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

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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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

**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:

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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.

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. Davis Maxey
Vice President - Tax Planning