of the institutional financing. Worthen's rent for the primary term of the lease (the first 25 years) was the amount necessary to amortize fully the institutional financing. At the end of the primary term of the lease, if Worthen did not exercise its option to repurchase the building, Worthen could renew the lease for a rental stream that, after considering the ground rentals payable back to Worthen, repaid Lyon its $500,000 investment with six percent compound interest.

The Internal Revenue Service ("IRS"), in an audit of Lyon, determined that the transaction was a financing and disallowed the related deductions. The District Court ruled in Lyon's favor and held that the claimed deductions were allowable, concluding that the legal intent of the parties had been to create a bona fide sale-and-leaseback in accordance with the form and language of the documents evidencing the transactions. The Eighth Circuit reversed, in an opinion that found the benefits and burdens of ownership of the building had been retained by Worthen. Specifically, the Eighth Circuit noted that any appreciation in the value of the building would accrue to Worthen either upon destruction or condemnation or through its fixed price purchase options.

The Supreme Court reversed the decision of the Eighth Circuit in a frequently-cited holding:

> In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory

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[5] 435 U.S. 561 (1978).

[6] The majority shareholder of Lyon also served on Worthen's board of directors.

> realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the Parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts. It suffices to say that, as here, a sale-and-leaseback, in and of itself, does not necessarily operate to deny a taxpayer's claim for deductions.[7]

In reaching its conclusion, the Supreme Court focused first on the economic substance of the transaction. To distinguish *Lazarus,*[8] the Court looked to the number of parties involved in the transaction, placing a strong emphasis on the presence of an institutional investor unrelated to the parties in the transaction, noting that the structure resulted from the restrictions imposed on Worthen by the banking authorities and pointing out that the tax rates of the parties were not disparate. The Court pointed out that more than one party was interested in participating in the transaction but that Lyon won the opportunity, reasoning that if Lyon had not participated in the transaction another interested investor would have.

The Court found economic substance and indicia of ownership in the recourse nature of Lyon's liability on the mortgage to the institutional investor. The Court was influenced by the business risk to Lyon through the primary liability on the debt that Lyon assumed, noting that Lyon's use of its capital for the purpose of the financing made Lyon less able to obtain financing for other business needs. Further, the likelihood that Worthen would exercise its option to purchase the property was viewed by the Court as uncertain, leaving Lyon with the potential for ownership of the property after the lease term. The Court did not view the six-percent compound fixed rate of return on Lyon's investment in the event Worthen exercised the purchase option to compel treatment of the transaction as a financing for tax purposes.

Although a substantial focus of the Supreme Court in *Lyon* was the economic substance of the transaction at issue, the Court examined other factors, some of which are discussed above, that are generally viewed as indicative of which party in a transaction is the tax owner of property. For example, the relationship between the amounts due under the lease and the amount of the financing, the accounting treatment of the parties, the relationship among the parties, the risk of depreciation/loss borne by Lyon, the reasonableness of the rentals and option purchase prices, and the residual interest in the building owned by Lyon were factors considered by the Court. In its holding, the Court restated its test for respecting the status of a lessor as a question of whether the lessor retained "significant and genuine attributes of the traditional lessor status," apparently

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[7]*Id. at* 583-584.

[8]*See* note 4, *infra.*

referencing a type of benefits and burdens analysis in addition to the test for economic substance of a transaction. Various of the benefits and burdens factors considered by the Supreme Court in *Lyon*, as well as by other courts subsequent to the *Lyon* decision. are often advanced by the IRS as factors relevant in determining the tax ownership of leased property.[9]

2. Developments after *Frank Lyon Co.*

Since the Supreme Court decision in *Lyon*, courts have had a number of opportunities to consider the criteria for determining tax ownership of property, in the context of both sale-leasebacks and leveraged leases. A good example is the Tax Court's decision in *Torres v. Commissioner*,[10] in which it reviewed the tax ownership criteria in the context of a sale-leaseback. To evaluate the transaction in *Torres*, the Tax Court first applied an analysis similar to that of the Supreme Court in *Lyon* to determine whether the transaction in issue had sufficient economic substance to be recognized for federal income tax purposes. Specifically, the Tax Court determined that economic substance is present if the transaction has a business purpose and if the party claiming tax ownership has a reasonable expectation of profit apart from expected tax benefits (*i.e.*, a reasonable possibility that the purported owner could recoup its investment from the income potential and residual value of the property). Once the threshold issue of economic substance was resolved, the Tax Court went on to consider whether the transaction conferred sufficient benefits and burdens of ownership on Regency Associates, the putative owner-lessor of the subject equipment, for it to be considered the owner of the equipment for federal income tax purposes.

[9] *See* Rev. Rul. 55-540, 1955-2 C.B. 39 (enumerates factors considered by IRS in determining whether a putative lease of equipment is a lease or a conditional sales contract); Rev. Proc. 75-21, 1975-1 C.B. 715 (sets forth guidelines for advance ruling purposes in determining whether leveraged leases are true leases of property for federal income tax purposes). A discussion of factors set forth in Rev. Rul. 55-540 and Rev. Proc. 75-21, is set forth below. *See also* Rev. Rul. 83-47, 1983-1 C.B. 63 (a corporation that leased townhouses to potential buyers who could not qualify for mortgage loans with payments essentially equal to debt service on the properties and then sold the properties to the potential buyers once the buyers had built a good credit history was engaging in a financing arrangement).

[10] 88 T.C. 702 (1987). The facts in *Torres* are somewhat involved. Copylease was in the business of leasing photocopying equipment to end-users. Copylease sold the equipment subject to a lease to Curtis Corp. in exchange for $1,200,000 in cash and a nonrecourse note for $8,800,000. Copylease then leased the equipment back from Curtis Corp. Rental payments under the lease consisted of a fixed portion and a contingent portion based on the cash flow to Copylease from the leases. Torres was the general partner of a limited partnership known as Regency Associates. Simultaneously with the execution of the agreements between Curtis Corp. and Copylease, Regency Associates purchased from Curtis Corp. the equipment and lease rights that Curtis Corp. had acquired through the sale-leaseback transaction with Copylease. Regency Associates paid Curtis Corp. $115,000 in cash and delivered a nonrecourse note for $9,985,000. The nonrecourse note executed by Regency Associates required payment of principal and interest over a 15-year period. To the extent rental payments from Copylease were not made when due, Regency Associates could defer payment on the nonrecourse note to Curtis Corp. The Tax Court held that Regency was the owner of the equipment for federal income tax purposes.

In *Torres*, the Tax Court considered a number of factors as indicative of the benefits and burdens of ownership outside the context of a sale-leaseback, including the passage of legal title, the treatment of the parties, the obligation of the seller to deliver a deed and of the buyer to make payments. In the context of a sale-leaseback, the Tax Court noted that such factors as whether the purchaser had the right of possession, paid property taxes, bore the risk of loss or damage to the property and received profit from the operation of the property were less relevant factors because such factors are the normal result of a lease transaction. The Tax Court considered several other factors to be of greater importance, including: a useful life that extended beyond the lease term, existence of a purchase option at less than fair market value, and a provision for renewal of the lease term at less than fair market value.

More recently, in *Regents Park Partners v. Commissioner*,[11] the Tax Court again applied both the economic substance analysis and the benefits and burdens analysis to determine that the partners in the partnership acquired basis in the property from the nonrecourse acquisition debt only up to the fair market value of the property, which was less than the outstanding indebtedness.

Recent decisions of the Tax Court, together with the Supreme Court's decision in *Frank Lyon Co.*, indicate that the factors relevant to the benefits and burdens of ownership should be weighed once a determination has been made that a transaction has economic substance. The following therefore divides factors to be considered in making a determination of tax ownership of property into two parts.

3. Factors indicating economic substance.

The foregoing authorities identify the following factors as indicative that a transaction has economic substance:

a. Parties. The Supreme Court in *Lyon* viewed the relationship between the parties, the relative tax rates of the parties and the existence of a third, independent party to the transaction as indicative that the form of the transaction advanced by the parties had economic substance.

b. Business Purpose. The existence of a business purpose for the transaction other than potential tax benefits was considered indicative of economic substance by the Tax Court in *Torres*.

[11] 63 T.C.M. 3131 (1992) (partnership acquired buildings from HUD; buildings were purchased subject to non-recourse indebtedness that exceeded the appraised value of the buildings).

c. Profit Expectation. The availability or expectation of profit by the parties to the transaction has been a factor indicating tax ownership of the property.[12]

4. Factors indicating benefits and burdens of ownership.

Once a determination is made that a transaction has economic substance, the benefits and burdens of ownership test is applied. Factors from the foregoing authorities that may be considered in determining which party has the benefits and burdens of ownership include, among others:

a. Possession. Possession of the property was listed by the Tax Court in *Regents Park* as a factor indicating ownership for federal income tax purposes. However, in *Torres*, the Tax Court noted that a lessor is not normally vested with the right of possession during the term of a lease. There, the Tax Court found the extension of the useful life of the property beyond the term of the lease so as to give the purchaser a meaningful future possessory right in the property to be more indicative of tax ownership in the context of a lease.

b. Property Taxes. Responsibility for the payment of property taxes was cited by the Tax Court in *Regents Park* as a factor indicating tax ownership of property. The Tax Court noted in *Torres* that "because net leases are common in commercial settings, it is less relevant that [the lessor] was not responsible for the payment of property taxes." [13]

c. Risk of Casualty Loss. According to the Tax Court in *Regents Park*, responsibility for the risk of loss or damage to the property is a factor indicating tax ownership of property. As with payment of property taxes, this is a responsibility that is often allocated to the lessee in a net lease; thus, the Tax Court recognized in *Torres* that the factor is less relevant in a commercial setting.[14]

d. Likelihood of Exercise of Renewal Option. The existence of a renewal option at a nominal amount indicated to the Tax Court in *Torres* that the arrangement is a financing rather than a lease, and favors treatment of the nominal lessee as the tax owner of the building.

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[12] *See Regents Park Partners v. Commissioner, supra*; Rev. Proc. 75-21, 1975-1 C.B. 715.

[13] *Torres v. Comm'r, supra* at 721 (1987).

[14] *Id.* at 721.

e. Treatment by Parties for Accounting and Other Purposes. The Supreme Court in *Lyon* stated its awareness that the treatment of a transaction for financial accounting purposes need not necessarily be the same as that for federal income tax purposes. However, the Court noted that consistency of treatment of the transaction for financial accounting purposes favored treating the nominal lessor as the tax owner of the property. In *Torres*, the Tax Court considered the treatment of the parties for accounting and other purposes to be relevant to a determination of which party bore the benefits and burdens of ownership.

f. Benefit of Appreciation/Risk of Depreciation. Liability on purchase money indebtedness or risk of loss in the event of the devaluation of the property was seen by the Supreme Court in *Lyon* as a factor favoring treatment of the nominal lessor as the tax owner of the property. The Tax Court in *Illinois Power Co. v. Commissioner*,[15] viewed the fixed rate of return to one of the parties to be that of a lender and therefore indicative that the risk of loss fell on the other party to the transaction.

g. Legal Title. Passage of legal title to the property is a factor considered by the Tax Court in *Torres* and *Regents Park* to be relevant in determining tax ownership of property.

h. Payments Apply to Equity. Where a portion of the payments under the agreement are made specifically applicable to an equity interest to be acquired by the lessee, or legal title to the property passes under the agreement, treatment of the nominal lessee as the tax owner is favored.[16] Passage of legal title to the property was also a factor considered by the Tax Court in *Torres* and *Regents Park* to be relevant in determining tax ownership of property.

In addition to the foregoing, in analyzing the benefits and burdens of ownership with respect to leased property, the courts have also taken into account to varying degrees many of the factors that are considered relevant by the IRS as reflected in its revenue rulings and revenue procedures. These administrative authorities are discussed in greater detail below.

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[15] 87 T.C. 1417 (1986) (Illinois Power Co. ("IPC") created a subsidiary ("IPFC"), gave 50 percent of the stock of IPFC to a university, sold nuclear fuel to IPFC, which purchased the fuel through commercial paper the payment of which was guaranteed by IPC. IPFC simultaneously leased back the fuel to IPC. The Tax Court held that IPC could disavow the form of the sale-leaseback and treat the transaction as a financing).

[16] *See also* Rev. Rul. 55-540, *supra*.

5. Rev. Rul. 55-540.

Rev. Rul. 55-540, 1955-2 C.B. 39, sets forth a number of factors that the IRS considers, in the context of an equipment lease, in determining whether a transaction is treated as a lease or a financing arrangement for federal income tax purposes. The ruling provides that the "intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed," governs the determination of whether an agreement is a lease or a conditional sales contract. As noted above, there have been developments in case law subsequent to the release of Rev. Rul. 55-540, and the ruling must be read in light of those developments. Nonetheless, Rev. Rul. 55-540 still provides helpful guidance to the extent that it offers insight into the factors considered by the IRS in making such tax ownership determinations and is frequently cited by the IRS in its rulings.[17]

Rev. Rul. 55-540 provides that, although no single fact is controlling, the following conditions (in addition to certain of the factors listed above) are helpful in determining the tax ownership of property in a sale-leaseback transaction:

a. Rentals Disproportionate. When the total amount to be paid by the lessee for a relatively short period of use is an inordinately large portion of the total required to be paid to secure transfer of title, treatment of the nominal lessee as the tax owner is favored.

b. Rentals Exceed Fair Market Value. Treatment of the nominal lessee as tax owner is favored when the agreed rental payments materially exceed the current fair rental value of the leased property, indicating an element other than compensation for the use of property.

c. Bargain Option to Purchase. The existence of an option to acquire the leased property for a price that is nominal in relation to its value at the time of the exercise of the purchase option indicates that the nominal lessee is the owner of the property for federal income tax purposes.[18]

d. Designation of Portion of Payments as Interest. The designation of some portion of the rental payments as interest is indicative of ownership by the nominal lessee.

[17] *See, e.g.,* Priv. Ltr. Rul. 93-13-001 (Apr. 7, 1992) (leases for the use of automobiles by retail customers were true leases).

[18] *See also* Rev. Proc. 75-21, 1975-1 C.B. 715.

e. Rental Payments Based on Use. The existence of rental payments at an hourly, daily or weekly rate, or based on production, use, mileage or a similar measure and not directly related to the normal purchase price, is a factor indicating tax ownership by the nominal lessor, provided that, if there is an option to purchase, the option price reasonably approximates the fair market value of the property on the option date.

f. Rental Payments not Required throughout Lease Term. Where the sum of specified rentals over a relatively short part of the expected useful life of the property approximates the price at which the property could have been purchased, plus interest and/or carrying charges, and the lessee may continue to use the equipment for an additional period approximating its remaining estimated useful life for relatively nominal or token amounts, the nominal lessee is favored as tax owner.

g. Payments Approximate Purchase Price. Where the sum of the rentals payable under an agreement, plus the exercise prices of any options to purchase the property, approximate the purchase price of the property plus a stated return, the agreement more closely resembles a financing than a lease. In such case, the nominal lessee would appropriately be treated as the owner of the underlying property.

6. Rev. Proc. 75-21.

In Rev. Proc. 75-21, 1975-1 C.B. 715, the IRS set forth guidelines that it will use for advance ruling purposes in determining whether certain transactions ("leveraged leases") are leases rather than financing arrangements. Although the guidelines were intended to clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued, the IRS stated in Section 3 of Rev. Proc. 75-21 that it would consider ruling in cases where the guidelines are not satisfied, based on all the facts and circumstances. The ruling guidelines established in Rev. Proc. 75-21 have been applied by the IRS in recent years in the context of private rulings.[19] Certain of the facts and circumstances set forth in Rev. Proc. 75-21 that the IRS considers relevant in establishing that the lessor in a leveraged lease is the owner of the property for federal income tax purposes have been discussed *infra.* The following additional facts and circumstances are identified in Rev. Proc. 75-21:[20]

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[19] *See, e.g.*, Priv. Ltr. Rul. 91-45-008 (Aug. 12, 1991) (sale-leaseback of paper-mill equipment was determined to be a true lease); Priv. Ltr. Rul. 91-44-001 (May 14, 1991) (lease for use of an airplane and related facilities was determined to be a true lease); Priv. Ltr. Rul. 89-51-002 (Sept. 13, 1989) (Partnership that leased automobiles to third parties was not the owner of the automobiles for depreciation purposes).

[20] Like Rev. Proc. 55-540, Rev. Proc. 75-21 provides guidelines for determining whether a transaction may be treated as a lease for federal income tax purposes in the context of an equipment lease. However, like Rev. Rul. 55-540, Rev. Proc. 75-21 is helpful to the extent that it offers insight into the guidelines applied by the IRS in making tax

a. Minimum Unconditional "At Risk" Investment. When the property is first placed in service or use by the lessee, the minimum investment made by the lessor in the property must be 20 percent of the cost of the property. The lessor must maintain the minimum investment of 20 percent throughout the term of the lease and must demonstrate that an amount equal to 20 percent of the cost of the property is a reasonable estimate of the market value of the property at the end of the lease term.

b. Lessor Cannot Force Purchase by Lessee. When the property is first placed in service or use by the lessee, the lessor may not have a contractual right to cause any party to purchase the property.

c. No Investment by Lessee. No part of the cost of the property may be furnished by the lessee. No portion of the cost of improvements or additions to the property, except for improvements or additions that are owned by the lessee and are readily removable without causing material damage to the property, may be paid by the lessee.

d. No Lessee Loans or Guarantees. The lessee may not lend any of the funds necessary to acquire the property to the lessor and may not guarantee any indebtedness created in connection with the acquisition of the property by the lessor.

B. Analysis of the Lease.

In analyzing the effect of the Lease on tax ownership of the Building, it is important to note that the parties to the Lease have clearly indicated their intent in Section 3.02(b) of the Lease that, for all purposes other than accounting and regulatory purposes, including for bankruptcy and tax purposes, the Lease is to be treated as a financing transaction. Thus, the express, stated intent of the parties to the Lease is that the transaction be treated as a secured loan for all but limited accounting and regulatory purposes.[21] Accordingly, for state law enforceability purposes and all purposes other than accounting and regulatory purposes, assuming that the expressed intent of the parties is

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ownership determinations.

[21] Because the taxpayer chooses the form of the transaction, the courts have imposed restrictions on the ability of taxpayers to submit evidence of the substance of a transaction when seeking to disavow its form. The Third Circuit, in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), imposed a stringent burden of proof requirement that allows a taxpayer to challenge the tax consequences of a transaction's form only by a showing of mistake, undue influence, fraud or duress or any other ground that in an action between the transacting parties would be sufficient to set aside an agreement or to alter its construction. With regard to the transactions contemplated in the Lease, the treatment of the transaction as a financing for federal income tax purposes is fully consistent with the intent of the parties as evidenced by Section 3.02(b) of the Lease. Accordingly, the IRS will not face conflicting taxpayer characterizations of the Lease such that the *Danielson* rule would prevent the parties to the Lease from treating the Lease in conformity with the stated intent and substance of the Lease rather than its label.

respected, the Lease should be treated as a mortgage lien or security interest in the Building in favor of Brazos.[22]

State law defines the rights of the parties to a transaction and the legal consequences of the transaction; it is from that point that an analysis of the federal income tax consequences of the transaction may proceed.[23] The starting point for analyzing the Lease should therefore be a determination that the form of the Lease, as intended by the parties, is a financing, despite the labels placed on the operative documents. In continuing the analysis with respect to the Lease, as noted above it is necessary to determine whether the Lease has sufficient economic substance to be recognized for federal income tax purposes, and then to consider whether the Lease confers sufficient benefits and burdens of ownership on OPI for it to be considered the owner of the Building for federal income tax purposes (prior to the Assignment).

1. Economic Substance.

The factors enumerated above as indicating economic substance can be applied to the arrangement evidenced by the Lease as follows:

> a. Parties. It has been represented that neither Enron nor OPI has any ownership interest in Brazos; thus, Brazos and OPI are not related parties. Further, it has been represented that the marginal federal income tax rates of OPI and the partners of Brazos are substantially identical. The independence of the parties and the relative tax rates of the parties support treatment of the Lease in accordance with its form.
>
> b. Business Purpose. The existence of a business purpose for the Lease, long-term financing of the Building, supports treatment of the Lease in accordance with its form.
>
> c. Profit Expectation. OPI will be able to capture the benefits of any appreciation in the value of the Building as a result of OPI's option to purchase the Building for the Acquisition Cost after the third anniversary of the Lease Term.

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[22]Reference is made to our opinion letter dated April 14, 1997, which sets forth our opinion that the Lease and the Memorandum of Lease are sufficient to create a valid mortgage lien or security interest in favor of Brazos encumbering the Building and that the Lease is a legal, valid and binding obligation of OPI, subject to the qualification that our opinion should not be construed as meaning the Lease would be enforced as a lease. Our opinion states that it is predicated upon our conclusion that for state law purposes the transaction under the Lease and related documents would be characterized as a loan in keeping with the parties' expressed intent.

[23]*See Comm'r v. Crichton*, 122 F. 2d 181 (5th Cir. 1941) (mineral rights were real property under Louisiana law and, as real property, were of a like kind with improved city real estate); Rev. Rul. 55-749, 1955-2 C.B. 295 (where applicable state law considers water rights to be real property rights, the exchange of perpetual water rights for a fee interest in land constituted a nontaxable exchange of property of like kind).

Rental payments under the Lease are computed based on a formula that provides a specified return to Brazos after the payment of debt service on the Building pursuant to the Credit Agreement. The profit expectation of Brazos is therefore that of a lender, rather than an owner of the Building. The Acquisition Cost of the Building is $284,500,000, regardless of the fair market value of the Building at the time of the exercise of the option. This factor supports treatment of the Lease in accordance with its form.

The above-described factors support a determination that the Lease transaction has economic substance and that, accordingly, the Lease transaction should be recognized for federal income tax purposes in accordance with its form. As discussed above, the parties' intention that the Lease transaction be a financing for all purposes other than accounting and regulatory purposes, including lien enforceability purposes, should be respected as the form of the transaction for federal income tax purposes. Having crossed the economic substance threshold, it is appropriate to address the benefits and burdens of ownership factors.

2. Benefits and Burdens of Ownership.

An application of the factors enumerated above indicating benefits and burdens of ownership follows:

a. Possession. So long as the Lease is in effect, OPI will have possession of the Building. However, a lessor is not normally vested with the right of possession during the term of a lease. The relevant inquiry, therefore, is whether the useful life of the Building extends beyond the term of the Lease. The parties have represented that the remaining economic useful life of the Building as of April 14, 1997 is at least 50 years. The Initial Term of the Lease, plus all Renewal Terms, is 40 years. Accordingly, the useful life of the Building extends well beyond the term of the Lease. This factor therefore favors Brazos as tax owner of the Building.

b. Property Taxes. The Lease requires OPI to pay property taxes. As indicated by the Tax Court's decision in *Torres*, this factor is less relevant in the context of a commercial lease; however, the payment of property taxes by OPI favors OPI as tax owner of the Building.

c. Risk of Casualty Loss. The Lease requires OPI to maintain insurance on the Building. As indicated by the Tax Court's decision in *Torres*, this factor, like property taxes, is less relevant in the context of a commercial lease; however, OPI's responsibility for risk of casualty loss is a factor supporting OPI as tax owner of the Building.

d. Likelihood of Exercise of Renewal Option. OPI has no option to renew the Lease for a nominal rental amount. However, if OPI chooses not to renew the Lease. Section 11.03(b) of the Lease requires OPI to (a) purchase the Building for cash at the Acquisition Cost or (b) arrange for the property to be sold for cash pursuant to Section 11.04 of the Lease. The lack of a nominal renewal amount does not literally support OPI as tax owner of the Building, but a consideration of the consequences to OPI of non-renewal supports the likelihood of OPI renewing the Lease until the end of the Lease term.

e. Treatment of Parties for Accounting and Other Purposes. Brazos will be treated as the owner of the Building for financial accounting purposes pursuant to Section 3.02(a) of the Lease. Although the Supreme Court in *Frank Lyon Co.* recognized that this factor is not dispositive, federal income tax treatment consistent with that of financial accounting would indicate that Brazos should be treated as tax owner of the Building. For all other purposes, including bankruptcy and real estate lien enforceability purposes, the parties' express their intent in Section 3.02(b) of the Lease that OPI be treated as the owner of the Building and that the Lease be treated as the repayment and security provisions of a loan. Since accounting treatment is not dispositive and since the parties intend to treat the Lease as a financing for all other purposes, this factor appears to favor OPI as tax owner of the Building.

f. Benefit of Appreciation/Risk of Depreciation. Through its option to purchase the Building for the Acquisition Cost, OPI can effectively enjoy all of the benefit of appreciation in the value of the Building during the Lease. On any renewal date, if OPI chooses not to exercise its option to renew the Lease, OPI must either purchase the Building for cash at the Acquisition Cost or arrange for its sale to a third party pursuant to Section 11.04 of the Lease. Further, if OPI chooses to renew the Lease and Brazos is unable to obtain financing and equity contributions on terms acceptable to Brazos, its limited partners and OPI, Section 11.03(b) of the Lease requires OPI to either purchase the Building for an amount of cash equal to the Acquisition Cost or arrange for its sale to a third party. To the extent that proceeds of a sale of the Building to a third party exceed the Acquisition Cost, OPI receives such excess proceeds. In the event of a sale to a third party at a price less than the Acquisition Cost, the risk of depreciation loss depends on the sale price obtained. If the sale proceeds are 25 percent or more of the Acquisition Cost, OPI must pay Brazos the difference between the sale proceeds and the Acquisition Cost. If the sale proceeds are less than 25 percent of the Acquisition Cost, OPI is obligated to pay Brazos 75 percent of the Acquisition Cost plus an amount that Brazos determines in good faith to be the amount that the residual value of the Building was reduced in excess of that attributable to normal wear and tear, plus an amount that Brazos determines in good faith to be the amount the sale proceeds have been reduced due to certain Liens attaching to the Building that arise out of OPI's acts or failure to act. If OPI elects to

renew the Lease but the Building depreciates significantly, Brazos will be unable to obtain nonrecourse financing for the Building on terms identical to those under the Credit Agreement or otherwise acceptable to Brazos. In such case, the economic effect of the Lease provisions is to place the risk of depreciation loss on OPI. Thus, through the last renewal date of the Lease, OPI bears most of the risk of depreciation on the Building. Because Brazos has financed the Building with nonrecourse debt, in the event that the Building were significantly depreciated at the end of the final Renewal Term and Brazos and the Banks had not identified the depreciation prior to such time, permitting Brazos to invoke the Lease provision requiring OPI to purchase or arrange for the purchase of the Building if acceptable financing were not available, the Banks would bear the risk of the depreciation. On balance, this factor favors OPI as tax owner of the Building, because OPI enjoys all of the benefits of any appreciation of the Building and substantially all of the risk of depreciation of the Building.

g. Legal Title. Legal title to the Building is vested in Brazos during the term of the Lease. This factor favors Brazos as tax owner of the Building.

h. Acquisition of Title or Equity Interest. OPI does not acquire title to the Building or a stated equity interest in the Building merely upon payment of a specified amount of rentals, a factor favoring Brazos as tax owner of the Building.

i. Rental Payments Not Disproportionate. Rental payments under the Lease are based solely on the cost of borrowing and a return on equity for Brazos. Accordingly, rental payments will remain relatively level throughout the term of the Lease, except for adjustments based on interest rate changes. Therefore, the total amount to be paid by OPI for a relatively short period of use is not an inordinately large portion of the total required to be paid to secure transfer of title. This factor favors Brazos as tax owner of the Building.

j. Rentals Relation to Fair Market Value. Rental payments under the Lease are based on the cost of borrowing and return on equity for Brazos, not on the fair market value rental for the Building. The fact that rental payments are based on the cost of funds supports treatment of OPI as tax owner of the Building to the extent that the determination of rental amounts are made without regard to fair rental value. On the other hand, to the extent that the agreed rental payments do not materially exceed the current fair rental value, reduced weight should be accorded to this factor.

k. Bargain Purchase Option. OPI has an option to purchase the Building at the Acquisition Cost or arrange for a third party to purchase the Building under Section 11.04 of the Lease. OPI's option to purchase functions as a bargain purchase option to the extent it confers on OPI all of the benefits of appreciation of the Building.

Although OPI's purchase option will not necessarily result in a bargain or nominal price purchase, because the option exercise price does not take into account appreciation of the Building, this factor provides support for the treatment of OPI as tax owner of the Building.

l. Designation of Payments as Interest. Base Rent under the Lease contains a component, Basic Rent (Debt), that is based on the cost of funds to Brazos. In addition, Section 3.02(b) of the Lease indicates that for all but limited accounting and regulatory purposes, including for bankruptcy and tax purposes, the Lease is intended to be treated as a loan and all payments of Basic Rent, Additional Rent, proceeds of sale and other amounts payable under the Lease be treated as principal, interest and other amounts owing with respect to such loan. This factor favors OPI as tax owner of the Building.

m. Rental Payments Measured Based on Passage of Time, Not Purchase Price. Rental payments under the Lease are based on (a) the cost of funds related to the debt incurred by Brazos to purchase the Building and (b) a specified return on the equity contributed by Brazos to purchase the Building. Rental payments are therefore based on the purchase price of the Building. The rental payment structure favors OPI as tax owner of the Building.

n. Rental Payments Required Throughout Lease Term. Rental payments based on the carrying cost of the Building to Brazos are required throughout the Lease Term. The Lease does not permit OPI to use the Building for relatively nominal amounts after a certain amount of rental payments have been made. This factor supports Brazos as tax owner of the Building.

o. Minimum Unconditional At Risk Investment. Brazos has a stated equity interest in the Building of 3 percent of the Acquisition Cost of the Building. Brazos does not meet the requirement of Rev. Proc. 75-21 that the minimum initial investment of the lessor be 20 percent of the cost of the property and that the minimum initial investment remain at 20 percent at all times throughout the term of the lease. The comparatively small magnitude of the unconditional at risk investment on the part of Brazos is a factor favoring OPI as tax owner of the Building.

p. Payments Approximate Purchase Price. Under the Lease, the sum of the rentals payable by OPI, plus the Acquisition Cost of the Building, approximates the purchase price of the Building plus debt service and a stated return to Brazos. The structure of the Lease payments is consistent with that of a financing transaction, the form intended for the Lease transaction by the parties.

q. Lessor Can Force Purchase. Under Section 11.02 of the Lease, Brazos can force OPI to purchase the Building or find a third party to purchase the Building in certain circumstances described in Section 11.02(b) of the Lease. Further, if OPI elects to renew the Lease but Brazos is unable to obtain financing on terms identical to the Credit Agreement or terms otherwise acceptable to Brazos, Brazos may force OPI to purchase the Building or find a third party to purchase the Building. This factor favors OPI as tax owner of the Building.

r. Investment by Lessee. The cost of any additions and improvements to the Building are to be paid by OPI, pursuant to Section 8.04 of the Lease, so long as there is no Event of Default. OPI is permitted under the Lease to make additions and alterations subject to a requirement to notify (not obtain the consent of) Brazos if the cost of such additions and alterations exceeds $5,000,000. This factor favors OPI as tax owner of the Building.

s. Lessee Loans or Guarantees. Enron, OPI's parent, has guaranteed the payments by OPI under the Lease. OPI has indemnified Enron for any payments Enron is required to make under the Guaranty. Neither OPI nor Enron has guaranteed the payments to be made by Brazos under the Credit Agreement. This factor favors Brazos as tax owner of the Building.

On balance, an examination of the factors listed above indicates that the Lease should be treated as a financing for federal income tax purposes and that OPI should be treated as the tax owner of the Building. The principal factors that support the treatment of OPI as the tax owner of the Building are (i) the intent of the parties, expressed in the Lease, that for all purposes other than accounting and regulatory purposes the Lease is to be treated as a financing transaction, (ii) the option of OPI to purchase the Building at the Acquisition Cost, (iii) the ability of Brazos under certain circumstances to force OPI to purchase the Building at the Acquisition Cost or arrange for the purchase of the Building by a third party pursuant to Section 11.04 of the Lease, (iv) the fact that rental payments are based on the cost of funds plus a specified return to Brazos, and (v) the fact that OPI bears most of the risk of financial loss and enjoys the benefits of any appreciation in the value of the Building.

Based on this analysis, prior to the Assignment OPI should be treated as the owner of the Building for federal income tax purposes. As noted above, pursuant to the Assignment OPI assigned all of its rights under the Lease to Leasing Partners, and Leasing Partners assumed all of OPI's obligations under the Lease. Accordingly, following the Assignment Leasing Partners should be treated as the owner of the Building for federal income tax purposes.

C. Analysis of the Sublease.

Following the Assignment, Leasing Partners subleased the Building to Enron pursuant to the Sublease. Accordingly, it is necessary to analyze the Sublease in order to conclude that Leasing Partners should continue to be treated as the owner of the Building following the Sublease.

As with the Lease, it is appropriate to bifurcate the tax ownership analysis of the Sublease into two parts: economic substance and benefits and burdens of ownership. The factors enumerated above can be applied to the arrangement evidenced by the Sublease as follows:

1. Economic Substance.

a. Parties. Enron controls Leasing Partners through its wholly-owned subsidiary, OPI. Enron also guarantees the payments to Brazos under the Lease; however, OPI, the 97 percent limited partner of Leasing Partners, has indemnified Enron for any payments Enron is required to make under the Guaranty. This factor supports Leasing Partners as tax owner of the Building.

b. Business purpose. Leasing Partners is receiving fair market value rental for the Building, while Enron is receiving the use of the Building. These valid business purposes for the Sublease support treatment of Leasing Partners as tax owner of the Building in accordance with the form of the transaction.

c. Profit Expectation. Rental payments under the Sublease are expected to exceed debt service payable by Leasing Partners to Brazos. Leasing Partners therefore has the expectation of profit from the lease arrangement, a factor supporting treatment of Leasing Partners as tax owner of the Building in accordance with the form of the transaction.

Unlike the Lease, the Sublease does not evidence an intent by the parties that it be treated as a financing transaction or anything other than a sublease for all purposes. Thus, application of the factors indicating economic substance support treating the Sublease as a true lease in accordance with its form and, accordingly, treating Leasing Partners as remaining the tax owner of the Building following the Sublease. Having crossed the economic substance threshold, it is appropriate to address the benefits and burdens of ownership factors.

2. Benefits and Burdens of Ownership.

a. Possession. So long as the Sublease is in effect, Enron will have possession of the Building. However, a lessor is not normally vested with the right of possession during the term of a lease. The relevant inquiry, therefore, is whether the useful life of the Building extends beyond the term of the Sublease. The parties have

represented that remaining economic useful life of the Building as of April 14, 1997 is at least 50 years. The Initial Term of the Sublease, plus all Renewal Terms, is 20 years. Accordingly, the useful life of the Building extends well beyond the term of the Sublease. This factor therefore favors Leasing Partners as tax owner of the Building.

b. Property Taxes. The Sublease requires Enron to pay property taxes. As indicated by the Tax Court's decision in *Torres*, this factor is less relevant in the context of a commercial lease; however, the payment of property taxes by Enron favors Enron as tax owner of the Building.

c. Risk of Casualty Loss. The Sublease requires Enron to maintain insurance on the Building. As indicated by the Tax Court's decision in *Torres*, this factor, like property taxes, is less relevant in the context of a commercial lease; however, Enron's responsibility for risk of casualty loss is a factor supporting Enron as tax owner of the Building.

d. Likelihood of Exercise of Renewal Option. Enron has no option to renew the Sublease for a bargain rental amount, a factor that favors recognition of Leasing Partners as tax owner of the Building.

e. Treatment of Parties for Accounting and Other Purposes. The Sublease is silent with respect to the financial accounting treatment of the Sublease by the parties. Leasing Partners and Enron have represented that they will treat the Sublease as a true lease for accounting and other purposes. Although the Supreme Court in *Frank Lyon Co.* recognized that this factor is not dispositive, federal income tax treatment consistent with that of financial accounting would indicate that Leasing Partners should be treated as tax owner of the Building.

f. Benefit of Appreciation/Risk of Depreciation. At the end of five years, pursuant to the terms of the Lease, if Enron does not exercise its right to make the Cancellation Payment and cancel the Sublease, Leasing Partners can terminate the Lease. To terminate the Lease, Leasing Partners will be required to purchase the Building from Brazos at the Acquisition Cost or to arrange for the sale of the Building to a third party pursuant to Section 11.04 of the Lease. Under Section 11.04 of the Lease, if the purchase price of the Building does not equal or exceed the Acquisition Cost, Leasing Partners is at risk to pay Brazos all or at least a substantial portion of the shortfall. Accordingly, Leasing Partners bears the risk of loss if the Sublease is not renewed at the end of the Initial Term, a factor indicative of tax ownership by Leasing Partners. Enron has the right to purchase the Building only at its then-appraised fair market value at the end of the Sublease. Thus, as between Leasing Partners and Enron, Leasing Partners will enjoy the benefit of any

appreciation of the Building. This factor favors Leasing Partners as tax owner of the Building.

g. Legal Title. Legal title to the Building is vested in Brazos during the term of the Lease. This factor does not clearly favor either Enron or Leasing Partners as tax owner of the Building.

h. Payments Applicable to Equity. Enron does not acquire an equity interest in or title to the Building through payment of rents, a factor favoring Leasing Partners as tax owner of the Building.

i. Rental Payments Not Disproportionate. Rental payments under the Sublease are level throughout the term of the Sublease, except for adjustments based on the Consumer Price Index. Enron has no option to acquire the Building at other than fair market value. Therefore, the total amount to be paid by Enron for a relatively short period of use is not an inordinately large portion of the total required to be paid to secure transfer of title. This factor favors Leasing Partners as tax owner of the Building.

j. Rentals Do Not Exceed Fair Market Value. Rental payments under the Sublease do not exceed fair market value. Enron and Leasing Partners have represented that the rental payments required under the Sublease approximate fair market value rental for the Building. Fair market value rental payments support Leasing Partners as tax owner of the Building.

k. Bargain Purchase Option. Enron has an option to purchase the Building at a price equal to fair market value at the end of the Initial Term and both Renewal Terms of the Sublease. The lack of a bargain purchase option on the part of Enron favors treating Leasing Partners as tax owner of the Building.

l. Designation of Portion of Payments as Interest. No portion of the rental payments under the Sublease are designated as interest, a factor favoring Leasing Partners as tax owner of the Building.

m. Rental Payments Based on Use. Rental payments under the Sublease are required monthly and are based on the amount of space rented. Rental payments are not based on the normal purchase price of the Building. Except for annual adjustments based on the Consumer Price Index, rental payments under the Sublease are level throughout the Initial Term and both Renewal Terms. The rental payment structure favors Leasing Partners as tax owner of the Building.

n. Rental Payments Required throughout Lease Term. Rental payments are required under the Sublease throughout the Initial Term and both Renewal Terms. This factor supports Leasing Partners as tax owner of the Building.

o. Minimum Unconditional At Risk Investment. Leasing Partners does not meet the requirement of Rev. Proc. 75-21 that the minimum initial investment of the lessor be 20 percent of the cost of the property and that the minimum initial investment remain at 20 percent at all times throughout the term of the lease. Lack of a 20 percent minimum unconditional at risk investment on the part of Leasing Partners is a factor favoring Enron as tax owner of the Building.

p. Payments do not Approximate Purchase Price. Enron has an option to purchase the Building only at the end of the Initial Term and both Renewal Terms for the Building's then-appraised fair market value. Thus, the sum of the rentals payable by Enron under the Sublease, plus the exercise price of the option to purchase the Building, far exceed the purchase price of the Building plus a stated return. Accordingly, the form of the Sublease should be respected as a sublease.

q. Lessor Cannot Force Purchase. Under the Sublease, Leasing Partners has no right to force Enron or any other party to purchase the Building. This factor favors Leasing Partners as tax owner of the Building.

r. Investment by Lessee. The cost of any additions and improvements to the Building are to be paid by Enron. This factor favors Enron as tax owner of the Building.

s. Lessee Loans or Guarantees. Enron has guaranteed the payments by Leasing Partners under the Lease with Brazos. This factor favors Enron as tax owner of the Building.

On balance, an examination of the factors listed above indicates that the Sublease should be treated as a true lease for federal income tax purposes and that Leasing Partners should be treated as the tax owner of the Building. The lack of a bargain purchase option by Enron, the lack of an equity accumulation from the rental payments by Enron and the fact that Leasing Partners bears the risk of financial loss and enjoys any appreciation from a change in the value of the Building are facts and circumstances that support Leasing Partners as tax owner of the Building for federal income tax purposes.

CONCLUSION

Based upon the facts, representations, law and analysis set forth above, in our opinion (i) prior to the Assignment OPI should be treated as the owner of the Building for federal income tax purposes, (ii) following the Assignment Leasing Partners should be treated as the owner of the Building for federal income tax purposes, and (iii) the Sublease should be treated as a sublease and accordingly Leasing Partners should continue to be treated as the owner of the Building for federal income tax purposes following the Sublease.

The opinions expressed herein are as of the date hereof, and we assume no obligation to update or supplement such opinions to reflect any facts or circumstances that may hereafter come to our attention or any changes in law that may hereafter occur or become effective.

This opinion is given to you by us solely for your use and is not to be quoted or otherwise referred to or furnished to any governmental agency (other than the Internal Revenue Service in connection with an examination of the transactions contemplated by the Lease, the Assignment and the Sublease) or to other persons without our prior written consent.

Very truly yours,

VINSON & ELKINS L.L.P.

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Ernst & Young

Ernst & Young LLP
One Houston Center
Suite 2400
1221 McKinney Street
Houston, Texas [illegible]

Phone [illegible]
Fax [illegible]
www.ey.com

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November 16, 1999

Mr. R. Davis Maxey
Vice President -- Tax Planning
Enron Corp.
1400 Smith Street
Houston, TX 77002-7361

Redetermination of Earnings and Profits of Enron Liquids Holding Corporation

This letter sets forth our views concerning the redetermination of the earnings and profits ("E&P") of Enron Liquids Holding Corp. ("ELHC") following the contribution of Enron Pipeline Company ("EPC") to Enron Operations Corp. ("EOC").

FACTS

In reaching the conclusions stated herein, we have made certain assumptions based on the facts Alicia Goodrow, Jim Holman and you have presented to us orally and in writing. Any changes to the facts or invalidity of these assumptions may affect the conclusions stated herein. We have made no independent determination regarding such facts and circumstances.

ELHC has issued both preferred and common stock. The preferred stock is held 80.20% by Enron Leasing Partners, LP (limited partnership for federal income tax purposes); 10.45% by EPC; and 9.35% by Enron. The common stock is held 80% by Enron and 20% by Organizational Partner, Inc., a deconsolidated subsidiary of Enron. ELHC joins in the filing of Enron's consolidated federal income tax return.[1] The Enron consolidated group files its returns on a calendar year basis.

ELHC has redeemed a portion of both its preferred and common stock quarterly since March 1998. For federal income tax purposes, you have indicated that these redemptions will be treated as distributions with respect to stock (e.g., dividends) by reason of Section 302(d). The

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[1] We understand that the preferred stock is described under Section 1504(a)(4) and accordingly is excluded from the 80% vote and value test under Section 1504(a)(2) because it is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock, and is not convertible into another class of stock.

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following schedule illustrates both the redemptions and dividends either made or expected to be made during the 1999 calendar year:

	Redemptions			Cash Dividends on Preferred Stock		
Date	Preferred Stock	Common Stock	Total	ELHC	EOC	Total
3/31/99	29,575,240	16,551,145	46,126,385	12,745,518		12,745,518
6/30/99	21,675,000	12,345,935	34,020,935	10,885,906		10,885,906
9/30/99	29,950,000	17,357,858	47,307,858	11,138,075		11,138,075
12/31/99	29,600,000	16,692,687	46,292,687	11,063,319	17,446,358	28,509,677
	110,800,240	62,947,625	173,747,865	45,812,818	17,446,358	63,259,176

As of December 31, 1998, ELHC has accumulated E&P of approximately $19,980,151. (See attached schedule for all numerical references.) ELHC is expected to generate approximately $37,072,554 of current E&P for the taxable year ended December 31, 1999. ELHC's E&P has been adjusted for the E&P derived by EOC, Enron Gas Liquids, Inc. ("EGLI"), Enron Louisiana Transportation Company ("ELTC"), Enron Products Pipeline, Inc. ("EPPI"), and EOTT Energy Corporation ("EOTT"), wholly owned subsidiaries of ELHC.

EPC is a wholly owned subsidiary of Enron with accumulated E&P of $968,753,074 at December 31, 1998. EPC is expected to generate approximately $184,616,953 of current E&P for the December 31, 1999 year.

TRANSACTION

The following transaction has been proposed:

- EPC will sell its 10.45% preferred stock interest in ELHC to Enron in exchange for an interest bearing note of equal value.
- Following the sale of EPC's preferred stock interest in ELHC, Enron will contribute 100% of the common stock of EPC to EOC in exchange for 1,000 shares non-voting, perpetual preferred stock with a stated dividend rate of 7% per annum of equal value.
- Incident to the transaction, in an attempt to reorganize along business lines, EGLI; ELTC; EPPI; and EOTT will be disposed of through intercompany sales or liquidations.

ISSUE

Upon the contribution of the stock of EPC to EOC, to what extent will EPC's current and accumulated E&P be replicated under Reg. §1.1502-33(f)(2) to the E&P of EOC and ELHC?

DISCUSSION AND ANALYSIS

Federal Income Tax Treatment of Distributions with Respect to Stock

Sections 301(a) and (c) provide, in part, that: (1) the portion of a distribution of property made by a corporation to a shareholder with respect to its stock which is a dividend shall be included in the shareholder's gross income; (2) the portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock; and (3) the portion of which is not a dividend to the extent that it exceeds the adjusted basis of the stock shall be treated as gain from the sale or exchange of property.

The term "dividend" means any distribution of property made by a corporation to its shareholders out of its E&P accumulated after February 28, 1913, or out of its E&P of the taxable year, without regard to the amount of E&P at the time the distribution was made.[2] Included as dividends are certain distributions in redemption of stock.[3]

Reg. §1.316-2(a) provides that a distribution with respect to stock is made, first, from the distributing corporation's E&P for the taxable year during which the distribution occurs. The determination of current E&P is made as of the end of the taxable year, without adjustment for any distributions made during the year and without regard to the amount of E&P on hand at the beginning of the taxable year or at the time of distribution.[4] If the total distributions made during the taxable year exceed the current E&P of that year, the excess amount is considered a taxable dividend to the extent of the distributing corporation's E&P accumulated after February 28, 1913.[5]

Consolidated Return Provisions

The consolidated return regulations provide a system for tiering up the E&P of the members of a consolidated group to each of the higher tier members and ultimately to the common parent. Each owning member adjusts its own E&P for its share of the E&P of its subsidiaries, using the principles applied to adjust the basis of a subsidiary's stock under Reg. §1.1502-32.[6] E&P

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[2] Section 316(a).

[3] Section 302(d).

[4] Section 316(a)(2); Reg. §1.316-2(b); Rev. Rul. 74-164, 1974-1 C.B. 74.

[5] Reg. §1.316-2(a) and (b).

[6] Reg. §1.1502-33(b).

adjustments are made as of the close of each consolidated return year, and as of any other time if a determination at that time is necessary to determine the earnings and profits of any person.[7]

The consolidated return regulations also contain special rules for determining the E&P of a member upon a restructuring of the consolidated group. Reg. §1.1502-33(f)(2) requires that if a member's location within a group changes, appropriate adjustments must be made to the E&P of the members to prevent E&P from being eliminated. Although the scope of this rule is not entirely clear, two examples are given to illustrate its meaning: if *P* transfers all of *S*'s stock to another member in a transaction to which Section 351 and Reg. §1.1502-13 apply, the transferee's E&P is adjusted immediately after the transfer to reflect *S*'s E&P immediately before the transfer from consolidated return years. On the other hand, if the transferee purchases *S*'s stock from *P*, the transferee's E&P is not adjusted.

Based on rule set forth in Reg. §1.1502-33(f)(2), it appears that both EOC and ELHC's E&P should be adjusted for EPC's current year E&P following the contribution of 100% of EPC's stock to EOC by Enron. Reg. §1.1502-33(f)(2) does not specify the *manner* in which EPC's E&P is replicated to EOC and to ELHC. Presumably, the replication occurs as if the stock of EPC had always been owned by EOC, and EPC's E&P is tiered up under the normal consolidated return E&P system under Reg. §1.1502-33(b).[8] Although not free from doubt, due to the issuance of the preferred stock by EOC to Enron, it appears that some portion of EPC's E&P which is replicated to EOC should be allocated to the preferred stock held by Enron. Because the preferred stock was not outstanding prior to the contribution of the stock of EPC to

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[7] Reg. §1.1502-33(b)(1). Because the Enron group's consolidated return year does not close as a result of the transaction, and EPC's individual year likewise does not close, Reg. §1.1502-33 should not operate to convert EPC's current E&P generated before the date of the proposed transaction to accumulated E&P.

[8] Note that Reg. §1.1502-33(f)(2) makes no distinction between current and accumulated E&P. Under Reg. §1.1502-33(f)(1), if there is a group structure change as defined in that section, the E&P of the new common parent is adjusted to reflect the E&P of the old common parent. Reg. §1.1502-33(f)(1) specifically states that this adjustment is made as if the new corporate parent succeeds to the E&P of the old common parent in a Section 381(a) transaction. In general, Section 381(c)(2) requires an acquiring corporation, in a transaction to which Section 381(a) applies, to succeed to, and take into account, the E&P of the target corporation as of the close of the date of distribution or transfer. Reg. §1.381(c)(2)-1(a)(1). Although the acquiring corporation inherits the target corporation's E&P on the date of the transaction under Section 381(c)(2), this E&P will be treated as accumulated E&P rather than current E&P of the acquiring corporation. Reg. §1.381(c)(2)-1(a)(2) and -1(a)(7), Example 1. Because Reg. §1.1502-33(f)(2) does not state that the E&P replication is deemed to occur in a deemed Section 381(a) transaction as does Reg. §1.1502-33(f)(1), there does not appear to be a specific provision that requires EPC's E&P to be treated as accumulated in EOC's and ELHC's hands. Thus, it appears that EPC's E&P would retain its character as current and accumulated, as the case may be, in EOC's and ELHC's hands.

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EOC, no allocation of EPC's replicated E&P to the EOC preferred stock appears to be necessary prior to the date the contribution occurs.[9]

It is estimated that EPC will generate approximately $184,616,953 of current E&P for the taxable year ended December 31, 1999. Assuming that the contribution of EPC stock to EOC occurs on December 1, 1999, approximately $1,076,932 ($184,616,953 x 7% x 1/12) should be allocated to the preferred stock interest owned by Enron following the tier up to EOC. The remaining current year E&P of $183,540,021 ($184,616,953 less $1,076,932 allocated to the preferred interest) generated by EPC should be allocated to the common stock interest owned by ELHC following the tier up to EOC. This amount, $183,540,021 should likewise be tiered up to ELHC as of the date of the contribution.

Availability of EPC's E&P

As previously discussed, Reg. §1.316-2(a) dictates that any corporate distribution comes, first, from the corporation's E&P for the taxable year during which the distribution occurs. The taxpayer makes the determination of current E&P as of the end of the taxable year, without adjustment for any distributions made during the year and without regard to the amount of E&P on hand at the beginning of the taxable year or at the time of distribution.[10] As such, at the end of the year, ELHC will have current year E&P of approximately $220,612,574 ($183,540,021 generated by EPC plus $37,072,554 generated by ELHC and subsidiaries) without taking into consideration any distributions throughout the year.

The priority-sequencing of corporate distributions need only occur where the aggregate amount of the distributions exceeds current E&P for the taxable year. Moreover, where such excess exists, IRS regulations render inconsequential the order of priority of distributions for purposes of applying current E&P. Under Reg. §1.316-2(b), the year's E&P is apportioned to all distributions on a pro rata basis, regardless of when they occurred during the year. The excess is deemed to come from post-February 28, 1913 E&P on hand as of the date of the particular distribution.[11] Because EPC's E&P presumably is not replicated under Reg. §1.1502-33(f)(2) until the date of the contribution of the EPC stock to EOC, only the current E&P (i.e., during calendar 1999) generated by EPC is available to offset the distributions occurring in March, June, and September, 1999. According to the distribution schedule above, total distributions for the year will exceed ELHC's current E&P. Thus, priority-sequencing must be performed.

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[9] Note that Reg. §1.1502-33(f)(2) provides, by way of illustration, that the adjustment to the higher tier members' E&P occurs *immediately after* the transaction.

[10] Rev. Rul. 74-164, 1974-1 C.B. 74.

[11] Section 316(a)(1); Reg. §§1.316-2(b) and (c).

Neither the parenthetical language of Section 316(a)(2) nor the regulations which require pro rata apportionment of the year's current E&P reflect any distinction between distributions made with respect to the same or different classes of stock. The IRS, nonetheless, takes the position that in determining the extent to which distributions made during the year with respect to different classes of stock come from current E&P, the taxpayer should consider any preferential rights of a particular class. Distributions made with respect to stock of the preferred class take priority over other distributions coming from current E&P.[12]

Based on the distribution schedule above, $174,059,416 of the total distributions relates to preferred stockholders. In completing the priority-sequencing, this amount should be treated as coming out of the current year E&P of $220,612,574. The remaining current year E&P of approximately $46,553,158 should then be apportioned to all remaining distributions on a pro-rata basis, regardless of when they occurred during the year. As such, approximately $11,638,290 ($46,553,158 divided by 4) of each distribution would be allocated to current year E&P. The excess would be deemed to come from post-February 28, 1913 accumulated E&P on hand as of the date of the particular distribution. Because EPC's E&P presumably does not replicate until the date of contribution of the EPC stock to EOC (which is currently scheduled to be December 1, 1999), only the $19,980,151 of accumulated E&P attributable to ELHC as of the beginning of the year should be allocable to the distributions occurring in March, June, and September, 1999. However, EPC's accumulated E&P of $968,753,074 should be available for any distribution subsequent to the contribution of the EPC stock to EOC.

CONCLUSION

Upon the contribution of the stock of EPC to EOC, it is more likely than not that EPC's current and accumulated E&P will be replicated under Reg. §1.1502-33(f)(2) to the E&P of EOC and ELHC. As described in detail above, a portion of EPC's current year E&P, upon tiering up to EOC, would be allocated to the preferred stock interest owned by Enron with the remainder being allocated to ELHC's common stock interest.

Therefore, ELHC should have sufficient E&P to treat the preferred dividends and preferred and common stock redemptions made for the tax year ended December 31, 1999, totaling $237,007,041, as dividends for purposes of Section 301.

Our comments, as stated above, are based upon the analysis of the Code, the Regulations thereunder, current case law, and published rulings. The foregoing are subject to change, and such change may be retroactively effective. If so, our views, as set forth above, may be affected and may not be relied upon. Further, any variation or differences in the facts as orally represented to us and recited herein, for any reason, might affect our conclusions, perhaps in an

[12] Rev. Rul. 69-440, 1969-2 C.B. 46.

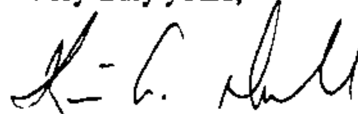
adverse manner, and make them inapplicable. In addition, we have undertaken no obligation to update this letter for changes in facts or law occurring subsequent to the date thereof.

This letter represents our views as to the interpretation of existing law and, accordingly, no assurance can be given that the Service or courts will agree with the above analysis. Furthermore, we have not undertaken any analysis of foreign, state, or local tax consequences in the above.

This letter is addressed to your particular inquires and is not intended to be distributed to, or used by, third parties without our prior knowledge.

Thank you for the opportunity to work with you on this project. If you have any questions or would like to like to discuss this letter further, please call me at 713/750-8366 or Witland LeBlanc at 713/750-5947.

Very truly yours,



Kevin A. Duvall
Partner