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PRIVILEGED AND CONFIDENTIAL
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March 21, 2001

R. Davis Maxey
Vice President Tax Research and Planning
ENRON Corp.
1400 Smith Street
P.O. Box 1188
Houston, Texas 77251-1188

Dear Dave:

You have requested our opinion with respect to certain federal income tax consequences under the Internal Revenue Code of 1986, as amended (the "Code"), of the formation and operation of Maliseet Properties, Inc. ("Maliseet").

This document is subject to the attorney-client privilege and the work-product doctrine. It contains the legal opinions, thoughts, impressions, and conclusions of McKee Nelson, Ernst & Young LLP with respect to certain federal income tax matters. McKee Nelson, Ernst & Young LLP, as special tax counsel for Enron Corp., an Oregon corporation ("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 addressed herein. In that regard, this document is 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. DOCUMENTS EXAMINED

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

N165UA Assignment and Assumption Agreement dated as of January 28, 1999, by and between BT Ever, Inc., a New York Corporation ("BT Ever"), and ECT Investments Holding Corp., a Delaware Corporation ("ECT");

Aircraft Interest Purchase Agreement (N165UA) dated as of January 28, 1999, by and between BT Ever and ECT (the "N165UA Purchase Agreement");

Consent, Waiver and Agreement N165UA dated as of January 28, 1999, by and among United Airlines, Inc., a Delaware corporation, BT Ever, ECT, and First Security Bank, National Association, as Trustee (the "Trustee") (the "United Airlines Consent");

N83870 Assignment and Assumption Agreement dated as of January 28, 1999, by and between BT Ever and ECT;

Aircraft Interest Purchase Agreement (N83870) dated as of January 28, 1999, by and between BT Ever and ECT (together with the N165UA Purchase Agreement, the "Aircraft Purchase Agreements");

Consent, Waiver and Agreement N83870 dated as of January 28, 1999, by and among Continental Airlines, Inc., a Delaware corporation, BT Ever, ECT, and the Trustee (the "Continental Airlines Consent," together with the United Airlines Consent, the "Consents");

Amended and Restated Certificate of Incorporation of Maliseet Properties, Inc., a Delaware corporation filed January 27, 1999 ("Certificate of Incorporation");

Amended and Restated Bylaws of Maliseet Properties, Inc., adopted January 27, 1999 (the "Bylaws");

Purchase and Sale Agreement dated as of January 28, 1999, by and between BT Green, Inc, a New York Corporation ("BT Green"), and Enron (the "Enron Mortgage Securities Purchase Agreement");

Purchase and Sale Agreement dated as of January 28, 1999, by and between BT Green and Bankers Trust Company, a New York banking corporation ("Bankers Trust"), acting through its branch office in London, England (the "London Branch") (the "Bankers Trust Mortgage Securities Purchase Agreement");

Subscription and Contribution Agreement dated as of January 28, 1999, by and between Enron and Maliseet (the "Enron Contribution Agreement");

Stock Purchase Agreement, dated as of January 28, 1999, by and between Enron and Bankers Trust (the "Initial Common Stock Purchase Agreement");

Two Year Put Agreement dated as of January 28, 1999, by and between Bankers Trust and Enron (the "Two Year Put Agreement");

78 Month Put Agreement dated as of January 28, 1999, by and between Bankers Trust and Enron (the "78 Month Put Agreement," together with the Two Year Put Agreement, the "Put Agreements");

Guaranty of Obligations dated as of January 28, 1999, by Enron in favor of Bankers Trust (the "Guaranty");

Shareholder Agreement dated as of January 28, 1999, by and among Enron, Bankers Trust, and Maliseet (the "Shareholders Agreement");

Management Agreement dated as of January 28, 1999, by and between Maliseet and Enron;

Subscription and Contribution Agreement dated as of January 28, 1999, by and between Bankers Trust and Maliseet (the "Bankers Trust Contribution Agreement," together with the Enron Contribution Agreement, the "Contribution Agreements");

Put and Call Agreement dated as of January 28, 1999 by and between Bankers Trust and Enron (the "Put and Call Agreement"); and

Promissory Note of Maliseet, dated January 28, 1999, in the principal amount of $5,396,318 (the "Debt Security").

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 in 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. For purposes of this letter, the terms "phantom income" and "phantom deductions" refer, respectively, to items of taxable income or deduction with respect to a REMIC residual interest that are not matched by economic benefits or burdens associated with the ownership of such interest. Similarly, the terms "economic income" and "economic deductions" refer, respectively, to items of income or deduction with respect to a REMIC residual interest that are matched by economic benefits or detriments associated with the ownership of such interest.

II. STATEMENT OF FACTS

In rendering this opinion, we have relied upon the facts as set forth below, which you have represented to us are true to the best of your knowledge and belief.

A. The Bankers Trust and the Enron Affiliated Groups

BT Ever, BT Green, Bankers Trust, and Bankers Trust Corporation, a New York corporation ("BT Corp"), are all members of the affiliated group, within the meaning of section 1504(a)(1),[1] of which BT Corp is the common parent (the "Bankers Trust Affiliated Group"). Enron and ECT are members of the affiliated group, within the meaning of section 1504(a)(1), of which Enron is the common parent (the "Enron Affiliated Group").

B. The London Branch's Acquisition of the Residual Interests and the Mortgage Securities

Prior to January 1, 1999, Bankers Trust, operating through the London Branch,[2] purchased residual interests (the "Residual Interests"), within the meaning of section 860G(a)(2), in a number of REMICs, as defined in section 860D(a). The London Branch purchased the Residual Interests in two packages. The Residual Interests currently generate phantom income and are not expected to generate phantom deductions until after January 1, 2004. In addition, prior to January 28, 1999, BT Green purchased certain mortgage securities (the "Mortgage Securities").

C. The Leased Equipment

Prior to January 28, 1999, BT Ever owned all the beneficial interests in certain trust estates, which included two aircraft and related records and equipment (the "Leased Equipment"). Each aircraft was subject to a lease, one to United Airlines and one to Continental Airlines (the "Leases").

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[1] All references to sections are to 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.

[2] Unless otherwise noted, all references to actions of the London Branch refer to actions of Bankers Trust operating through the London Branch.

D. Maliseet

Prior to January 28, 1999, Enron owned all of the outstanding stock of Maliseet. Such stock consisted of 1,000 shares (the "Initial Common Stock") of the common stock of Maliseet (the "Common Stock").

E. The January 28, 1999, Transactions

1. The Maliseet Transactions

a. The Capitalization of Maliseet

On January 28, 1999, BT Green sold to the London Branch undivided interests in certain of the Mortgage Securities (the "BT Mortgage Securities") for $2,724,817.79 pursuant to the Bankers Trust Mortgage Securities Purchase Agreement, and sold to Enron its remaining undivided interests in the Mortgage Securities (the "Enron Mortgage Securities") for $24,798,594.21 pursuant to the Enron Mortgage Securities Purchase Agreement. Immediately thereafter, in accordance with the Enron Contribution Agreement, Enron contributed the Enron Mortgage Securities to Maliseet in exchange for 39,000 shares of Maliseet Series A Preferred Stock (the "Series A Preferred Stock"), and 572 shares of Maliseet Series B Preferred Stock (the "Series B Preferred Stock," together with the Series A Preferred Stock, the "Preferred Stock"; the 39,000 shares of the Series A Preferred Stock and the 572 shares of the Series B Preferred Stock received by Enron pursuant to the Enron Contribution Agreement are herein referred to as the "Enron Shares"). Pursuant to the Initial Common Stock Purchase Agreement, Enron then sold to the London Branch the Initial Common Stock for $100. The London Branch then contributed the BT Mortgage Securities and the Residual Interests to Maliseet in exchange for 1,000 shares of the Common Stock (the "Additional Common Stock," together with the Enron Shares, the "Shares"), worth approximately $1,250,000, and the Debt Security, with a principal amount of $5,396,318 and an agreed value of $1,639,818, pursuant to the Bankers Trust Contribution Agreement.

The following sections describe the rights and privileges attached to shares of the Series B Preferred Stock, the Series A Preferred Stock, and the Common Stock that Enron and the London Branch received pursuant to the Contribution Agreements.

i. The Series B Preferred Stock

(a) Dividends

Dividends with respect to each share of Series B Preferred Stock are cumulative and accrue at an annual rate of 15 percent (the "Series A Dividend Rate") of the liquidation preference with respect to such stock (the "Preferred B Liquidation Preference") as of the start of each three-month period beginning on January 1, April 1, July 1, and October 1 (each a "Quarterly Distribution Period"). Initially, the Preferred B Liquidation Preference was $1,000 (the "Initial Preferred B Liquidation Preference"). Payment of dividends for any Quarterly Distribution Period with respect to the Series B Preferred Stock is limited by the lesser of (1) the cash received by Maliseet during the quarter from all sources (including certain borrowings) over expenditures during that period (including repayments of principal of certain borrowings and amounts paid to redeem the outstanding Preferred Stock) ("Available Net Cash Proceeds"); and (2) the funds that are legally available for the payment of such dividends on such date as determined in accordance with General Corporate Law of the State of Delaware ("Legally Available Funds"). To the extent that dividends accrued with respect to the Series B Preferred Stock are greater than the lesser of Available Net Cash Proceeds and Legally Available Funds, such amount will increase the Preferred B Liquidation Preference. In addition, to the extent that there is an excess of Legally Available Funds and Available Net Cash Proceeds over the aggregate quarterly dividend on the Preferred Stock, an amount equal to the lesser of Available Net Cash Proceeds and Legally Available Funds, after giving effect to the payment or required payment of dividends on the Preferred Stock, will be distributed to reduce pro rata the aggregate Preferred B Liquidation Preference and the Preferred A Liquidation Preference, as that term is defined herein, to the extent that such liquidation preferences were previously increased (such distributions are referred to herein as "Excess Distributions"); Excess Distributions with respect to the Series B Preferred Stock will decrease the Preferred B Liquidation Preference, but not below the Initial Preferred B Liquidation Preference. The Certificate of Incorporation requires that dividends be paid to the holders of the outstanding shares of the Series B Preferred Stock prior to the holders of any other classes or series of shares of Maliseet.

(b) Liquidating Distributions

In the event of a voluntary or involuntary liquidation, dissolution, or winding up of Maliseet, the holders of shares of the Series B Preferred Stock then outstanding are entitled to receive an amount equal to the lesser of (1) the aggregate amount of the Preferred B Liquidation Preference, plus all accrued and unpaid dividends to the date fixed for such distribution that have not yet been included in such Preferred B Liquidation Preference (the "Adjusted Preferred B Liquidation Preference"); and (2) the net fair market value of Maliseet. These distributions are to be paid out of the assets of Maliseet available for distribution to stockholders and are to be paid before any distributions are made to the holders of any other class or series of shares of Maliseet. The holders of the Series B Preferred Stock are not entitled to any further liquidating distributions.

(c) Voting Rights

Except as required by law, the holders of the outstanding shares of Series B Preferred Stock are not entitled to vote on, or consent to, any matter.

(d) Redemption Rights

Maliseet may redeem the Series B Preferred Stock at any time after January 28, 1999, upon the vote of the holders of 80 percent of the shares of the Series A Preferred Stock then outstanding and 80 percent of the Common Stock then outstanding. At any time on or after January 28, 2004, the board of directors of Maliseet may cause Maliseet to redeem the Series B Preferred Stock, provided that the holders of 80 percent of the shares of the Series A Preferred Stock then outstanding and 80 percent of the shares of the Common Stock then outstanding vote in favor such redemption. The redemption price paid to the redeeming shareholder of Series B Preferred Stock depends on the date of the redemption. If Maliseet redeems the Series B Preferred Stock prior to January 28, 2001, the holder of such stock is entitled to cash equal to 120 percent of the Adjusted Preferred B Liquidation Preference; if Maliseet redeems the Series B Preferred Stock on or after January 28, 2001, but prior to January 27, 2002, the holder of such stock is entitled to cash equal to 115 percent of the Adjusted Preferred B Liquidation Preference; if Maliseet redeems the Series B Preferred Stock on or after January 28, 2002, but prior to January 27, 2003, the holder of such stock is entitled to cash equal to 110 percent of the Adjusted Preferred B Liquidation Preference; if Maliseet redeems the Series B Preferred Stock on or after January 28, 2003, but prior to January 27, 2004, the holder of such stock is entitled to cash equal to 105 percent of the Adjusted Preferred B Liquidation Preference; finally, if Maliseet redeems the Series B Preferred Stock on or after January 28, 2004, the holder of such stock is entitled to cash equal to 100 percent of the Adjusted Preferred B Liquidation Preference.

ii. The Series A Preferred Stock

(a) Dividends

Dividends with respect to outstanding shares of the Series A Preferred Stock are cumulative and, as of January 27, 1999, began to accrue at an annual rate of 5.06788 percent (the "Series A Dividend Rate") of the liquidation preference with respect to such stock (the "Preferred A Liquidation Preference") as of the start of each Quarterly Distribution Period. On December 31 of each year, however, the Series A Dividend Rate then in effect, is increased or decreased by the "Yield Differential," provided, however, that the Series A Dividend Rate can never exceed 5.06788 percent. For this purpose, the Yield Differential as of December 31 of any year means (i) the "Adjusted Yield" for the calendar year ended on such date minus (ii) the Adjusted Yield for the preceding calendar year. The "Adjusted Yield" for any calendar year other than the calendar year ended on December 31, 1998, means the quotient, expressed as a percentage, obtained by dividing (i) the aggregate amount of all interest payments received or receivable on account of the "Portfolio Securities" during such period by (ii) the aggregate principal amount of all such Portfolio Securities. For purposes of calculating the Yield Differential as of December 31, 1999, the Adjusted Yield for the calendar year ended December 31, 1998, was fixed at 5.60591 percent. "Portfolio Securities" for this purpose means the securities and investments, including temporary investments and cash equivalents, held by Maliseet from time to time in accordance with the Bylaws.

Initially, the Preferred A Liquidation Preference was $620.98 (the "Initial Preferred A Liquidation Preference"). Payment of dividends with respect to the Series A Preferred Stock is limited by the lesser of Available Net Cash Proceeds and Legally Available Funds, after taking into account dividends paid with respect to the Series B Preferred Stock. To the extent that dividends accrued with respect to the Series A Preferred Stock are greater than the lesser of Available Net Cash Proceeds and Legally Available Funds, after taking into account dividends paid with respect to the Series B Preferred Stock (the "Undistributed Preferred A Dividends"), such amount will increase the Preferred A Liquidation Preference. Excess Distributions with respect to the Series A Preferred Stock will decrease the Preferred A Liquidation Preference, but not below the Initial Preferred A Liquidation Preference. Claims of holders of the Series A Preferred Stock to dividend distributions are junior to those of holders of the Series B Preferred Stock, but are senior to those of holders of all other classes and series of shares of Maliseet.

(b) Liquidating Distributions

In the event of a voluntary or involuntary liquidation, dissolution, or winding up of Maliseet, the holders of the Series A Preferred Stock then outstanding are entitled to receive an amount equal to the lesser of (1) the aggregate amount of the Preferred A Liquidation Preference, plus all accrued and unpaid dividends to the date fixed for such distribution that have not yet been included in such Preferred A Liquidation Preference (the "Adjusted Preferred A Liquidation Preference"); and (2) the net fair market value of Maliseet less the aggregate Adjusted Preferred B Liquidation Preference. These distributions are to be paid out of the assets of Maliseet available for distribution to holders of the Series A Preferred Stock after satisfying the claims of the holders of the Series B Preferred Stock, but before any distributions are made to the holders of all other classes and series of shares of Maliseet. The holders of the Series A Preferred Stock are not entitled to any further liquidating distributions.

(c) Voting Rights

Except as required by law, the holders of the outstanding shares of the Series A Preferred Stock are entitled to vote with the holders of the Common Stock as a single class. Each holder of the Series A Preferred Stock is entitled to cast one vote for each such outstanding share. The holders of the Series A Preferred Stock have the right to vote for the directors. The vote of the holders of 80 percent of the shares of the Series A Preferred Stock then outstanding and 80 percent of the shares of Common Stock then outstanding is required (1) to amend or repeal the Certificate of Incorporation; (2) except in certain circumstances, to issue, redeem, purchase or otherwise acquire additional shares of Maliseet after January 28, 1999; (3) to cause Maliseet to merge or consolidate with another entity or dissolve; (4) to incur, assume or obligate Maliseet by contract for any indebtedness, except indebtedness authorized by the Bylaws; (5) to declare bankruptcy; (6) to transfer amounts from Maliseet's surplus account to its capital account(s); and (7) to increase the par value of the Preferred Stock and the Common Stock.

(d) Redemption Rights

Maliseet may redeem the Series A Preferred Stock at any time after January 28, 1999, upon the vote of holders of 80 percent of the shares of the Series A Preferred Stock then outstanding and 80 percent of the shares of the Common Stock then outstanding.

iii. The Common Stock

(a) Rights to Distributions

Holders of the Common Stock are entitled to receive dividends as the board of directors declares such dividends. If any accrued dividends with respect to the Preferred Stock have not been fully paid through the next recently completed Quarterly Distribution Period, however, no dividend will be declared, paid, or set aside for distribution to the holders of the Common Stock. Furthermore, distributions to the holders of the Common Stock, when aggregated with any distributions made to the holders of the Preferred Stock, cannot exceed Maliseet's Legally Available Funds on the date of such distribution.

(b) Liquidation Rights

In the event of a voluntary or involuntary liquidation, dissolution, or winding up of Maliseet, the holders of the Common Stock are entitled to share in the funds, assets, and property of Maliseet, but only after amounts sufficient to satisfy the Preferred B Liquidation Preference and the Preferred A Liquidation Preference, and any dividend arrearages with respect to the Preferred Stock have been paid or set aside in cash.

(c) Voting Rights

The voting rights of the holders of the Common Stock are identical to those of the holders of the Series A Preferred Stock.

(d) Redemption Rights

Maliseet may redeem the outstanding shares of the Common Stock at any time after January 28, 1999, upon the vote of the holders of 80 percent of the shares of the Series A Preferred Stock then outstanding and 80 percent of the shares of the Common Stock then outstanding.

b. The Shareholders Agreement

In connection with the execution and consummation of the Contribution Agreements, on January 28, 1999, Enron and the London Branch entered into the Shareholders Agreement, which sets forth the parties' agreement regarding certain matters relating to the Shares and the Initial Common Stock and the operation and management of Maliseet. The following paragraphs describe certain provisions of that agreement.

i. The Recapitalization Right

Under the Shareholders Agreement, at the request of any holder of shares of Maliseet representing at least one percent of the aggregate number of shares of the Series A Preferred Stock or one percent of the aggregate number of shares of Common Stock outstanding at such time on or after January 28, 2004, Maliseet will be recapitalized (a "Recapitalization"). Upon the exercise of a shareholder's right to effect a Recapitalization (the "Recapitalization Right"), Enron will cause Maliseet to redeem all of the outstanding shares of the Series B Preferred Stock in accordance with the Certificate of Incorporation. In addition, the holders of the Series A Preferred Stock and the Common Stock will cause their stock to be voted in favor of the redemption of the Series B Preferred Stock.

On the date of a Recapitalization (a "Recapitalization Date"), each holder of shares of the Common Stock and the holder of the Debt Security will exchange such instruments for notes having an aggregate fair market value of the shares or the Debt Security surrendered ("Recapitalization Notes"); each holder of shares of Series A Preferred Stock will exchange shares of the Series A Preferred Stock for shares of Common Stock on a share-for-share basis. Pursuant to the Guaranty, Enron has guaranteed all obligations of Maliseet that currently exist or may exist under any Recapitalization Notes.

ii. REIT Status of Maliseet

Pursuant to the Shareholders Agreement, Enron agreed to take all action necessary to cause Maliseet to qualify as a real estate investment trust as defined in section 856(a) (a "REIT") for all times from and after January 1, 1999, and prior to January 1, 2004.

iii. Consent Dividends

Pursuant to the Shareholders Agreement, Bankers Trust agreed to treat Maliseet as having paid it sufficient "consent dividends" within the meaning of section 565, to maintain Maliseet's status as a REIT. Section 4 of the Shareholders Agreement provides as follows:

> [Bankers Trust] acknowledges that [Maliseet] is expected to have U.S. federal taxable income (before taking into account the dividends paid deduction allowed

to a REIT) in excess of its cash flow for one or more taxable years of [Maliseet], which will require [Bankers Trust] to agree to treat [Maliseet] as having paid to [Bankers Trust] "consent dividends," within the meaning of Section 565 of the Code, in order to maintain [Maliseet]'s status as a REIT under the Code. [Bankers Trust] agrees that, upon receipt of reasonable advance notice by [Maliseet] of the amount of the consent dividend required to be consented to by [Bankers Trust] for any taxable year of [Maliseet], it will consent to be treated for U.S. federal and applicable state income tax purposes as if [Bankers Trust] had received an actual cash dividend from [Maliseet] at the end of such taxable year equal to the amount of such consent dividend . . . .

c. The Put Agreements

Pursuant to the Two Year Put Agreement, Bankers Trust has the right to require Enron to cause certain of its affiliates to purchase from it any Recapitalization Notes it receives in a Recapitalization at any time on or after the two-year anniversary of a Recapitalization Date. Pursuant to the 78 Month Put Agreement, Bankers Trust has the right to require Enron to cause certain of its affiliates to purchase from it any Recapitalization Notes it receives in a Recapitalization at any time on or after the 78-month anniversary of a Recapitalization Date.

d. The Put and Call Agreement

Pursuant to the Put and Call Agreement, in the event that, as a result of a change in law, Maliseet would not qualify as a REIT, would not be permitted to hold the Residual Interests or would not be able to make certain consent dividends that are deductible in computing real estate investment trust taxable income (as defined in section 857(b)(2) such that Maliseet could reduce its taxable income to less than 5 percent of its real estate taxable income (computed without adjustment for the deduction for dividends paid for in section 857(b)(2)(B)) (a "Change of Law"), Enron would have the right to require Bankers Trust to purchase, and Bankers Trust would have the right to purchase from Enron, all rights, title and interest of Enron in any shares of the Preferred Stock for an amount equal to their fair market value, as determined pursuant to the Put and Call Agreement.

The transactions implemented pursuant to the Bankers Trust Mortgage Securities Purchase Agreement, the Enron Mortgage Securities Purchase Agreement, the Contribution Agreements, the Initial Common Stock Purchase Agreement, the Shareholders Agreement, the Two Year Put Agreement, the 78 Month Put Agreement and the Put and Call Agreement are referred to herein as the "Maliseet Transactions."

2. The Leased Equipment Transactions

As of January 28, 1999, pursuant to the Aircraft Purchase Agreements, BT Ever sold all of its rights, title, and interest relating to the Leased Equipment, subject to the United Lease and the Continental Lease, to ECT for an aggregate amount of $44,046,885.85. Pursuant to the Consents, United Airlines and Continental Airlines consented to the assignment and assumption of the Leases by ECT.

The transactions contemplated by the Aircraft Purchase Agreements are referred to herein as the "Leased Equipment Transactions." The Maliseet Transactions and the Leased Equipment Transactions together are referred to herein as the "Transactions."

F. The Subsequent Transaction

On or about June 4, 1999, Deutsche Bank purchased all of the outstanding stock of BT Corp (the "DB Acquisition"). We have assumed that, as a result of that stock purchase, BT Corp underwent a change in ownership within the meaning of section 382(g).

III. REPRESENTATIONS AND ASSUMPTIONS

In rendering this opinion, we have relied upon the representations and assumptions set forth below. You have represented to us the following, which are true to the best of your knowledge and belief:

1. All members of the Enron Affiliated Group, all members of the Bankers Trust Affiliated Group, and Maliseet have and will at all times act in accordance with the form of the transactions as reflected in the documents listed in Section I of this letter.

2. Maliseet was incorporated under the laws of the State of Delaware on April 16, 1985. It was not incorporated in anticipation of or in connection with the Maliseet Transactions.

3. From April 16, 1985, until the transfer of the Residual Interests and the Mortgage Securities to Maliseet, Enron owned 100 percent of the outstanding stock of Maliseet.

4. The three most important purposes of the members of the Enron Affiliated Group for participating in the Transactions, as of January 28, 1999, were (a) to invest in the Mortgage Securities and the Residual Interests, (b) to invest in the Leased Equipment, and (c) to increase the pre-tax financial accounting income and the net earnings on the Enron consolidated financial statements as a result of the Transactions. As of January 28, 1999, the members of the Enron Affiliated Group believed that the Transactions would achieve all of the purposes described in the preceding sentence, which would in turn

provide the members of the Enron Affiliated Group with significant and material benefits.

5. Enron made its investment in the Enron Mortgage Securities on an all-equity basis and ECT made its investment in the Leased Equipment on an all-equity basis. The invested funds came from existing cash on hand at Enron, ECT, and other entities of which Enron owned 50 percent or more by vote or value ("Affiliates"). Although Enron was borrowing in the market for general corporate purposes at the time it made its investment in the Enron Mortgage Securities and at the time ECT made its investment in the Leased Equipment, neither Enron, ECT, nor any Affiliates of Enron borrowed any money or incurred any debt for the specific purpose of making the investments in the Enron Mortgage Securities or the Leased Equipment.

6. As of January 28, 1999, the Enron Affiliated Group expected to earn a pre-tax profit of at least five percent, annually, in connection with its investment in the Series A Preferred Stock, a pre-tax profit of at least 15 percent, annually, in connection with its investment in the Series B Preferred Stock, and a pre-tax profit, annually, of at least 4.12 percent, and very possibly more, in connection with its investment in the Leased Equipment.

7. If Maliseet had purchased the Residual Interests from the London Branch, Enron would have reported an increase in net income for financial accounting purposes of approximately $99,454,000 (through a reduction in tax expense) for its taxable years 1999-2003 (the "Purchase Benefit"). Enron will report the Purchase Benefit as a consequence of the Transactions. The increased financial accounting income benefit to Enron from Maliseet's acquisition of the Residual Interests in a carryover-basis transaction is approximately $44,338,950 (the "Carryover Benefit"). While the Carryover Benefit is significant (and may be qualitatively somewhat superior to the Purchase Benefit in that it is presented for accounting purposes in an arguably more favorable light), it is materially less important than the Purchase Benefit, and thus Enron's principal purpose for engaging in the Maliseet Transactions was to obtain the Purchase Benefit.

8. The Purchase Benefits of the two packages of Residual Interests were not materially different from each other and the Carryover Benefits of the two packages of Residual Interests were not materially different from each other. Each of the two packages of Residual Interests as contributed to Maliseet would have contributed significantly to the financial accounting benefits available to the entities included in the Enron consolidated financial statements had Maliseet purchased the Residual Interests.

9. No member of the Enron Affiliated Group intends to take or, as of the date hereof, has taken any action that would generate, for federal income tax purposes, any item of income, gain, deduction, or loss from the utilization, directly or indirectly, of any increase

or decrease in the basis of any asset (other than a Residual Interest) that is attributable, directly or indirectly, to phantom income or phantom deductions with respect to the Residual Interests, other than to the extent such items would have been available to Enron had Maliseet purchased the Residual Interests.

10. No representations were made to any member of the Enron Affiliated Group with respect to the allowability of deductions for interest on any borrowing by any other member of the Enron Affiliated Group or any member of the Bankers Trust Affiliated Group in connection with the acquisition of interests in Maliseet or the Leased Equipment. No representations were made to any member of the Enron Affiliated Group with respect to the allowability of deductions for legal fees or bank fees incurred by Enron in connection with the Transactions.

11. No debt that may have been incurred by any of Bankers Trust or its Affiliates in connection with the acquisition by the London Branch of the Residual Interests, the BT Mortgage Securities, and the Initial Common Stock it purchased pursuant to the Initial Common Stock Purchase Agreement was borrowed from or arranged by any of Enron or its Affiliates. Neither Enron nor any of its Affiliates know, or have reason to know, that any amounts were borrowed, directly or indirectly, from a lender located outside the United States in connection with the London Branch's acquisition of the Residual Interests and the BT Mortgage Securities.

12. No debt that may have been incurred by Enron or its Affiliates in connection with the Transactions was borrowed from or arranged by Bankers Trust or any of its Affiliates or any lender located outside the United States.

13. No federal income tax credits have been or will be generated by the operations of Maliseet, by the Leased Equipment, or otherwise by any of the Transactions.

14. Bankers Trust provided Enron and its Affiliates with written projections for the Leased Equipment, and of accruals of items of income and deductions of investors in Maliseet for taxable years ending before January 1, 2004. All such written projections stated, or would have led a reasonable investor to believe, that the cumulative amount of all items of gross income (excluding items of gross income attributable to cash, cash equivalents, or marketable securities) that would be accrued by investors in Maliseet or by the Enron Affiliated Group as a result of the Transactions for federal income tax purposes through the end of each taxable year ending before January 1, 2004, would exceed the cumulative amount of all items of gross deduction that would be accrued by investors in Maliseet or by the Enron Affiliated Group for federal income tax purposes through the end of such year. No oral projections or representations provided or made to Enron or its Affiliates stated, or would have led a reasonable investor to believe, that the cumulative amount of all items of gross deduction that would be accrued by the investors in Maliseet or by the

Enron Affiliated Group as a result of the Transactions for federal income tax purposes through the end of each taxable year ending before January 1, 2004, would exceed the cumulative amount of all items of gross income (excluding items of gross income attributable to cash, cash equivalents, or marketable securities) that would be accrued by investors in Maliseet or by the Enron Affiliated Group for federal income tax purposes through the end of such year. For purposes of this paragraph, the term "marketable securities" means any securities that are part of an issue, any portion of which is traded on an established securities market, and any securities that are regularly quoted by brokers or dealers making a market.

15. Enron's investments in Maliseet and the Leased Equipment were each undertaken with the objective of deriving a "cash-on-cash profit," without regard to the value of any federal income tax attributes arising from such investments, and taking into account all fees paid in connection with such investments. As of January 28, 1999, Enron, Bankers Trust, and any other investor in Maliseet each had a reasonable expectation of earning a cash-on-cash profit from its investment in Maliseet and its investment in the Leased Equipment.

16. At the time it transferred the Enron Mortgage Securities to Maliseet in exchange for the Enron Shares, Enron had no plan or intention of transferring, disposing of, or exchanging stock of Maliseet representing 20 percent or more of the total combined voting power of all classes of stock entitled to vote or 20 percent or more of the total number of shares of each other class of stock, other than pursuant to a Recapitalization.

17. In connection with its acquisition of the Residual Interests and the Mortgage Securities, Maliseet assumed no liabilities from either Enron or Bankers Trust.

18. None of the Residual Interests, the Enron Mortgage Securities, or the BT Mortgage Securities were subject to any liabilities at the time of their transfer to Maliseet.

19. As of January 28, 1999, Bankers Trust's adjusted basis for federal income tax purposes in the Residual Interests exceeded the fair market value of the Residual Interests.

20. As of January 28, 1999, Bankers Trust's adjusted basis for federal income tax purposes in the Residual Interests was approximately $120 million.

21. As of January 28, 1999, the adjusted basis of the Residual Interests was expected to increase by approximately $268 million on or after such date.

22. On January 28, 1999, Enron expected that most of the benefits of the anticipated basis increase of approximately $268 million generated on or after January 28, 1999, would be

realized before the benefits of the existing basis of approximately $120 million would be realized.

23. Immediately prior to its acquisition of the Mortgage Securities and the Residual Interests, Maliseet was not entitled to use a net operating loss carryover, did not have a net operating loss for the taxable year that included January 28, 1999, and did not have a net unrealized built-in loss (a "NUBIL") within the meaning of section 382(h).

24. In connection with the Leased Equipment Transactions, BT Ever and ECT have validly taken all actions necessary to transfer, for purposes other than for federal income tax purposes, ownership of the Leased Equipment to ECT.

You have consented to the following assumptions:

1. The terms of all documents described in Section I above were, on the date such documents were executed, commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree, and the value ascribed to any asset in such documents was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of such asset.

2. For its taxable year that included January 28, 1999, the London Branch was disregarded as an entity separate from Bankers Trust for federal income tax purposes.

3. The stock received by each shareholder of Maliseet had a fair market value on January 28, 1999, approximately equal to the sum of the cash and the fair market value of the property, if any, contributed by such shareholder in exchange for such stock.

4. The Debt Security is properly classified as debt for federal income tax purposes.

5. As of January 28, 1999, it was highly unlikely that Bankers Trust, or any transferee of Bankers Trust's interests in Maliseet, would dispose of its interests in Maliseet in a taxable transaction on or before January 1, 2004.

6. Each of Bankers Trust and its Affiliates will at all times act in accordance with the form of the transactions as reflected in the documents listed in Section I of this letter.

7. The London Branch acquired the Residual Interests in two packages; it acquired one package in September 1997 and the other package in December 1997. The seller of the Residual Interests did not construct either package at the direction of the London Branch, Maliseet, Enron or any of their Affiliates for the purpose of the Transactions. The London Branch offered the Residual Interests in two packages (both of which have

positive cash flow) to Maliseet as a unit in the form of a carryover-basis transaction; the London Branch did not offer to sell the Residual Interests in a taxable transaction, nor did the London Branch offer to Maliseet or Enron less than all of the Residual Interests. The London Branch had significant and material reasons for preferring a carryover-basis transaction.

8. The sponsoring investment banks of the Mortgage Securities are not the issuers of such interests; the sponsoring investment banks merely arranged for the Mortgage Securities to be issued.

9. At the time of the Maliseet Transactions, Bankers Trust had no plan or intention of transferring, disposing of, or exchanging the Initial Common Stock and the Additional Common Stock, other than pursuant to a Recapitalization.

10. Maliseet's acquisition of the Residual Interests was not an asset acquisition, or part of an asset acquisition, described in section 381(a).

11. Immediately prior to the transfer of the Residual Interests to Maliseet, neither Bankers Trust nor any loss group or loss subgroup, as applicable, of which Bankers Trust was a member ("BT Loss Group") had a NUBIL, determined in accordance with section 382(h) and section 1.1502-91(g) of the Treasury Regulations.

12. Immediately prior to the DB Acquisition, neither Bankers Trust nor a BT Loss Group had a NUBIL, determined in accordance with section 382(h) and section 1.1502-91(g) of the Treasury Regulations.

13. If, on January 28, 1999, Bankers Trust had issued to Enron stock of Bankers Trust with a value equal to the value of the Enron Shares on such date, such issuance would not have caused Bankers Trust to experience an ownership change within the meaning of section 382(g).

14. If, on January 28, 1999, BT Corp had issued to Enron stock of BT Corp with a value equal to the value of the Enron Shares on such date, such issuance would not have caused the BT Corp to experience an ownership change within the meaning of section 382(g).

15. If Banker's Trust had retained the Residual Interests that were transferred to Maliseet, any federal income tax deductions or losses generated by such Residual Interests could have been utilized both by Bankers Trust if it were to file federal income tax returns as a separate company and by the Bankers Trust Affiliated Group if Bankers Trust were to file consolidated federal income tax returns with such consolidated group.

16. Each of the Leases is and, at all times since its inception, has been a "true lease" for federal income tax purposes.

For purposes of rendering this opinion, you have also consented to our reliance on the advice that we received from Potter Anderson & Corroon LLP relating to Delaware law and the additional information that we have obtained through consultation with officers, employees or legal representatives of Maliseet and members of the Enron Affiliated Group, as specifically set out in this letter. In addition, you have also consented to our reliance on the opinion that you have received from King & Spalding relating to the qualification of Maliseet as a REIT.

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. The January 28, 1999, transfers to Maliseet by the London Branch and by Enron in exchange for the Shares and the Debt Security should qualify as transactions described in section 351.

2. Maliseet's basis in the Residual Interests should equal Bankers Trust's basis in the Residual Interests immediately before the transfer of the Residual Interests to Maliseet.

3. Enron will be treated as the owner of the Enron Shares and the Leased Equipment for federal income tax purposes.

4. Section 269 should not apply so as to disallow any phantom deductions generated by the Residual Interests in the hands of Maliseet.

5. Maliseet's use of phantom deductions generated by the Residual Interests should not be subject to a limitation under section 382 as a result solely of either (a) the transfer of the Residual Interests and the Mortgage Securities to Maliseet; or (b) the DB Acquisition.

6. It is more likely than not that registration as a tax shelter under section 6111 is not required for any of Maliseet, the Residual Interests, or the Transactions (taken as a group) prior to January 28, 1999.

7. The members of the Enron Affiliated Group should not be subject to penalties under section 6707 for failing to register Maliseet, the Residual Interests, or the Transactions (taken as a group) as a tax shelter under section 6111 prior to January 28, 1999.

8. Provided that (i) Bankers Trust, as the sole owner of the common stock of Maliseet, properly consents to be treated as having received a consent dividend under section 565

with respect to such stock for any taxable year of Maliseet, (ii) Maliseet timely files such consent with its federal income tax return for such taxable year, and (iii) all dividends that would have been required to be paid through December 31 of such taxable year in respect of the Series A Preferred Stock and the Series B Preferred Stock if such consent dividend had actually been paid in respect of the Common Stock on December 31, have been paid in full as of such date, Maliseet should be entitled to a deduction for dividends paid, as defined in section 561, in respect of such consent dividends; accordingly, Maliseet should be able to deduct the amount of such consent dividends under section 857(b)(2)(B).

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 section 1.6662-4(d)(3)(ii) of the Treasury Regulations, that there is substantial authority (within the meaning of section 1.6662-4(d) of the Treasury Regulations) 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").

V. LEGAL ANALYSIS

A. Section 351 Qualification of Transfers to Maliseet

1. Section 351

Section 351(a) provides that "[n]o gain or loss shall be 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 corporation." See I.R.C. § 351(a). Section 351(b) provides that if an exchange would be subject to section 351(a) but for the fact that, in addition to stock of the transferee corporation, the transferor receives other property or money ("boot"), then such transferor recognizes the gain (if any) inherent in the property such transferor transferred to the transferee corporation to the extent of the amount of money plus the fair market value of other boot received by such person. See I.R.C. § 351(b)(1). If there is a loss inherent in the property transferred, recognition of such loss is not allowed, even if the transferor receives boot in the exchange. See I.R.C. § 351(b)(2).

2. Transfers to an Investment Company and Diversification

Under section 351(e), the nonrecognition treatment of section 351(a) is not available for transfers to an investment company. I.R.C. § 351(e). A transferee that is a REIT will be considered to be an investment company if the transfer results in diversification of the transferors' interests. See I.R.C. § 351(e)(1); Treas. Reg. § 1.351-1(c)(1). Under Treasury

Regulations, a transfer of stocks and securities will not result in diversification of the transferors' interests if each transferor transfers a diversified portfolio of stock and securities. See Treas. Reg. § 1.351-1(c)(6)(i). For purposes of this rule, a portfolio of stocks and securities is diversified if it satisfies the 25- and 50- percent tests of section 368(a)(2)(F)(ii), with certain modifications not relevant here. See id. To satisfy these 25- and 50- percent tests, not more than 25 percent of the value of a corporation's total assets may be invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets may be invested in the stock and securities of five or fewer issuers. See I.R.C. § 368(a)(2)(F)(ii). For purposes of these tests, all members of a controlled group of corporations (within the meaning of section 1563(a)) are treated as one issuer. See id.

Although Maliseet is a REIT, the transfer to it by Enron did not result in the diversification of Enron's interests and the transfer to it by the London Branch did not result in the diversification of the London Branch's interests. Based on Exhibit C of the Bankers Trust Contribution Agreement, at the time of their contribution to Maliseet by the London Branch, no one Mortgage Security and no one Residual Interest accounted for as much as 25 percent of the total value of the BT Mortgage Securities and the Residual Interests contributed to Maliseet by the London Branch and the aggregate fair market value of the five largest of the BT Mortgage Securities and the Residual Interests contributed to Maliseet by the London Branch was less than 50 percent of the total value of the BT Mortgage Securities and the Residual Interests contributed to Maliseet by the London Branch. Even assuming the Residual Interests were treated as a single security, the London Branch's transfer of its interest in the BT Mortgage Securities and the Residual Interests would satisfy the 25- and 50- percent tests. In addition, based on Exhibit A of the Enron Contribution Agreement, no one Enron Mortgage Security contributed to Maliseet had a value that was equal to as much as 25 percent of the total value of the Enron Mortgage Securities contributed to Maliseet by Enron and the aggregate value of the five largest Enron Mortgage Securities contributed to Maliseet by Enron was less than 50 percent of the Enron Mortgage Securities contributed to Maliseet by Enron.[3] Accordingly, we believe that Maliseet is not an investment company, and section 351(e) is not applicable to the transactions considered herein.

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[3] The same sponsoring investment bank created more than one of the Mortgage Securities Maliseet acquired pursuant to the Contribution Agreements. For example, Commercial Mortgage Acceptance Corporation, Morgan Stanley Capital I, DLJ Commercial Mortgage Corp., DLJ Commercial Mortgage Corp., Nationslink Funding Corporation, and Merrill Lynch Mortgage Investors are each sponsors of multiple Mortgage Securities. You have consented, however, to our assumption that the sponsoring investment bank is not the issuer of the interests and that the sponsoring investment banks merely arranged for the Mortgage Securities to be issued. Because the definitions of controlled groups in section 1563 all depend on ownership of stock, the identity of sponsoring investment banks should have no effect on the determination of whether Maliseet is diversified.

3. Property

As described above, section 351 requires a transfer of "property" in exchange for stock. See I.R.C. § 351(a). Qualification of the transfers of the Mortgage Securities and the Residual Interests to Maliseet as transfers described in section 351(a), therefore, in part, depends on whether the Mortgage Securities and the Residual Interests constitute "property."

When Bankers Trust transferred the Residual Interests to Maliseet, Enron and Bankers Trust, the two main parties in interest, agreed that the value of the Residual Interests was $165,000. Thus, we think a court should find that they have positive economic value. Cf. Sleiman v. Commissioner, 187 F.3d 1352, 1360 (11th Cir. 1999) (stating that the result of an arm's-length price negotiation generally is conclusive proof of the total value of the property bargained for); VGS Corp. v. Commissioner, 68 T.C 563, 589 (1977) (suggesting that a purchase price that results from arm's-length bargaining is the best evidence of fair market value). Moreover, as the Treasury Regulations acknowledge, residual interests in REMICs are transferable in carryover-basis transactions (such as transactions governed by section 351), even if they have negative value. See Treas. Reg. § 1.475(c)-2(c)(2) (discussing treatment of REMIC residual interests with negative value acquired before January 4, 1995, in carryover-basis transactions). Accordingly, we believe the Residual Interests should be treated as property for purposes of section 351. See, e.g., In re Chrome Plate, Inc. v. United States, 614 F.2d 990, 995 (5th Cir.) (stating that, for purposes of section 351, the term "property" encompasses whatever may be transferred), cert. denied, 449 U.S. 842 (1980); Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1175-76 (3d Cir. 1974) (adopting an expansive definition of the term "property"), cert. denied, 419 U.S. 826 (1974); E. I. Du Pont De Nemours & Co. v. United States, 471 F.2d 1211, 1218 (Ct. Cl. 1973) (stating that the word property has a "broad reach in tax law"); H. B. Zachry Co. v. Commissioner, 49 T.C. 73, 80 (1967) (holding that an oil payment is property). Moreover, we believe that the Mortgage Securities should, without doubt, be treated as property for purposes of Section 351(a). Therefore, based on the foregoing and your representation that the stock received by each shareholder of Maliseet had a fair market value on January 28, 1999, approximately equal to the sum of the cash and the fair market value of the property, if any contributed by such shareholder in exchange for such stock, we believe that the Shares were issued solely in exchange for a transfer of property, specifically the Residual Interests and the Mortgage Securities.

4. Stock

As described above, section 351 requires a transfer in exchange for "stock" of the transferee corporation. The determination of whether an instrument is debt or equity depends upon the facts and circumstances of each case. See Lundgren v. Commissioner, 376 F.2d 623, 626 (9th Cir. 1967). Because the line between debt and equity can be fine, the courts have used a multiple-factor analysis in classifying corporate instruments. No one factor is controlling; all factors must be taken into account. See John Kelley Co. v. Commissioner, 326 U.S. 521, 530 (1946); Hardman v. United States, 827 F.2d 1409, 1411-12 (9th Cir. 1987).

The factors applied by the courts differ slightly from case to case, but the analysis is intended to isolate the debt and equity features of the instrument to determine which characterization predominates. See Hardman, 827 F.2d at 1412 (listing 11 factors); Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968) (listing 16 factors); Development Corp. of America v. Commissioner, 55 T.C.M. (CCH) 455, 481 (1988) (listing 13 factors). Those factors commonly discussed by the courts include the following: name of the instrument, existence of a fixed maturity date, source of payments, enforcement rights, participation in management, subordination, intent of the parties, capitalization of the entity, identity of interest between creditor and shareholder, return on capital payable out of earnings, and the ability to obtain outside loans. See, e.g., Hardman, 827 F.2d at 1412; Fin Hay Realty Co., 398 F.2d at 696; Development Corp. of America, 55 T.C.M. (CCH) at 481.

The following sections analyze the classification of the Common Stock and the Series A Preferred Stock for purposes of determining the qualification of the transfers of the Mortgage Securities and the Residual Interests to Maliseet under section 351.

a. The Common Stock

The Common Stock is designated as stock, shares in all profits and losses of Maliseet after the preferences of the Series A Preferred Stock and the Series B Preferred Stock, and represents approximately 53 percent of the voting power of the authorized Common Stock and Preferred Stock of Maliseet. In addition, distributions to holders of the Common Stock are not only subject to the priority status of distributions to the holders of the Series A Preferred Stock and the Series B Preferred Stock, but also are limited to Legally Available Funds. In contrast to these strong equity features, we find no factors indicating that debt characterization would be appropriate for the Common Stock. Accordingly, we believe the Common Stock, including the Additional Common Stock, should be classified as equity for federal income tax purposes.

b. The Series A Preferred Stock

We consider the designation of the Series A Preferred Stock as stock in Maliseet to be a very strong factor in favor of recognizing the instrument's classification as equity. We have found only one case in which instruments that were unequivocally designated as stock were not treated as equity, absent a disavowal of the form by the taxpayer. See Bolinger-Franklin Lumber Co. v. Commissioner, 7 B.T.A. 402 (1927). In contrast to that single case, the courts have repeatedly refused to treat preferred stock as debt, even where the preferred stock has many of the classic indicia of debt (e.g., a fixed maturity date, fixed dividends payable without regard to earnings, no additional participation in profits, no sharing in losses). See Milwaukee & Suburban Transp. Corp. v. Commissioner, 283 F.2d 279 (7th Cir. 1960), cert. denied, 386 U.S.

976 (1962); Lee Tel. Co. v. Commissioner, 260 F.2d 114 (4th Cir. 1958); Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942); Pacific Southwest Realty Co. v. Commissioner, 128 F.2d 815 (9th Cir.), cert. denied, 317 U.S. 663 (1942); Kentucky River Coal Corp. v. Lucas, 51 F.2d 586 (W.D. Ky. 1931), aff'd, 63 F.2d 1007 (6th Cir. 1932); Texas Drivurself Sys., Inc. v. Commissioner, 3 T.C.M. (CCH) 289 (1944). Thus, we believe an equity designation for an instrument creates a strong presumption of equity classification.

The fact that the Series A Preferred Stock has voting rights, and the fact that quarterly payment of the preferred return is limited by Available Net Cash Proceeds and Legally Available Funds after taking into account distributions on the Series B Preferred Stock, further support the equity classification of the Series A Preferred Stock.

The Series A Preferred Stock, however, has two features that may be regarded as characteristics of debt: (1) the Recapitalization Right; and (2) the right to receive the Undistributed Preferred A Dividend in a liquidation or recapitalization (the "Undistributed Preferred A Dividend Right").

i. The Recapitalization Right

The Recapitalization Right might be viewed as establishing a fixed maturity date for the Series A Preferred Stock. While the presence of a fixed maturity date is often considered critical to a finding that an instrument is debt, the absence of a fixed maturity date is not required in order for an instrument to be classified as equity. A provision for redemption by a fixed date is not uncommon in preferred stock, and the presence of this feature appears to have been given little weight in classifying instruments that are validly issued as preferred stock. See Crawford Drug Stores, Inc. v. United States, 220 F.2d 292, 295-96 (10th Cir. 1955); Meridian & Thirteenth Realty Co., 132 F.2d at 187-88; Pacific Southwest Realty Co., 128 F.2d at 817-18; Finance & Inv. Corp. v. Burnet, 57 F.2d 444, 445 (D.C. Cir. 1932); Dorsey v. United States, 311 F. Supp. 625, 627, 629 (S.D. Fla. 1969); Nestle Holdings, Inc. v. Commissioner, 94 T.C. 803, 814 (1990); Snyder v. Commissioner, 93 T.C. 529, 547 (1989); Charles L. Huisking & Co. v. Commissioner, 4 T.C. 595, 599 (1945); see also Rev. Rul. 94-28, 1994-1 C.B. 86 (recognizing that traditional mandatory redemption rights are a common characteristic of preferred stock treated as equity for tax purposes); Rev. Rul. 78-142, 1978-1 C.B. 111 (ruling that a transaction qualified as a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D) where the sole consideration was preferred stock that was callable beginning five years after the reorganization and was subject to mandatory serial redemptions beginning five years after the reorganization).

In the event of a Recapitalization, a holder of shares of the Series A Preferred Stock would exchange such shares for debt instruments of Maliseet having a fair market value equal to the then fair market value of the shares surrendered. Thus, while the right to force a Recapitalization gives the holders of the Series A Preferred Stock the ability to determine the date on which their interests in Maliseet will be retired, such right does not establish the amount that they will ultimately be paid for their interests. Accordingly, the Recapitalization Right should not render the Series A Preferred Stock debt for federal income tax purposes.

ii. The Undistributed Preferred A Dividend Right

With respect to the effect of rights similar to the Undistributed Preferred A Dividend Right on the classification of an instrument, the case law is mixed. Compare Commissioner v. H. P. Hood & Sons, Inc., 141 F.2d 467, 470 (1st Cir. 1944) (affirming the debt classification of an instrument the annual payments on which were limited to earnings, but were cumulative and absolutely payable upon maturity), and Commissioner v. O. P. P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935) (same), with Milwaukee & Suburban Transp. Corp., 283 F.2d at 283 (classifying as equity cumulative preferred stock with dividends ultimately payable without regard to earnings), First Mortgage Corp. of Philadelphia v. Commissioner, 135 F.2d 121, 124-25 (3d Cir. 1943) (same), and United States v. South Georgia Ry. Co., 107 F.2d 3, 6 (5th Cir. 1939) (same). Although the right to receive fixed amounts upon a corporate liquidation may be treated as evidence that a security is debt rather than equity, that factor is not dispositive of the instrument's classification.

iii. Summary

While courts often discuss the factors described above in attempting to characterize an instrument as debt or equity, the ultimate determination of the nature of the interest is not based on any formula or adding up of these factors. Rather, these factors are used as aids in deciding whether the investor has subjected its capital to the risks of the business in return for a share of the profits (in the manner of an equity holder), or has insulated his capital from the risks of the business and defined his return without regard to the profits of the business (in the manner of a creditor).

On balance, we believe the facts that the Series A Preferred Stock shares in the profits of Maliseet up to the amount of its preferential dividend, has a vote, has no creditor type rights (i.e., right to accelerate or demand payment) in the event of a failure of Maliseet to pay dividends, and receives a current return only to the extent of the lesser of Legally Available Funds and Available Net Cash Proceeds indicate an investment of an equity nature. We further believe that such equity features outweigh the potential debt features represented by the Recapitalization Right and the Undistributed Preferred A Dividend Right.[4] Accordingly, we believe that the

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4 A debt/equity analysis of just the preference rights of the Series A Preferred Stock, viewed in isolation from the other risks and benefits that attach to those interests, might differ from an analysis of the interests as a whole. In general, an instrument is determined to be either debt or equity in its entirety. We are aware of only two instances, out of the myriad of cases addressing the debt/equity issue, in which the courts have treated a single instrument as including both debt and equity interests for tax purposes. See Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir. 1960); Richmond, Fredericksburg & Potomac R.R. Co. v. Commissioner, 62 T.C. 174 (1974), aff'd, 528 F.2d 917 (4th Cir. 1975); Richmond, Fredericksburg & Potomac R.R. Co. v. Commissioner, 33 B.T.A. 895 (1936),

Series A Preferred Stock should be treated as equity rather than debt for federal income tax purposes.

5. Control

Section 351 permits nonrecognition of gain or loss upon the transfer of property to a corporation only when the transferors are in control of the transferee corporation immediately after the exchange. See I.R.C. § 351(a). The Service takes the position that control, for this purpose, 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 each other class of stock of the corporation (the "Control Requirement"). See I.R.C. §§ 351(a), 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

In form, Enron and the London Branch received Common Stock and Preferred Stock in exchange for their transfers of the Mortgage Securities and the Residual Interests to Maliseet. The London Branch also received the Debt Security, which for purposes of this opinion is assumed to be debt for federal income tax purposes, in exchange for its transfers of the BT Mortgage Securities and all of the Residual Interests to Maliseet. After these transfers, the London Branch and Enron together owned 100 percent of the outstanding stock of Maliseet. At that time, Enron had no plan or intention of transferring, disposing of, or exchanging stock of Maliseet representing 20 percent or more of the total combined voting power of all classes of stock entitled to vote or 20 percent or more of the total number of shares of each other class of stock, other than possibly pursuant to a Recapitalization in which Enron would acquire shares representing 100 percent of the outstanding stock of Maliseet. In addition, the London Branch had no plan or intention of transferring, disposing of, or exchanging any of the Common Stock, other than possibly pursuant to a Recapitalization. In any event, however, a Recapitalization will not occur before January 1, 2004. Accordingly, because Enron and the London Branch together owned 100 percent of the outstanding stock of Maliseet immediately after the transfers of the Mortgage Securities and the Residual Interests to Maliseet and had no plan or intention of disposing of such stock until possibly on or after January 1, 2004, Enron and the London Branch should be treated as satisfying the Control Requirement in connection with such transfers.

aff'd sub nom. Helvering v. Richmond, F. & P.R. Co., 90 F.2d 971 (4th Cir. 1937). We note that the Service rejected as a general rule a bifurcation approach in the final regulations for contingent debt issued for cash or publicly traded property. See Treas. Reg. § 1.1275-6(h), example 2 (illustrating no bifurcation of contingent interest based on increase in value of composite stock index); Treas. Reg. § 1.1275-4(b)(7)(vi), example 1 (1996) (providing for no bifurcation of contingent principal). We believe that a court should not bifurcate the Series A Preferred Stock for purposes of characterizing it as both debt and equity.

6. Transfers of Liabilities

Under sections 357(b) and 357(c), the assumption of a transferor's liabilities by the transferee corporation (whether by assumption or because transferred property is subject to liabilities) will, under some circumstances, cause a transferor to recognize gain in a transaction that is otherwise subject to the nonrecognition rule of section 351(a). See I.R.C. § 357. Based on our review of the information that we have relied on in rendering this opinion and your representations, we understand that Maliseet assumed no liabilities and that no property subject to liabilities was transferred to Maliseet in connection with the Maliseet Transactions. Accordingly, we believe that sections 357(b) and 357(c) do not apply to the contributions of property to Maliseet.

7. Substance of the Maliseet Transactions

a. Substantiality of Stock Received

In order for the transfer of assets by each of the London Branch and Enron to be subject to section 351, each of the London Branch and Enron must have received stock in exchange for some portion of the transferred assets. Section 351 and the Treasury Regulations promulgated thereunder do not establish any minimum amount of stock that must be received in order to qualify a transfer of property to a corporation for section 351 treatment. We are not aware of any cases that have imposed any minimum requirements under section 351 relating to the amount of stock received. Nonetheless, we do believe that such stock should be more than de minimis in order to provide substance to the participation of a transferor in the stock exchange. See Rev. Rul. 79-194, 1979-1 C.B. 145 (stock held by a group of investors that received one percent of a corporation's stock in a contribution transaction and then purchased 50 percent of the corporation's stock from the other transferor was excluded in determining whether the Control Requirement was satisfied because the value of the stock received from the issuer was small relative to the value of the stock the group ultimately received in the sale transaction); see also Treas. Reg. § 1.351-1(a)(1)(ii) (asserting that stock or securities issued for property that is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property is not treated as having been issued in return for property if the primary purpose of the transfer is to qualify under section 351 the exchanges of property by other persons transferring property); cf. Rev. Proc. 77-37, § 3.07, 1977-2 C.B. 568 (providing that, for purposes of issuing advance rulings regarding the application of section 351, a transferor will not be treated as an accommodation transferor if the property such transferor transfers has a fair market value equal to, or in excess of, 10 percent of the fair market value of the stock and securities already owned by that transferor).

In the Maliseet Transactions, the London Branch received the Additional Common Stock, which had a value in excess of 43 percent of the value of the property it contributed and representing almost 2.5 percent of the vote and almost five percent of the value of all of the outstanding stock of Maliseet immediately after the Maliseet Transactions. Accordingly, we believe that the Additional Common Stock should be considered of sufficient substance to cause the London Branch's participation in the contributions to Maliseet to be respected for purposes of section 351.

In addition, in the Maliseet Transactions, Enron received the Enron Shares with a value equal to 100 percent of the value of the property it contributed and representing approximately 95 percent of the vote and approximately 95 percent of the value of the outstanding stock of Maliseet immediately after the Maliseet Transactions. Accordingly, we believe that the Enron Shares should also be considered of sufficient substance to cause Enron's participation in the contributions to Maliseet to be respected for purposes of section 351.

b. Bifurcation

Section 351(b) provides explicit rules for the taxation of transfers of property in exchange for stock and boot. This statutory scheme prohibits the recognition of any loss on such a transaction. See I.R.C. § 351(b)(2). We are not aware of any authority that would permit a taxpayer or the Service to bifurcate a single transfer of property in exchange for stock and other property into separate transfers of property for stock and property for other property. To the contrary, the authorities indicate that section 351 does not allow a portion of the consideration received in a transaction (whether the transaction consists of a single step or multiple steps that are in substance a single transaction) that satisfies the requirements of section 351(a) (or would satisfy the requirements of section 351(a) except for the receipt of boot) to be viewed separately as consideration for a sale. See, e.g., Dennis v. Commissioner, 473 F.2d 274, 285 (5th Cir. 1973) (denying installment sale treatment with respect to payments on a promissory note received in connection with a transfer that qualified as an exchange described in section 351); Turner Constr. Co. v. United States, 364 F.2d 525 (2d Cir. 1966) (disallowing sale treatment for sole shareholder's exchange of equipment for corporation's six month promissory note on the basis that the exchange was part of a series of transactions that qualified as tax-free transfers under the predecessor of section 351); Campbell v. Carter Found. Prod. Co., 322 F.2d 827 (5th Cir. 1963) (denying sale treatment for sole shareholder's exchange of oil and gas property for corporation's five-year note on the basis that the exchange was a contribution of property to the transferee corporation in which no gain or loss was recognized); Camp Wolters Enters. Inc. v. Commissioner, 230 F.2d 555 (5th Cir.) (denying sale treatment for shareholders' exchange of assets for corporation's notes, finding that such exchange was not an isolated transaction, but instead was part of a plan to form and finance the corporation), cert. denied, 352 U.S. 826 (1956); Nye v. Commissioner, 50 T.C. 203 (1968) (refusing to treat as separate transactions the initial capitalization of a corporation and a subsequent exchange by the shareholders of assets for corporate notes), acq., 1969-2 C.B. xxv; Dickey v. Commissioner, 32 B.T.A. 1283 (1935) (denying sale treatment for sole shareholder's exchange of assets for cash where such exchange was preceded by such shareholder's exchange of other assets for stock of the corporation), acq., C.B. XIV-2, 6 (1935); First Seattle Dexter Horton Nat'l Bank v. Commissioner, 27 B.T.A. 1242

(1933) (holding that an exchange of property for stock of the transferee corporation was not a transaction separate from the transferors' contemporaneous exchange of stock of another corporation for cash from the transferee corporation), aff'd, 77 F.2d 45 (9th Cir. 1935); see also Rev. Rul. 68-55, 1968-1 C.B. 140 (treating each asset as transferred separately in exchange for a portion of each category of consideration received in a section 351 transaction). Accordingly, we believe that the transfer by London Branch to Maliseet should not be bifurcated into a transfer for the Additional Common Stock and a separate transfer for the Debt Security.[5]

8. Conclusion

Based on the foregoing we have concluded that Enron and Bankers Trust should be treated as transferring property, specifically the Mortgage Securities and the Residual Interests, to Maliseet in exchange for stock of Maliseet, and that immediately after such exchange Enron and Bankers Trust should be treated as in control of Maliseet within the meaning of section 368(c). Accordingly, Enron's and Bankers Trust's transfers of the Mortgage Securities and the Residual Interests to Maliseet in exchange for the Additional Common Stock, the Enron Shares, and the Debt Security should be treated as transfers described in section 351.

B. Basis of Residual Interests

Under section 362, the basis to a transferee corporation of property acquired in a transaction to which section 351 applies is the same as it would be in the hands of the transferor, increased by the amount of gain recognized by the transferor on the transfer of such property. I.R.C. § 362(a). As described above, section 351(b) requires a transferor that receives boot in a transaction otherwise subject to the nonrecognition rule of section 351(a) to recognize the gain inherent in the property transferred to the extent of the boot received.

The Debt Security should be treated as boot received by the London Branch in a transaction that, but for the London Branch's receipt of boot, would be described in section 351(a). On the date the London Branch transferred the Residual Interests to Maliseet, the Residual Interests had an adjusted tax basis in excess of their fair market value. As a result, we believe that the London Branch realized a loss on the contribution of the Residual Interests to Maliseet. Section 351(b)(2), however, should disallow the recognition of such loss. Accordingly, because the London Branch should recognize no gain on the contribution of the Residual Interests to Maliseet, we believe that Maliseet should have a basis in the Residual

[5] The London Branch might recognize a loss on a portion of the Residual Interests if the transfers from the London Branch to Maliseet were bifurcated for tax purposes into an exchange of a proportionate share of the Residual Interests for the Additional Common Stock and a separate exchange of a proportionate share of the Residual Interests for the Debt Security.

Interests equal to the London Branch's basis in the Residual Interests immediately before the contribution of the Residual Interests to Maliseet.[6]

C. Recognition of Enron's Ownership of the Enron Shares and the Leased Equipment

1. Profit Motive

a. Pre-tax Motive Requirement

In determining whether a taxpayer will be respected as the owner of property, a threshold inquiry is whether the transaction that put the taxpayer in the position of ownership will be respected for federal income tax purposes. This inquiry focuses on whether the transaction is a "sham" by considering whether the transaction was entered into for a valid business purpose or whether the transaction itself had economic substance. See Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978) (holding that a transaction will be recognized for tax purposes only if it has "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"); James v. Commissioner, 899 F.2d 905, 908 (10th Cir. 1990) ("It is well established that transactions lacking an appreciable effect, other than tax reduction, on a taxpayer's beneficial interest will not be recognized for tax purposes.") (citing Knetsch v. United States, 364 U.S. 361, 366 (1960)); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists."); Goldstein v. Commissioner, 364 F.2d 734, 740 (2d Cir. 1966) (stating that deductions will not be permitted if they arise from transactions lacking any "purpose, substance, or utility apart from their anticipated tax consequences"), cert. denied, 385 U.S. 1005 (1967); Gefen v. Commissioner, 87 T.C. 1471, 1490 (1986) ("where a transaction

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6 In the short period during which the London Branch held the BT Mortgage Securities prior to their contribution to Maliseet, it is possible that the value of those interests increased. If they had increased, the London Branch would recognize any gain inherent in such BT Mortgage Securities to the extent of the value of the Debt Security on January 28, 1999. Private letter rulings issued by the Service have allocated that gain to the basis of the assets with respect to which such gains were recognized. See, e.g., Priv. Ltr. Rul. 85-50-037; Priv. Ltr. Rul. 85-17-040; Priv. Ltr. Rul. 85-16-031; Priv. Ltr. Rul. 85-12-071. Accordingly, if the value of the BT Mortgage Securities increased during the period beginning on the date the London Branch purchased the BT Mortgage Securities from BT Green and ending on the date that the London Branch contributed the BT Mortgage Securities to Maliseet, the BT Mortgage Securities should have a basis in the hands of Maliseet equal to the sum of their bases in the hands of the London Branch and the lesser of (1) the value of the Debt Security on the date received and (2) the gain inherent in the BT Mortgage Securities on the date contributed to Maliseet. If the value of the BT Mortgage Securities contributed by the London Branch decreased after the London Branch acquired them, they would have a basis in the hands of Maliseet equal to their basis in the hands of the London Branch.

is entered into without any purpose other than to obtain tax benefits, the form of the transaction will be disregarded and the tax benefits will be denied").

The courts generally apply the pre-tax profit motive test to distinguish between sham transactions that were entered into primarily to obtain certain tax benefits, and legitimate, economically profitable activities that were entered into for reasons other than solely to obtain tax benefits. See Casebeer v. Commissioner, 909 F.2d 1360, 1365-66 (9th Cir. 1990), aff'g 89 T.C. 1229 (1987); James, 899 F.2d at 908-09; Shriver v. Commissioner, 899 F.2d 724, 726 (8th Cir. 1990); Rice's Toyota World, 752 F.2d at 91, 94; Goldstein, 364 F.2d at 740; Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054, 1062 (1988); Gefen, 87 T.C. at 1490. Under this approach, "[a] transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." Gefen, 87 T.C. at 1490.

The courts are not in agreement as to what constitutes proper motive and sufficient profit to satisfy the test. As for motive, some courts require that the taxpayer have an actual and honest belief or intention that the transaction will be profitable, even if the taxpayer's expectations might be unrealistic. See Smith v. Commissioner, 937 F.2d 1089, 1093 (6th Cir. 1991); Bryant v. Commissioner, 928 F.2d 745, 750 (6th Cir. 1991); Bessenyey v Commissioner, 379 F.2d 252, 257 (2d Cir. 1967); Mercer v. Commissioner, 376 F.2d 708, 709-10 (9th Cir. 1967); see also Treas. Reg. § 1.183-2(a) (stating that a small chance of making a large profit, depending on the facts and circumstances, could indicate a legitimate profit motive). Other courts require a "reasonable possibility" of economic profit, determined at the time of the taxpayer's investment. See Rice's Toyota World, 752 F.2d at 91; Friendship Dairies, Inc., 90 T.C. at 1062; Gefen, 87 T.C. at 1492; see also Mukerji v. Commissioner, 87 T.C. 926, 964 (1986) ("realistic opportunity" for economic profit must exist). One court equated the lack of economic substance with "the absence of any real chance for profit associated with the transaction." Shriver, 899 F.2d at 726-27.

The courts have generally refused to require any particular amount of profit to satisfy the test. In sale/leaseback cases, the courts have required only a pre-tax cash-on-cash profit; that is, an anticipated pre-tax return in excess of the investment, calculated without regard to the time value of money. See, e.g., James, 899 F.2d at 910-12; Rice's Toyota World, 751 F.2d at 94; Broun v. United States, 92-2 U.S.T.C. (CCH) 50,569 (M.D. Ga. 1992). In some cases, the Tax Court has required more than a de minimis amount of profit, especially in those transactions featuring financial instruments such as those making up straddle positions. See, e.g., Krumhorn v. Commissioner, 103 T.C. 29, 53-54 (1994); Sheldon v. Commissioner, 94 T.C. 738, 768 (1990); see also Hilton v. Commissioner, 74 T.C. 305, 353 n.23 (1980) (measuring economic substance against a six percent rate of return requirement), aff'd per curiam, 671 F.2d 316, 317 (9th Cir.) ("We deem the six percent rate of return to be for illustrative purposes only. No suggestion of a minimum required rate of return is made."), cert. denied, 459 U.S. 907 (1982).

The suggestion that a minimum required return is necessary was strongly discredited in a more recent Tax Court decision where the court stated,

> we do not feel competent, in the absence of legislative guidance, to require that a particular return must be expected before a "profit" is recognizable, . . . As stated in sec. 1.183-2(b)(9), Income Tax Regs., in a closely related context, "the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit."

Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n.52 (1985). Although what level of profit will satisfy the de minimis rule is unclear, the Service, in its leveraged lease guideline, has suggested that any amount of profit is acceptable, although the guideline might require that any residual value used in computing that profit not include any increase or decrease for inflation. See Rev. Proc. 75-21, § 4(6), 1975-1 C.B. 715, modified by, Rev. Proc. 79-48, 1979-2 C.B. 529, modified by, Rev. Proc. 81-71, 1981-2 C.B. 731.

You have advised us that Enron Affiliated Group expects to earn a pre-tax profit, annually, of at least five percent, in connection with its investment in the Series A Preferred Stock, a pre-tax profit, annually, of at least 15 percent, in connection with its investment in the Series B Preferred Stock, and a pre-tax profit, annually, of at least 4.12 percent, and very possibly more, in connection with its investment in the Leased Equipment. This is not "de minimis" in our view. Thus, assuming a pre-tax profit motive is required, we believe that Enron should satisfy the pre-tax profit motive test.

b. Treatment of Finance Costs

Although Enron has funded its investment in Maliseet with the Enron Mortgage Securities, the purchase of which was made on an all-equity basis, and its investment in the Leased Equipment on an all-equity basis, you have asked us to consider whether any imputed equity costs must be taken into account in making a pre-tax profit determination. In a number of rulings regarding leveraged leases, the National Office of the Service has concluded that the cost of equity and interest payments on funds borrowed to make an equity investment should not be considered in determining profitability unless the debt is recourse to the investment. See Tech. Adv. Mem. 82-32-012 (Apr. 29, 1982) (advising that interest should not be included in the total cost of equity in determining profitability of leveraged lease deal unless equity investment is subject to recourse financing), reconsidering Tech. Adv. Mem. 82-32-001 (Aug. 31, 1981) (same); Tech. Adv. Mem. 81-44-014 (July 29, 1981) (advising that the rate of return test of Internal Revenue Manual 4236-873 should not be used to determine whether leveraged lease transactions were entered into with expectation of profit). In both of these rulings, the National Office rejected the argument that the profit test must include imputed interest on the actual equity investment.

Although it is inappropriate to impute interest on an actual equity investment, it is appropriate to include actual interest incurred on recourse notes used to finance a particular investment, as opposed to leverage an entire investment portfolio, to determine the amount of investment; such interest is a "fixed cost of the transaction." Casebeer, 909 F.2d at 1366. Under the rationale of Casebeer, it would be unnecessary to take into account interest on debt unless the debt proceeds could be directly traced to the investment at issue.[7] See Casebeer, 909 F.2d at 1366; cf. I.R.C. § 246A(d)(3) (defining portfolio indebtedness to include any indebtedness directly attributable to investment in portfolio stock); Treas. Reg. § 1.163-8T(c) (providing that, for purposes of section 469 and section 163(d) and (h), interest expense is allocated in accordance with the use of the debt proceeds). In fact, the Service's position in its guidelines on equipment leasing transactions (the "Guidelines") is that only the direct costs of financing an equity investment must be considered in evaluating the profit requirement. See Rev. Proc. 75-21. These authorities indicate that interest cost need only be taken into account if the debt is a recourse obligation and the interest thereon is a direct cost of the party using the debt proceeds.

We have, however, considered whether it would be appropriate to impute interest on an actual investment under the avoided cost method of section 263A(f)[8] or the allocation and apportionment method of section 861.[9] Where a method of allocating interest expense other than direct tracing is appropriate, Congress or Treasury have published such rules. We believe that applying a tracing method to determine the amount of investment is appropriate where there are no such rules, as is the case here. Therefore, based on the representation that the equity Enron used to make its investments in the Enron Shares and the Leased Equipment is not traceable to borrowed funds, we believe that no imputed equity costs should be taken into account to determine whether Enron satisfies the profit test.

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7 We note that the Tax Court's decision in H. Enterprises Int'l Inc. v. Commissioner, 105 T.C. 71 (1995), in which the court concluded the sections 246 and 265(a)(2) may be applied where borrowings of a subsidiary are directly attributable to the purchase of portfolio stock and tax-exempt securities, respectively, is distinguishable because (a) those provisions are aimed specifically at matching borrowing and income and (b) the money in that case was borrowed for the purpose of investing in portfolio stock and tax-exempt securities. You have advised us that neither Enron nor any of its Affiliates has borrowed any money for the specific purpose of making the Enron Affiliated Group's investment in the Enron Mortgage Securities and the Leased Equipment.

8 Section 263 requires interest to be capitalized if it is direcuy attributable to "production expenditures" or if it could have been avoided if production expenditures had not been incurred. See I.R.C. § 263A(f).

9 Section 1.861-9T of the Treasury Regulations requires interest expense incurred by a foreign corporation to be allocated to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate, for purposes of computing the foreign corporation's U.S. taxable income. See Treas. Reg. § 1.861-9T(a).

c. Consideration of Present Value Concepts

You have asked to consider whether, for purposes of determining pre-tax profit potential, anticipated future cash flows must be discounted for inflation or some other discount rate in accordance with present value concepts. The Service and the courts generally have not utilized a present value analysis when applying the pre-tax profit motive test.

The courts have not required that a discount for inflation be made in determining profit potential and generally have declined to consider the time value of anticipated cash flows as being relevant to a sham transaction analysis. See Sacks v. Commissioner, 69 F.3d 982, 991 (9th Cir. 1995) (stating in dicta that the Tax Court's utilization of a 6 percent discount rate did not appear to be supported by the record and that an investor is not "bound to discount the future at the rate the Commissioner thinks prudent"); Hilton v. Commissioner, 671 F.2d 316, 317 (9th Cir. 1982) (finding that the Tax Court's use of a discount rate was for "illustrative purposes only" and declining to suggest a minimum required rate of return); Estate of Thomas, 84 T.C. at 430-38 (1985) (finding a reasonable profit potential without discounting cash flows or the residual value for inflation or the time value of money); see also Casebeer, 909 F.2d at 1366 n.13 (noting that neither the taxpayers nor the government faulted the approach of the Tax Court in determining whether the transactions had economic substance, including the fact that it ignored the time value of money in its analysis); Johnson v. United States, 11 Cl. Ct. 17, 36-37 (1986) (rejecting the Service's argument that the value of the residual should be discounted for inflation in determining the profit objective for purposes of section 183).

Similarly, in the Guidelines, the value of a lessor's residual investment in a leveraged lease transaction must be determined without including an increase or decrease for inflation or deflation during the lease term. See Rev. Proc. 75-21. The value of the residual is also taken into account in determining whether the lessor meets the profit requirement. Although the Guidelines do not specify whether the residual interest must also be determined on a no-inflation basis for purposes of determining the lessor's anticipated profit, the Guidelines do not require that cash flows during the lease term be determined on a present value basis.[10] See id. Therefore, it does not appear that the Guidelines would require applying a present value analysis to the expected cash flow and residual value of the Enron Shares to determine whether Enron's investments in Maliseet and the Leased Equipment satisfy the pre-tax profit motive test.

In a series of private rulings, the Service has specifically rejected the use of discount rates to determine profit potential. See, e.g., Tech. Adv. Mem. 83-32-005 (Feb. 25, 1983); Tech. Adv. Mem. 82-32-012 (Apr. 29, 1982), reconsidering Tech. Adv. Mem. 82-32-001 (Aug. 31, 1981);

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[10] Enron's investments in the Enron Mortgage Securities and in the Leased Equipment are different from the typical leveraged lease transaction in that the Enron Affiliated Group is not relying on a residual to achieve a profit. Moreover, the rationale for requiring that the residual in a leveraged lease be determined on a no-inflation basis, which indicates whether the lessor has a meaningful economic interest in the leased property, is not applicable.

Tech. Adv. Mem. 81-44-014 (July 29, 1981). In these rulings, the National Office rejected the examiner's approach of discounting future income and cash flow (in accordance with provisions of the Internal Revenue Manual) by a present value factor to determine whether the profit test had been satisfied because the Guidelines simply do not contemplate the use of a present value discounting analysis. While these rulings do not specifically address the issue of discounting future cash flow to remove the impact of inflation and are not Service pronouncements on which taxpayers may generally rely, they do suggest that the Service may take the position that a present value analysis of future cash flows is not required in determining whether a taxpayer has satisfied the profit test under the Guidelines.

Accordingly, we believe that Enron should not be required to utilize present value concepts to determine whether it satisfies the profit test.

2. Investment in the Enron Shares and the Leased Equipment

Whether a taxpayer will be respected as the owner of property for United States federal income tax purposes depends on whether the taxpayer bears the economic burdens and is entitled to the economic benefits of ownership of the property. See, e.g., Frank Lyon Co., 435 U.S. at 583-84; Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981); see also Rev. Rul. 71-265, 1971-1 C.B. 223 (ruling that a sale of real estate occurs at the time possession and the benefits and burdens of ownership are transferred to the buyer); see also Priv. Ltr. Rul. 96-13-010 (Dec. 26, 1995) (reciting that the taxpayer represented that it would acquire the benefits and burdens of ownership and would be the owner of the facility in connection with its request for a section 29 ruling); Priv. Ltr. Rul. 95-29-019 (Apr. 24, 1995) (same). Whether the taxpayer bears the benefits and burdens of ownership of property is a question of fact that must be ascertained from the parties' intention as evidenced by the agreements read in light of the attending facts and circumstances. See Grodt & McKay Realty, 77 T.C. at 1237. Courts have considered the following factors in making this determination: (a) whether legal title passes; (b) how the parties treat the transaction; (c) whether any equity was acquired in the property; (d) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (e) whether the right of possession is vested in the purchaser; (f) which party pays the property taxes; (g) which party bears the risk of loss or damage to the property; and (h) which party receives the profits from the operation and sale of the property. See id. at 1237-38; Sanders v. Commissioner, 75 T.C. 157, 164 (1980) (identifying control, possession and title as the primary factors in determining whether one has a depreciable interest in property); see also Rev. Rul. 79-264, 1979-2 C.B. 92 (identifying as incidents of ownership legal title, contractual duty to pay for capital investment, responsibility for maintenance and repair, duty to pay, risk of loss and risk of diminution in value).

When making the determination of whether the benefits and burdens of the ownership of stock, including preferred stock, have been transferred, the courts have considered the following factors: (a) whether the taxpayer has the right to exercise conversion rights inherent in the stock;

(b) whether the taxpayer has the right to receive dividends on the stock; (c) whether the taxpayer reports gain on redemptions of the stock; (d) whether the taxpayer has the right to vote the stock; (e) whether the taxpayer bears the burden of a decline in value of the stock; and (f) whether the taxpayer bears the burden of any assessments on the shares. See Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181, 201 (1989); Anderson v. Commissioner, 92 T.C. 138, 177 (1989).

As applied to the Transactions, all of these factors point to the conclusion that Enron owns the Enron Shares and the Leased Equipment. With respect to the Enron Shares, Maliseet and Enron executed the Enron Contribution Agreement whereby Enron contributed the Enron Mortgage Securities to Maliseet in exchange for the Enron Shares. Enron and Maliseet intended that Enron own such shares; Enron is the record owner of such shares, is entitled to receive distributions with respect to such shares, is entitled to exercise any voting rights inherent in such shares, and is responsible for the payment of any taxes or any other assessments with respect to such shares after January 28, 1999. Finally, Enron bears the risk that the value of the Enron Shares will decline after January 28, 1999.[11] Accordingly, we believe that Enron will be treated as the owner of the Enron Shares that it received pursuant to the Enron Contribution Agreement.

With respect to the Leased Equipment, ECT purchased the Leased Equipment pursuant to the Aircraft Purchase Agreements. Those agreements pass all right, title and interest in and to the Leased Equipment to ECT, and provide that upon payment of the purchase price, all risk of loss in the Leased Equipment passes to ECT, and ECT is responsible for insuring the Leased Equipment. Furthermore, BT Ever and ECT validly took all actions necessary to transfer, for purposes other than for federal income tax purposes, ownership of the Leased Equipment to ECT. Finally, because the United Lease and the Continental Lease are "true leases" for federal income tax purposes, BT Ever had the ability to transfer ownership of the Leased Equipment to ECT. Accordingly, we believe that ECT will be treated as the owner of the Leased Equipment purchased pursuant to the Aircraft Purchase Agreements.

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11 We have considered whether the Put and Call Agreement will limit Enron's risk that the value of the Enron Shares will decline after January 28, 1999. As described above, if there is a Change of Law, Enron would have the right to require Bankers Trust to purchase all rights, title and interest of Enron in any shares of the Preferred Stock for an amount equal to their fair market value, as determined pursuant to the Put and Call Agreement. Because Enron will not receive more than the fair market value of the Enron Shares in the event that it exercises its put right pursuant to the Put and Call Agreement, the Put and Call Agreement does not limit Enron's risk of loss with respect to the Enron Shares.

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

D. Application of Section 269 to the Phantom Deductions Generated by the Residual Interests to Maliseet

1. Section 269 Generally

Section 269(a) provides that if

> (1) any person or persons acquire, . . . directly or indirectly, control of a corporation, or
>
> (2) any corporation acquires, . . . directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,
>
> and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance.

I.R.C. § 269(a). For purposes of section 269(a), "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation. See id.

Neither direct nor indirect control of Maliseet shifted as a result of the contributions of the Residual Interests and the Mortgage Securities to Maliseet. Before those contributions, Enron owned directly 100 percent of the total combined voting power of all classes of stock of Maliseet entitled to vote and 100 percent of the total value of shares of all classes of stock of Maliseet. After those contributions to Maliseet, Enron owned, directly and indirectly, approximately 95 percent of the total combined voting power of all classes of stock of Maliseet entitled to vote and approximately 95 percent of the total value of shares of all classes of stock of Maliseet. Therefore, in connection with its transfer of the Enron Mortgage Securities to Maliseet, Enron did not acquire, directly or indirectly, control of Maliseet. Furthermore, prior to its transfers of the Residual Interests and the BT Mortgage Securities to Maliseet, the London Branch did not own either directly or indirectly, any of the voting power or value of Maliseet. After those transfers, it owned, directly and indirectly, approximately five percent of the total combined voting power of all classes of stock of Maliseet entitled to vote and five percent of the value of shares of all classes of stock of Maliseet. Therefore, in connection its transfers of the Residual Interest and the BT Mortgage Securities to Maliseet, the London Branch did not acquire, directly or indirectly, control of Maliseet. Accordingly, section 269(a)(1) does not apply to the transfers of the Residual Interests and the Mortgage Securities to Maliseet.

In connection with the transfers of the Residual Interests and the Mortgage Securities to Maliseet, however, Maliseet directly acquired the Residual Interests, property of Bankers Trust, a corporation not controlled, directly or indirectly, by Maliseet or Enron immediately before such acquisition. In addition, as described above, the basis of the Residual Interests will be determined by reference to the basis in the hands of Bankers Trust immediately prior to their transfer to Maliseet. Section 269(a)(2), therefore, will apply, if the principal purpose for Maliseet's acquisition of the Residual Interests was the "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy." See I.R.C. § 269(a).

2. The Principal Purpose Requirement: Aggregation and Comparison of Tax-Avoidance and Non-tax-avoidance Purposes

Section 269(a) requires a determination of whether "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax." I.R.C. § 269(a). Where a transaction has more than two purposes, the statute could be interpreted three ways.

First, all of the purposes of the acquisition could be identified, and a determination could be made whether the most important purpose was a tax-avoidance purpose. While this may seem, at first blush, to be the most straightforward interpretation of the statute, it loses its logical force upon reflection. If a transaction has many purposes, the "principal" purpose under this interpretation could be a purpose with relatively little importance.

Second, all the tax-avoidance purposes for the transaction could be identified, and if any one of them were more important than some non-tax-avoidance purpose for the transaction, the principal purpose of the transaction would be tax avoidance. While this interpretation does not seem consistent with the language of the statute, it finds support in the language of the legislative history of section 269.

Third, all the tax-avoidance purposes could be aggregated, and compared to all the non-tax-avoidance purposes. The group that was of greater importance would be the principal purpose for the transaction.

The most complete discussion of this issue is in U.S. Shelter Corporation v. United States, 13 Cl. Ct. 606 (1987). In that case, the court considered four different scenarios assuming one tax purpose and two non-tax purposes for the acquisition. See 13 Cl. Ct. at 619 n.10. Where the tax-avoidance purpose was 60 percent of the total purpose, and each non-tax purpose was 20 percent of the total purpose, tax avoidance was the principal purpose. See id. Where the tax-avoidance purpose was 20 percent, and the two non-tax-avoidance purposes were 40 percent each, tax avoidance was not the principal purpose. See id. Where the tax-avoidance purpose was 30 percent, one non-tax-avoidance purpose was 60 percent and the other 10 percent, the Service and the taxpayer agreed that tax avoidance was not the principal purpose.[12] See id. Finally, where the tax avoidance purpose was 40 percent, and each of the other purposes was 30 percent, the Service argued that tax avoidance was the principal purpose because it exceeded in importance any other purpose. See id. On the other hand, the taxpayer argued that tax avoidance was not the principal purpose because the other two purposes, taken together, exceeded it in importance. See id.

The court interpreted the legislative history of the provision to suggest that "a tax avoidance purpose must be compared to each separate non-tax avoidance (e.g., business) purpose, and, if it exceeds in importance any one of these, then Section 269 applies." Id. at 620. Nonetheless, the court concluded, "[a] more logical reading of the statute suggests treating tax avoidance purposes together as well as aggregating legitimate non-tax avoidance business purposes." Id. The court noted:

> Several decisions, although not specifically addressing the aggregation/segregation issue, have found Section 269 inapplicable where the taxpayer's objectives, taken together, establish a more important purpose than the tax avoidance purpose. See Louisville Store of Liberty, Ky., Inc. v. United States, 179 Ct. Cl. 847, 855, 376 F.2d, 314, 319 (1967); Capri, Inc. v. Commissioner, 65 T.C. 162, 179-80 (1975); D'Arcy-MacManus & Masius, Inc. v. Commissioner, 63 T.C. 440, 449 (1975); Princeton Aviation Corp. v. Commissioner, 47 T.C.M. (CCH) 575, 585 (1983); Thrifty Supply of Spokane, Inc. v. Commissioner, 35 T.C.M. (CCH) 276, 281-83 (1976); Fedcal Distributing Co. v. Commissioner, 22 T.C.M. (CCH) 935, 940-41 (1963).

Id. at 620 n.12. The court observed that its approach was the same one as "[t]he only court to address this issue in depth": the Fifth Circuit in Bobsee Corporation v. United States, 411 F.2d 231 (5th Cir. 1969). Id. at 620. The Bobsee court, like the U.S. Shelter court, relied on the legislative history of the Revenue Bill of 1943 (the "1943 Act"), which added section 129, the predecessor of section 269. See Bobsee Corp. v. United States, 411 F.2d 231, 235 (5th Cir. 1969). Because the main body of the legislative history is clear -- but its language is sometimes muddy -- it is worth examining in depth.

[12] While the court noted that section 1.269-3(a) of the Treasury Regulations provided that "'[i]f the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose,'" U.S. Shelter Corp., 18 Cl. Ct. at 619-20 (emphasis omitted), it concluded that that was not the way that portion of the regulations should be understood. See id. at 620.

The House passed section 129 of the 1943 Act with the following text:

> If any person or persons acquire, on or after October 8, 1940, directly or indirectly, an interest in, or control of, a corporation, or property, and the Commissioner finds that one of the principal purposes for which such acquisition was made or availed of is the avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance, then such deduction, credit, or other allowance shall not be allowed.

Seidman's Legislative History of Federal Income and Excess Profits Tax Laws: 1953-1939, at 1969 (Prentice-Hall 1954). The Senate Finance Committee's version of that section provided:

> If any person or persons acquire, on or after October 8, 1940, directly or indirectly, control (more than 50 per centum) of a corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed.

Id. The Senate version dropped any reference to an acquisition of property. It also changed the "one of the principal purposes" language to "the principal purpose." Moreover, it clarified that the "deduction, credit, or other allowance" must be one "which such person would not otherwise enjoy." Finally, it added an objective test of "control" -- "more than 50 per centum," though it did not indicate whether 50 percent of value, vote, or both would be required.

The Senate Finance Committee report contrasted the Senate provision with the House provision as follows:

> Your committee believe [*sic*] that the House provision goes much further than the objectives sought. It creates a realm of uncertainty in connection with any acquisition which might result in any reduction of tax liability or be availed of in reduction of tax liability by any person or persons. Your committee has restricted the section so that it will apply only to situations where any person or persons acquire, on or after October 8, 1940, directly or indirectly, control (more than 50 percent) of a corporation, and the principal purpose for which such acquisition was made in [*sic*] evasion or avoidance of Federal income or excess-profits tax by securing the benefit of a deduction, credit, or other allowance, which such person would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. . . .
>
> Your committee retained the provision giving the Commissioner authority to make allowances or adjustments in proper cases. The success of such a

> provision will depend upon a sane and intelligent administration. It should not be used to upset or overturn bona fide transactions or to harass and annoy taxpayers who have acquired such property in bona fide acquisitions with no intent to avoid or evade Federal income or profits taxes.

S. Rep. No. 78-627, at 26-27 (1943). According to the Senate Finance Committee report, therefore, the Senate version of the provision was intended to have less effect on taxpayers than the House version. The report seemed to identify three changes the Senate made to the House version of the statute.

First, as amended by the Senate, the application of the statute would be limited to cases of the acquisition of more than 50 percent of a corporation. It would not extend to acquisitions of property.

Second, as amended by the Senate, the statute would apply only when *the* principal purpose of the acquisition, not merely *one* of the principal purposes of the acquisition, was the evasion or avoidance of tax.

Third, as amended by the Senate, the statute would apply only when the deduction, credit, or other allowance secured by the acquisition of control is one that the acquirer would not otherwise enjoy.

While the Senate Finance Committee report mentioned these items in its description of the "restricted" section, it did not specifically identify them as the aspects of the provision that made the statute more restricted. Moreover, the Senate Finance Committee report also stated: "[t]he House bill made section 129 operative if one of the principal purposes was tax avoidance. Your committee believes that the section should be operative only if the evasion or avoidance purpose outranks or exceeds in importance, any other one purpose." Id. at 59. These statements create an ambiguity as to the effect of the change from "one of the principal purposes" to "the principal purpose."

In U.S. Shelter, the court examined the language of section 1.269-3(a) of the 1962 Treasury Regulations, which provided that "'[i]f the purpose to evade or avoid federal income tax exceeds in importance any other purpose, it is the principal purpose.'" 13 Cl. Ct. 606, 619-20. The court concluded that "the principal purpose" language should not be interpreted to mean that, as long as the Government could identify one purpose for the acquisition that was less important than the evasion or avoidance purpose, section 269 would be called into play. See id. at 620. Its conclusion was based, in part, on a similar conclusion reached by the Fifth Circuit in Bobsee. See id. Analyzing the Senate committee report, the court in Bobsee stated:

> It seems clear that the Senate amendment was intended to increase the quantum of tax motivation necessary to bring a transaction within the proscription of the

> statute. However, as defined in the Senate report, the principal purpose could be a less significant motivation than that required by the House bill. For instance, if an acquirer has one very minute non-tax motive and a slightly more intense tax motive, then the standard articulated by the committee report would permit the application of section 269 even though the acquirer had other non-tax purposes greatly exceeding the tax purpose. Consequently, our Green Light decision [Green Light Co. v. United States, 405 F.2d 1068 (5th Cir. 1968)] heeded the policy and the actual language of the section rather than the abortive attempt at definition in the Senate committee report. As we view the operation of the statute, there are only two relevant classes of purposes: tax-avoidance and non-tax-avoidance; the statute applies only if the former class exceeds the latter.[13]

Bobsee Corp., 411 F.2d at 239 (footnote omitted) (emphasis in the original).

The Conference Committee's formulation of section 129 of the 1943 Act is similar to its formulation in section 269 today. See H.R. Conf. Rep. No. 78-1079, at 23. The Conference Committee added to the Senate version a prohibition on acquisitions of property, but only if the basis of the property is determined by reference to its basis in the hands of the transferor corporation. See id. Also, it converted the 50 percent test to an "at least" test, and clarified that that test was a vote *or* value test. See id. The report of the Conference Committee stated:

> As contrasted with the House bill, the conference agreement narrows the scope of the section, considered desirable in view of the extent to which the House provision overlapped the broad provisions of sections 45 of the code (control cases) [the predecessor of section 482] and 141 of the code (affiliated cases) [the predecessor of the consolidated return rules], and of the principle of *Higgins v. Smith* (308 U.S. 473), and in order to emphasize the special function of the section, namely, to give tax enforcement agencies a clear basis for administration in those areas in which abuses are most apt to occur.

H.R. Conf. Rep. No. 78-1079, at 54 (1943).

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13 It may be noted that the Fifth Circuit's opinion in Green Light Company v. United States, 405 F.2d 1068 (5th Cir. 1968), did not clearly take the same position as the Fifth Circuit adopted subsequently in Bobsee Corporation v. United States, 411 F.2d 231 (5th Cir. 1969). In Green Light, the court stated that the "'principal purpose' . . . must exceed all other purposes in importance." 405 F.2d at 1070. Where a tax avoidance purpose is 40 percent of the purpose, and there are two non-tax 30 percent purposes, Bobsee clearly said the principal purpose was not tax avoidance, see Bobsee Corp., 411 F.2d at 239; but, Green Light was not as clear. See Green Light Co., 405 F.2d at 1070-71. On the other hand, the Fifth Circuit clearly followed its Bobsee approach in Slappey Drive Industrial Park v. United States, 561 F.2d 572 (5th Cir. 1977), in which it stated: "[w]e set forth the applicable standards in Bobsee Corp., supra. 'There are only two relevant classes of purposes: tax-avoidance and non-tax-avoidance; the statute applies only if the former class exceeds the latter.'" Slappey Drive Indus. Park, 561 F.2d at 585.

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We believe the most reasonable way to interpret the characterization of the final bill as "narrower" than the House version as attributable to: (1) the change from "one of the principal purposes" to "the principal purpose"; and (2) the limitation on acquisitions of property to those made from another corporation and in which the basis is determined by reference to the basis in the hands of the transferor. The House bill also apparently would have applied to the acquisition of "an interest" in a corporation, not only a controlling interest.

Our review suggests that the "the principal purpose" test can be understood in either of two ways:

1. All purposes are divided into two categories, "tax-avoidance" and "other." The purpose category with the greater import determines what "the" principal purpose is. This formulation of the test is consistent with Bobsee, but as discussed in note 11, is inconsistent with the Fifth Circuit's decision in Green Light.

2. The tax-avoidance purposes are identified. If any one of them is more important than any one non-tax-avoidance purpose, section 269 applies, even if there are other non-tax-avoidance purposes that are more important than any or all of the tax-avoidance purposes. This formulation of the test flows from language in the Senate Report but was strongly rejected by the courts in Bobsee and U.S. Shelter.

In summary, the only courts that have considered the issue explicitly have concluded that, in measuring the principal purpose of a transaction for purposes of section 269, all non-tax factors should be aggregated and compared to all tax factors. We have found no decision that explicitly rejects that approach. Although a number of courts track the language used in the 1943 Senate Finance Committee report and the regulations, there is no suggestion that they have considered the issue with any care and have rejected the approach articulated in U.S. Shelter. Indeed, some cases that have cited the Senate Finance Committee report language also cite (for other aspects of section 269) Bobsee or U.S. Shelter, the cases that have rejected a literal reading of that language, and make no attempt to reconcile the apparent conflict between the language of the Senate Finance Committee report and the holdings in Bobsee and U.S. Shelter. Moreover, the rejection of the language from the legislative history relates to the logic of section 269; the position taken by the courts in Bobsee and U.S. Shelter is much more consistent with the purpose of section 269 than the available alternative interpretations. Accordingly, we believe a court should conclude that, in determining the principal purpose of an acquisition under section 269, all the tax purposes should be compared with all the non-tax, business purposes.

3. The Relevant Purposes: The Purpose of the Investment, Not the Form of the Investment

Adopting the Bobsee-U.S. Shelter approach in evaluating whether section 269 applies suggests that the tax motivated and non-tax motivated purposes *of the investment* should be compared. Some cases, however, might be read to suggest that it is appropriate to consider the purpose for making the investment *in the form it was made*. The courts have made that suggestion when a taxpayer, given the option of purchasing the stock of a corporation or purchasing its assets, purchased the stock of a corporation. Nonetheless, even in those circumstances, the courts are divided as to whether the taxpayer has to justify the acquisition of stock rather than a direct acquisition of assets. Some courts that agree that the form chosen may be questioned appear to treat the form chosen as just one factor to be considered in deciding whether section 269 applies.

A leading case in which a court considered the method of acquisition in applying section 269 is Canaveral International Corporation v. Commissioner, 61 T.C. 520 (1974). In Canaveral, the taxpayer was interested in buying a yacht. However, when it discovered that the yacht had an inflated basis, the taxpayer chose instead to acquire the stock of the corporation that held the yacht as virtually its sole asset. The court said:

> [W]hen section 269 is placed in issue, it does require a showing that the most favorable tax route, when that route involves the acquisition of a corporation, was principally motivated by non-tax-related business reasons. Petitioner has shown no substantial business reasons for acquiring Norango's stock rather than the yacht. The evidence is persuasive that the transaction was so cast in an effort to obtain the tax benefits of the yacht's high basis which petitioner otherwise would not have enjoyed.

Canaveral Int'l Corp., 61 T.C. at 541.

Earlier, the Tax Court had adopted a similar approach in Industrial Suppliers, Inc. v. Commissioner, 50 T.C. 635 (1968). The court in Industrial Suppliers summarized the important facts for its section 269 analysis as follows:

> We have no doubt that Caldwell was interested in acquiring petitioner's inventory at what he considered to be a bargain price and, on first impression, this would appear to be a valid, business purpose for the acquisition of petitioner's stock. We are not convinced, however, that the tax benefits to be derived from the carryover of previous net operating losses was not the principal purpose for acquiring the inventory through the purchase of petitioner's stock rather than by a simply [*sic*] purchase of the inventory itself.

Industrial Suppliers, Inc., 50 T.C. at 646 (emphasis in the original). In other words, even though a business purpose supported the purchase of inventory (because the price of the inventory was less than its fair market value), the court still concluded that section 269 applied because tax avoidance was the principal purpose for acquiring the stock rather than acquiring the assets directly.

In VGS Corporation v. Commissioner, 68 T.C. 563 (1977), acq., 1979-2 C.B. 2, the Tax Court quoted its earlier language in Canaveral, stating, "'when section 269 is placed in issue, it does require a showing that the most favorable tax route, when that route involves the acquisition of a corporation, was principally motivated by non-tax-related business reasons.'" VGS Corp., 68 T.C. at 597 (emphasis supplied). It then justified its conclusion that section 269 did *not* apply to the C reorganization used to acquire the stock of VGS by concluding that the taxpayer had shown a "substantial business purpose for the merger as implemented." Id. at 597. First, an acquisition *for* stock was chosen so that the acquiror could use its future cash flow to finance future capital requirements of the acquired entity; an acquisition for cash or debt would have reduced the acquiror's cashflow. See id. Second, an acquisition *of* stock was justified because Vermont law appeared to require that the target remain in existence, and various permits of the target were nontransferable. See id.

Although some of the language quoted above appears, at first blush, to apply section 269 generally whenever the method chosen for the acquisition cannot be justified for business reasons, it should not be read so broadly. The Tax Court itself made this clear within a year of deciding Canaveral. In D'Arcy-MacManus & Masius, Inc. v. Commissioner, the Tax Court quoted the relevant language from Canaveral, but added emphasis to the words "when that route involves the acquisition of a corporation." See D'Arcy-MacManus & Masius, Inc. v. Commissioner, 63 T.C. 440, 452 (1975). It then said: "It is clear that the above-quoted statement does not apply to the instant case because here we have the acquisition of assets, not the acquisition of a corporation." Id.

In Inductotherm Industries, Inc. v. Commissioner, 48 T.C.M. (CCH) 167 (1984), the taxpayer demonstrated a business motive for acquiring the assets of a corporation of which it acquired control. The court said:

> the fact that Inductotherm would have acquired New Trident's technical assets in the absence of a tax avoidance motive does not end the inquiry. Rather, the determinative question under section 269 is whether the principal purpose of the acquisition of *control of a corporation* was tax avoidance, not whether there was an absence of a business purpose in acquiring a corporation's assets ...
>
> The fact that Inductotherm intended to use New Trident's technical assets for business reasons does not, in and of itself, explain the principal purpose of the

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> stock acquisition. This point was made clear in Industrial Suppliers, Inc. v. Commissioner, . . .
>
> This is not to suggest that section 269 will apply to every stock acquisition merely because such a transaction produces more favorable tax results than an asset acquisition otherwise would. However, when section 269 is placed in issue, the taxpayer must demonstrate that his selection of that method of acquisition was primarily motivated by genuine, nontax related, business reasons.

Inductotherm Indus., Inc., 48 T.C.M. (CCH) at 193-94 (emphasis in the original). Later in the opinion, the court said:

> We are convinced that Inductotherm's awareness of New Trident's losses and other unused tax benefits primarily motivated the stock acquisition. No other convincing reason appears on this record as to why it did not simply purchase the technical assets of New Trident from the coassignees (or the coassignees and Waltham's trustee), rather than implementing the "tortuous" (see Fawn Fashions, Inc. v. Commissioner, . . .) procedure of purchasing New Trident's stock.

Id. at 195.

The "tortuousness" of one method as opposed to an alternative has been noted by a number of courts in this context. In Fawn Fashions, Inc. v. Commissioner, 41 T.C. 205 (1963), the taxpayer purchased, for $500, a corporation with a net operating loss in excess of $193,000. The taxpayer claimed that it bought the corporation in order to protect the use of a trade name. Id. at 210. There, the court said:

> No convincing reason appears in the record as to why L & B did not simply buy the name Fawn from the receiver instead of going through the tortuous procedure of buying the franchise of the product corporation under a unique provision of Georgia law (which both parties indicate has not been interpreted by the State courts), then change the name of the shell corporation to K & S Corp., then put K & S Corp. through bankruptcy proceedings in the Federal District Court, then obtain the discharge in bankruptcy some 7 months after L & B acquired the corporation, then transfer L & B's sales activities to the corporation, and then change the name of the corporation from K & S Corp. back to Fawn Fashions, Inc.

Id. at 212. Without such "tortuous" procedures, the form chosen by a taxpayer is less likely to result in the application of section 269. See id.; see also Industrial Suppliers, Inc., 50 T.C. at 648 (referring to some of the procedures chosen by the taxpayer to effect its acquisition as "[t]hese manipulations and others in the record" and indicating its view that the "manipulations" "raise an inescapable inference that tax avoidance was the principal purpose for the acquisition of petitioner's stock").

Not all courts, however, will follow Canaveral and VGS. In United States v. Federated Department Stores, Inc., 170 B.R. 331 (S.D. Ohio 1994), the court rejected the approach of Canaveral and VGS:

> Contrary to Canaveral and VGS, the Court concludes that the method of acquisition is but one of many factors to consider when determining the principal purpose. "Consideration of the tax aspects of a transaction does not mandatorily require application of section 269 and . . . such consideration is only prudent business planning." D'Arcy, 63 T.C. at 451. The taxpayer may consider tax attributes when structuring its transactions so long as the principal purpose behind the acquisition is business motivated. Arwood, 30 T.C.M. at 22-23.

United States v. Federated Dep't Stores, Inc., 170 B.R. at 350.

The Federated Department Stores court quoted language from D'Arcy that we find helpful, particularly since, as noted previously, the Tax Court decided D'Arcy only a year after it decided Canaveral:

> The court in D'Arcy, 63 T.C. at 452-53, distinguishes Canaveral from a situation similar to the instant case. In D'Arcy, the court stated:
>
> > "While there is a great deal of difference between acquiring one asset, the yacht in Canaveral . . ., and acquiring a corporation, we do not see so great a difference between acquiring a corporation's entire operation (i.e. acquisition of assets) as here, and acquiring the corporation itself [(i.e. acquisition of stock)]. We do not think a change in form of acquisition from the acquisition of a corporation to the acquisition of a corporation's entire operation is so drastic to warrant a mandatory denial of the carryover of tax attributes."
>
> Id. at 452-53. Similarly, this Court does not believe that the difference between acquiring the assets of TFDC and acquiring the stock of TFDC is drastic enough to warrant mandatory denial of the carryover of NOLs. So long as the principal purpose behind acquiring TFDC was for business reasons, the NOL carryover should not be denied.

Federated Dep't Stores, 170 B.R. at 350.

Arwood Corporation v. Commissioner, 30 T.C.M. (CCH) 6 (1971), which Federated Department Stores also cites, involved the use of a net operating loss to which the taxpayer succeeded after two loss corporations were merged into it. See id. at 42. The court suggested that an acquisition of assets with a carryover basis will not attract the application of section 269 where only the method of acquisition, not the acquisition itself, was motivated to some extent by tax considerations; "[i]t must be remembered that section 269 addresses itself to a situation where the principal purpose of the *acquisition* is tax avoidance; in the present case only the *method* selected for effecting the acquisition was motivated to some extent by tax considerations." Id. at 22-23 (emphasis in the original).

Thus, the courts in Federated Department Stores, D'Arcy, and Arwood were not prepared to require a justification for the method of an acquisition to avoid the application of section 269 where the corporation acquired an ongoing business rather than what was essentially an incorporated asset.

We conclude from the case law discussed above that the position sometimes associated with Canaveral, that the method of acquisition must be justified for purposes of section 269, should apply only in a case where the taxpayer purchases stock in order to acquire the underlying assets. Where, as in our case, the taxpayer acquired assets, and did not have the option of buying the stock of a corporation that owned only those assets, it should not be necessary to justify the particular structure adopted to make that acquisition. As long as the business reasons for the transaction exceeded the tax-motivated reasons, the taxpayer should be permitted to "so arrange his affairs that his taxes shall be as low as possible." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).

4. The Relevant Tax Avoidance Purposes

Section 269 applies to acquisitions if "the principal purpose for which the acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy." I.R.C. § 269(a). The plain language of the statute thus makes two points clear. First, in determining whether a taxpayer had a proscribed purpose in making an acquisition, only the tax-avoidance purposes relating to the acquisition in question are relevant. Second, the fact that a taxpayer has a tax-avoidance purpose for an acquisition is relevant only if the acquisition secures tax benefits that the taxpayer would not have obtained but for the acquisition.

The Tax Court's decision in Commodores Point Terminal Corporation v. Commissioner, 11 T.C. 411 (1948), acq. 1949-1 C.B. 1, illustrates the rule that section 269 does not apply to a case where the taxpayer would have obtained the tax benefit regardless of whether the taxpayer acquired control in the acquisition in question. In Commodores Point, the taxpayer acquired 58 percent of the stock of Piggly Wiggly Corporation from its sole shareholder in exchange for its own bonds. The taxpayer's purpose for acquiring the Piggly Wiggly stock was to secure the dividend payments thereon. As a result of its ownership of Piggly Wiggly stock, the taxpayer received dividends and claimed a dividends received credit with respect thereto. The taxpayer's acquisition of Piggly Wiggly stock did not reduce Piggly Wiggly's taxable income or its income tax liability, and the receipt of dividends increased the taxpayer's taxable income and its resulting income tax liability. Nonetheless, the Commissioner challenged the dividends received credit, claiming that the taxpayer acquired control of Piggly Wiggly for the purpose of avoiding or evading federal income tax within the meaning of section 129 of the Revenue Act of 1943.

The Tax Court first considered the intent of section 129(a) in order to determine its scope. Reviewing the legislative history of section 129, the court noted:

> Another amendment [to the bill] was made [in the Senate] by the addition of the phrase "which such person would not otherwise enjoy." This qualification limited the applicability of the section to those cases where the deduction, credit, or allowance resulted from, or was attributable to, the acquired control.
>
> . . .
>
> [Section 129(a)] condemns tax avoidance <u>only</u> when there is an acquisition of control and the <u>employment of that control</u> for the principal purpose of avoiding or evading tax, the acquiring person thereby securing the benefit of a deduction, credit, or allowance "which such person or corporation would not otherwise enjoy." The word "otherwise" can only be interpreted to mean that the deduction, credit, or allowance, if it is to be disallowed, must stem from the acquired control.

<u>Id.</u> at 415-17 (emphasis added). Given the intended scope of the statute, the <u>Commodores Point</u> court concluded that section 129 did not apply to the taxpayer's acquisition of Piggly Wiggly stock. It declared:

> The dividends received credit claimed by petitioner in its 1944 return was in no sense dependent upon petitioner's acquisition of a controlling interest in the Piggly Wiggly Corporation. Petitioner would have received dividends and would have been entitled to claim a dividends received credit proportionately as great from any number of shares less than an amount constituting a controlling interest. There is no evidence, nor does respondent suggest, that petitioner received its dividends by virtue of its controlling interest. In this case the number of shares held by petitioner was determinative only of the amount of dividends received, and the control acquired was incidental to the primary purpose of the acquisition which was to increase the petitioner's gross income.

<u>Id.</u> at 417.

The Tax Court reached a similar conclusion regarding section 129(a) of the Internal Revenue Code of 1939 (the "1939 Code") in Coastal Oil Storage Company v. Commissioner, 25 T.C. 1304 (1956), aff'd in part and rev'd in part, 242 F.2d 396 (4th Cir. 1957). In Coastal Oil, the taxpayer's parent transferred to the taxpayer seven oil storage tanks in a carryover-basis transaction. See 25 T.C. at 1312. On its tax return for the year of the transfer, the taxpayer claimed the surtax exemption under section 15(b) of the 1939 Code and the minimum excess profits credit under section 431 of the 1939 Code. The Commissioner disallowed both the claimed surtax exemption and the excess profits credit. The Tax Court summarily found that section 129(a)(1) did not apply because the taxpayer did not acquire control of another corporation and, instead considered the application of section 129(a)(2) of the 1939 Code, the predecessor of section 269(a)(2), to the taxpayer's acquisition of the oil storage tanks. The Tax Court stated:

> the word 'otherwise' can only be interpreted to mean that a deduction, credit, or allowance, if it is to be disallowed under section 129, must stem from the acquisition. See Commodores Point Terminal Corporation, 11 T.C. 411, in which we discussed in considerable detail the legislative history and purpose of section 129. In that case the taxpayer corporation had acquired a controlling stock interest in another corporation, and one of the issues was whether it was entitled to a dividends received credit with respect to dividends on the stock. In holding that section 129 did not operate to deny the credit we pointed out that the dividends, and the consequent credit, were not dependent on the taxpayer's having acquired control of the other corporation, and that the only effect of control was as to the amount of the dividends and the credit. Applying similar reasoning here, we are of the opinion that the [taxpayer's] right to the benefit of an exemption and a credit was not dependent upon its acquisition of the tanks from [its parent]. Those tanks, of course, did not carry with them a right to an exemption or a credit. Accordingly, we hold that the acquisition of the tanks did not secure to the [taxpayer] the benefit of any exemption or credit which it would not otherwise enjoy under sections 15(b) and 431, respectively, and that therefore section 129 has no application in the instant case.

Id. at 1312.

The Fourth Circuit, however, reversed Coastal Oil on this issue. See 242 F.2d 396 (4th Cir. 1957). The Fourth Circuit first concluded that section 129(a)(1) applied because the parent corporation acquired control of the taxpayer through stock ownership and, while the exemption was formally claimed by the subsidiary, the parent ultimately benefited from the exemption. In addition, the court found that the predecessor of section 269(a)(2) applied. The court reasoned:

> Subsection (2) is applicable also, since taxpayer, as a result of the transfer from the parent corporation, received property having a basis for tax purposes which

> would be determined by reference to its basis in the hands of the parent corporation, and the transfer resulted in the securing of a surtax exemption and minimum profits credit, to which neither the taxpayer nor the parent corporation would have been entitled otherwise; for the taxpayer could not have enjoyed the benefit of the surtax exemption and excess profits tax credit but for the acquisition of the property producing the income from or against which the exemption and credit are claimed.

Id. at 399.

In Cromwell Corp. v. Commissioner, 43 T.C. 313 (1964), however, the Tax Court reaffirmed that section 269 of the Internal Revenue Code of 1954 (the "1954 Code") will not apply when certain benefits would have been enjoyed regardless of the acquisition of control of a corporation. See 43 T.C. at 317. In Cromwell, four individuals formed a holding company, Cromwell Corp. ("Cromwell"), for the purpose of acquiring the stock of Cornwell Quality Tools Co. ("Cornwell"), which owned all the stock of Kennedy Service Tools Co. ("Kennedy"). See id. at 315. Cromwell borrowed $400,000 to finance the purchase of Cornwell, with the loan secured by Cornwell's assets. See id. Following Cromwell's acquisition of Cornwell, Cornwell borrowed $400,000 and paid the loan proceeds as a dividend to Cromwell, which Cromwell used to pay off its $400,000 loan. See id. at 316. Because Cromwell filed a consolidated return that included all of the income of Cromwell, Cornwell and Kennedy, the intercompany dividend paid by Cornwell to Cromwell was eliminated in computing the consolidated income of the Cromwell affiliated group. See id.

The Service claimed that "the formation of Cromwell and its acquisition of Cornwell were acquisitions of control of corporations for the principal purpose of avoiding income taxes by securing the benefit of a deduction, credit, or other allowance which would not otherwise have been enjoyed, and comes within the purview of section 269(a) [of the 1954 Code]." Id. at 317. Accordingly, the Service disallowed to Cromwell the privilege of filing a consolidated return and asserted that the Cromwell affiliated group was taxable on the $400,000 dividend from Cornwell. See id.

The Tax Court rejected the Service's position and held that section 269 of the 1954 Code was inapplicable because the use of Cromwell to acquire the stock of Cornwell did not secure a benefit that would not otherwise have been available. Id. at 317. The court stated:

> [the taxpayers] contend, and we agree, that since the benefits received would have been enjoyed by means of the suggested alternatives, section 269 does not proscribe the use of a consolidated return. Viewed separately, [the taxpayers'] use of consolidated return does not contravene any specific section of the Code. When viewed together with the alternatives available to [the taxpayers], it does not contravene section 269.

Id. at 320. The court noted that Cromwell did not involve

> the usual section 269 situation where a taxpayer is attempting to secure the benefit of built-in tax advantages, typically a net operating loss carryover, by combining two corporations via an acquisition. . . . The formation of a holding company to acquire another corporation is not an unusual procedure and is not a "device" which would distort the income of [Cromwell, Cornwell, or Kennedy] or of the principals in the instant case, as comprehended by section 269.

Id. at 320.

Commodores Point, Coastal Oil, and Cromwell make clear that the Tax Court correctly understands that section 269 does not apply where the taxpayer would have obtained the tax benefit at issue without regard to whether the taxpayer acquired control in the acquisition under consideration. The Fourth Circuit, however, has adopted a different approach that does not, at least in the case of section 269(a)(2), attempt to relate the carryover basis to the tax benefit obtained.[14] Although it is unclear how broadly the Fourth Circuit intended its Coastal Oil decision to apply, on its face, the opinion would read out of section 269 the requirement that the taxpayer secure "the benefit of a deduction, credit, or other allowance which such . . . corporation would not otherwise enjoy." Such an interpretation is at odds with the literal language of section 269 and is inconsistent with its legislative history.

The Fourth Circuit reached its decision in Coastal Oil without reference to the legislative history of section 129 of the 1943 Code. In contrast, the Tax Court in Commodores Point extensively analyzed the legislative history before deciding that the benefit must flow from the acquisition of control in order to be disallowed under section 129. A further examination of that legislative history provides additional support for the Tax Court's position.

[14] The approach taken by the Fourth Circuit may be reflected in the Treasury Regulations promulgated under section 269. See Treas. Reg. § 1.269-6, example 3. In example 3 of section 1.269-6 of the Treasury Regulations, P corporation, a profitable corporation, acquires L corporation, which has been sustaining net operating losses, at the end of 1955. In 1956, P transfers a profitable business to L in a carryover-basis transaction "for the principal purpose of using the profits of such business to absorb the net operating loss carryover of L." The example concludes, "L Corporation's net operating loss carryovers will be disallowed under the provisions of section 269(a) without regard to the application of section 382." Because the example does not explicitly rely on the relationship of the basis of the assets to their fair market value, P possibly could have transferred the assets to L in a taxable transaction and been entitled to the benefit of the net operating losses. It might be that the example obliquely indicates that the reason the business transferred to L was profitable, from a tax standpoint, was because the carryover basis of the transferred assets was low. However, one could read the reference in the example to the fact that there was carryover of basis to L to indicate that the transaction runs afoul of section 269(a)(2). The example indicates that P acquired L "for the purpose of continuing and improving the operation of L Corporation's business"; accordingly, it is unlikely that the losses could have been disallowed under section 269(a)(1).

The House version of section 129 of the 1943 Code would have applied to any acquisition of property where "a" principal purpose was tax avoidance. The Senate changed the standard to "the" principal purpose and made the provision apply only to acquisitions of control of another corporation. The Conference Committee added back acquisitions of property if the basis of the property was determined by reference to its basis in the hands of the transferor. The report of the Conference Committee describes this evolution of the statutory rules as follows:

> Under the conference agreement, the categories of tax evasion and tax avoidance selected for specific treatment under section 129 are those characterized either by the acquisition of control of a corporation, or by the acquisition of property (with a transferred basis) by one corporation from another not controlled immediately prior to such acquisition by such first corporation. As contrasted with the House bill, the conference agreement narrows the scope of the section, considered desirable in view of the extent to which the House provision overlapped the broad provisions of sections 45 of the code (control cases) [now section 482] and 141 of the code (affiliated cases) [now covered by sections 1501-1504], and of the principle of *Higgins v. Smith* (308 U.S. 473), and in order to emphasize the special function of the section, namely, to give tax enforcement agencies a clear basis for administration in those areas in which abuses are most apt to occur. The shifting within a controlled group of property or an enterprise in the attempt to preserve to the transferor, or the underlying interest, a deduction, credit, or allowance reasonably related to the property or enterprise once owned but since parted with, is governed by section 45, as is a similar shift designed to afford the new owner a deduction, credit, or allowance, having a reasonable relationship to the old owner but not with the new.

H.R. Conf. Rep. 78-1079, at 54. This paragraph focuses on the scope of section 129. The last sentence, which summarizes the predecessor of section 482, indicates that where property or an "enterprise" is shifted within a controlled group, the Service has the power, under the predecessor of section 482, either to prevent the transferor from keeping the tax benefit inherent in the transferred property or enterprise or to stop the transferee from using that benefit. In other words, the predecessor of section 482 empowered the Service to allocate the tax benefit associated with the property or the enterprise between the transferor and the transferee.

The Conference Report clarifies that the conference agreement narrowed the scope of section 129, when compared to the House bill, particularly because the House bill overlapped the "broad provisions" of the predecessor of section 482. The Conference Report notes "the special function of section 129, namely, to give tax enforcement agencies a clear basis for administration in those areas in which abuses are most apt to occur." Id. The most natural reading of the paragraph is that the new section applies to the same type of shifting to which section 482 applies, but it applies in the context of entities that are not related. The reference to "those areas in which abuses are most apt to occur" is not likely to refer to a broader category of transaction than that to which section 482 is characterized as referring, transactions in which the deduction, credit, or allowance is reasonably related either to the transferred property or enterprise, or to the old owner. The surtax exemption in Coastal Oil does not fit that description, and the Fourth Circuit's approach to section 269 would apply that section to many more cases than to which section 482 applies. Accordingly, the holding of the Tax Court in Commodores Point seems more consistent with the legislative history of the provision. Hence, in deciding whether the principal purpose of the transaction was tax avoidance for purposes of section 269, any tax advantage that is not obtained by the taxpayer as a result of the proscribed section 269 transaction should not be considered a tax avoidance benefit.

It appears that the National Office has accepted this interpretation of section 269 in private letter rulings. In Private Letter Ruling 91-23-002 (February 14, 1991), a reverse cash merger was used by the acquiring group to acquire the stock of a target corporation. Loan proceeds made up a portion of the consideration for the purchase, and the agent apparently argued that section 269 might be used to disallow the interest deductions on the loans. Presumably, the theory was that the loans would not have been entered into, and the interest paid, absent the acquisition of control of the target corporation. The private letter ruling, however, rejected that argument:

> In the instant case it is the interest payments on the debt itself that creates the deduction, and not the acquisition of Target. The interest deduction would be available to the Acquiring consolidated group whether Target was acquired with the loan proceeds or not. Thus, it cannot be said that the acquisition of Target secured the benefit of a deduction that the Acquiring group would not otherwise have enjoyed. Therefore section 269(a)(1) is inapplicable to the acquisition.

The Chief Counsel's office of the Service has followed that position in some recently released field service advices. See Field Service Advice 1999-1028 (Release Date June 5, 1992), 1999 Tax Notes Today 81-56 (April 28, 1999); Field Service Advice 1999-995 (Release Date June 5, 1992), 1999 Tax Notes Today 75-32 (April 20, 1999). Both Field Service Advice 1999-1028 and Field Service Advice 1999-995 state:

> Our conclusion is consistent with the position of the Service in PLR 9123002. It was stated therein that it is the interest payments on the debt itself that create the deduction and not the acquisition of Target. The interest deduction would be available to the consolidated group whether Target was acquired with the loan proceeds or not. The letter ruling concluded, as a consequence, that the acquisition of Target did not secure the benefit of a deduction that the acquiring group would not otherwise have enjoyed. I.R.C. section 269 was therefore held to be inapplicable.

In Field Service Advice 199926011 (Release Date March 26, 1999), 1999 Tax Notes Today 128-28 (July 6, 1999), the Chief Counsel's office made a particular point of stressing that:

> A feature of I.R.C. section 269 that is easily overlooked because it is ordinarily satisfied is that the section applies only to tax allowances that the acquiring taxpayer 'would not otherwise enjoy' but for the acquisition. Cromwell Corp v. Commissioner, 43 TC 313 (1964).

Although the Chief Counsel's office, in that field service advice, advised that the taxpayer's position was incorrect, its concern for this issue is noteworthy. The Chief Counsel's office also analyzed whether the taxpayer would "otherwise" enjoy the benefit (supported by a cite to Cromwell) in Field Service Advice 1999-1065 (Undated Release), 1999 Tax Notes Today 100-78 (May 25, 1999).

Although private letter rulings and field service advices are not Service pronouncements on which taxpayers may generally rely, they do indicate the position the Service may take in connection with a particular issue. We have found no pronouncements more recent than the field service advices cited above that relate to this issue, and we are unaware of any indication that the Service will currently take a position different from the one taken in the field service advices cited above.

Accordingly, based upon a review of the legislative history of section 269, as well as recent administrative authorities, we believe the Fourth Circuit incorrectly decided Coastal Oil. In any event, there are two additional reasons Coastal Oil should not affect the outcome of any challenge by the Service of the Maliseet Transactions on the basis of section 269. First, Maliseet is a Delaware corporation [with its principal office in Texas], and the Court of Appeals having jurisdiction over an appeal of a Tax Court decision would be the [Fifth] Circuit; therefore, the Tax Court would not be compelled, under the Golsen rule,[15] to follow the Fourth Circuit's decision in Coastal Oil. Instead, it would be free to follow its own decision in Coastal Oil, as well other precedents, including Commodores Point. Second, Commodores Point remains good law because the Fourth Circuit in Coastal Oil distinguished it rather than suggested that it is incorrect.

5. Definition of Tax Avoidance or Evasion

We have found no authority that explicitly defines "evasion or avoidance of federal income tax" for purposes of section 269. The legislative history of section 129 of the 1939

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15 The Golsen rule is derived from the Tax Court's decision in Golsen v. Commissioner, 54 T.C. 742 (1970), in which the court held, "where the Court of Appeals to which appeal lies has already passed upon the issue before us, efficient and harmonious judicial administration calls for us to follow the decision of that court." 54 T.C. at 757.

Code, the predecessor of section 269, indicates that Congress intended a flexible approach to the definition of tax avoidance or evasion.

> Section 129, under your committee's amendment, as under the House bill, recognizes that any attempt to encompass tax evasion and avoidance problems by a specific description of the tax avoidance schemes will catch within its net both intended transactions and those not intended and will fail to catch both those intended to be caught and those not intended. . . . To determine what transactions constitute the condemned evasion or avoidance, section 129 must be read in its context and background. It is superimposed on the several existing provisions of the income and excess-profits-tax law, the basic policies of which contemplate the bona fide conduct of business in the ordinary way. Basic to the deduction, credit, and allowance provisions is a continuing enterprise so conducting its affairs. A substantial number of the code provisions, like sections 112, 113, and 141, are especially designed to remove tax impediments from such business transactions. It is nonconformity to the basic policies of these provisions of the code which is denoted by tax avoidance in section 129, and it is in the light of these basic policies that section 129 would necessarily have to be applied and administered. . . . The test of this nonconformity is, as was indicated in *Higgins v. Smith* [308 U.S. 473 (1940)], whether the transaction or a particular factor thereof "distorts the liability of the particular taxpayer" when the "essential nature" of the transaction or factor is examined in light of the "legislative plan" which the deduction or credit is intended to effectuate.

S. Rep. No. 78-627, at 60. Section 1.269-2(b) of the Treasury Regulations confirms that the determination of whether a purpose to obtain a benefit is a tax-avoidance purpose requires an analysis of whether the benefit distorts tax liability when the "essential nature" of the transaction is viewed in the context of a specific "legislative plan." That regulation provides that those circumstances involving the evasion or avoidance of tax may include those circumstances:

> in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction.

Treas. Reg. § 1.269-2(b). When a taxpayer determines its tax liability in accordance with the rules specified by Congress, and pays the tax Congress intended it should pay, there is no tax avoidance and no occasion for applying section 269. See Supreme Inv. Corp. v. United States, 468 F.2d 370, 376 (5th Cir. 1972).

6. Application of Section 269(a)(2) to the Maliseet's Acquisition of the Residual Interests

a. Identification of Relevant Purposes and Benefits

To decide whether section 269 should be applied to disallow the benefits associated with Maliseet's acquisition of the Residual Interests, we compare all the non-tax-avoidance purposes with any tax-avoidance purposes that might be identified in connection with Maliseet's acquisition of the Residual Interests. In identifying the relevant tax-avoidance purposes, we look only to those benefits that arise from the transaction described in section 269(a)(2): Maliseet's acquisition of the Residual Interests with a carryover basis. We can make this calculation based on the tax and non-tax benefits of the transaction as a whole. Because Maliseet acquired assets rather than stock, we need not evaluate more narrowly the tax and non-tax reasons for the choice of the particular form adopted in this transaction, particularly where, in this instance, the alternative route of acquiring the stock of a corporation (Bankers Trust) was not available.

The benefits of the Transactions to the Enron Affiliated Group are (1) the profits generated by the Leased Equipment, (2) the profits generated by the portfolio of assets in Maliseet, (3) an increase in pre-tax financial accounting income and net earnings on the Enron consolidated financial statements, and (4) the basis that will be created from the income generated by the Residual Interests, which may offset income in the future. The first three categories of benefits, which have no tax motivation, are substantial and certain, and together they may be more important than the fourth category of benefit. Nonetheless, even if we look only at the fourth category of benefit, the creation of basis from the income generated by the Residual Interests, we find that the comparison mandated by section 269 will not result in the application of section 269 to disallow benefits in this case.

In general, deductions with respect to the Residual Interests will be allowable only to the extent of Maliseet's adjusted tax basis in the Residual Interests. If Maliseet had acquired the Residual Interests in a taxable purchase, the Residual Interest would have had an initial basis in the hands of Maliseet equal to their purchase price, which would be their value of \$165,000. Because the Residual Interests were acquired with a carryover basis, the Residual Interests had an initial basis in the hands of Maliseet of approximately \$120 million (the "Carryover Basis"). As a result, the amount of deductions with respect to the Residual Interests that Maliseet will be allowed as a result of its acquisition of those assets in a carryover-basis transaction will exceed the amount of such deductions that it would have been allowed to use if it had acquired the Residual Interests with a cost basis (such excess deductions are referred to herein as the "Carryover Basis Deductions"); this results from the fact that the London Branch's basis in the Residual Interests was greater than \$165,000, the fair market value of the Residual Interests on

January 28, 1999. Acquiring the Residual Interests in a carryover-basis transaction, therefore, will avail Maliseet of an additional $119,835,000 (120,000,000 - 165,000)] of basis that would not have been available had Maliseet acquired the Residual Interests by purchase.

After Maliseet's acquisition of the Residual Interests, the Residual Interests are expected to generate additional basis of approximately $268 million. This approximately $268 million of basis cannot be considered a tax-motivated benefit subject to attack under section 269 because it would arise even if the Residual Interests were acquired in a taxable transaction, without a carryover basis; that is, it will not arise as a result of the transfer of the Residual Interests to Maliseet in a carryover-basis transaction.

The additional basis of approximately $268 million that will be generated by the Residual Interests is substantially larger than approximately $119.8 million, which is consistent with your representation that the non-tax-motivated benefits are more valuable to Enron than any tax-motivated benefits associated with the acquisition of the Residual Interests in a carryover-basis transaction.[16] Indeed, the comparison of approximately $268 million to approximately $119.8 million overstates the relative importance of the pre-acquisition basis of approximately $120 million. Most of the Residual Interests will continue to generate income (and thus basis) for some period following their acquisition by Maliseet. Subsequently generated phantom losses may be taken by Maliseet to the extent of this basis without regard to any carryover basis. Accordingly, the basis obtained as a result of the carryover-basis transaction will produce

[16] We note that there is substantial disagreement among the courts as to the application of section 269 to tax benefits arising after an acquisition. Compare Herculite Protective Fabrics Corp. v. Commissioner, 387 F.2d 475, 476 (3d Cir. 1968) (stating that, absent clear legislative mandate, the penalty of section 269 should not apply to deny a tax benefit that arises post-acquisition); and Zanesville Inv. Co. v. Commissioner, 335 F.2d 507, 514 (6th Cir. 1964) (rejecting the Government's argument that section 269 can be applied so as to deny the utilization of post-acquisition losses against post-acquisition income), with Hall Paving Co. v. United States, 471 F.2d 261, 263-64 (5th Cir. 1973) (holding that section 269 may be applied so as to prohibit post-acquisition losses from offsetting post-acquisition income); Borge v. Commissioner, 405 F.2d 673, 679 (2d Cir. 1968) (finding that section 269 may disallow deductions for post-acquisition losses of the acquired corporation), cert. den. sub. nom. Danica Enters., Inc. v. Commissioner, 395 U.S. 933 (1969); Luke v. Commissioner, 351 F.2d 568, 572 (7th Cir. 1965) (affirming the Tax Court's holding that section 269 can be applied to deny the carry forward of a post-acquisition net operating loss); R. P. Collins & Co., Inc. v. United States, 303 F.2d 142, 146 (1st Cir. 1962) (applying the predecessor of section 269 to deny a post-acquisition tax benefit). Courts have considered how to treat post-acquisition losses only after they have decided that the principal purpose of an acquisition was a prohibited purpose under section 269. But see R. P. Collins & Co., Inc., 303 F.2d at 150 (Aldrich, J., dissenting) (stating that "[i]f the principal purpose is liquidation, and liquidation involves the realization of a loss which is artificial to the taxpayer, then the realization of that loss is part of the purpose and must be condemned, and this even if the 'larger' benefit might be thought to be the cash profit"). The cases all determine *whether* section 269 should apply based on an evaluation of the role played in the acquisition by the presence (or, at least, economic accrual) of tax benefits prior to the acquisition. Moreover, those cases all arise under section 269(a)(1), involving the acquisition of control of a corporation. The acquisition by Enron could only potentially be attacked under paragraph (2) of section 269(a), and it is not clear how courts would treat the significance of post-acquisition losses in a transaction analyzed under section 269(a)(2), involving the acquisition of an asset with a carryover basis.

benefits only after utilization of the benefits resulting from the basis the Residual Interests generate after their acquisition by Maliseet, and thus is of significantly less value.

b. Whether the Carryover Basis Deductions Will Effect a Distortion of Income

i. The REMIC Provisions

Even if the tax benefit associated with the carryover of Bankers Trust's basis in the Residual Interests is treated as a tax-motivated benefit, the acquisition of the Residual Interests in a carryover-basis transaction will be treated as having a principal purpose of tax avoidance only if Carryover Basis Deductions have the effect or will have the effect of distorting Maliseet's or its shareholders' tax liability, viewing the "essential nature" of the transfer of the Residual Interests to Maliseet, in the context of the specific "legislative plan" underlying the taxation of REMICs. The following paragraphs examine whether the acquisition of the Residual Interests in a carryover-basis transaction will have that effect.

The Tax Reform Act of 1986 added the REMIC provisions (sections 860A through 860G) to the Code. In general, these provisions provide that the interest income of a REMIC with respect to mortgages that it holds passes through to the holders of interests in the REMIC. The timing of the inclusion of such interest income in the income of the holders of regular interests, however, is altered from the timing of such income to the REMIC. The REMIC provisions compensate for this timing difference by requiring that the holders of residual interests in the REMIC take into account in determining their income tax liability items of phantom income or phantom deductions such that the net income inclusion by all holders of interests (regular and residual) in the REMIC will, in the aggregate, match the interest income of the REMIC in both timing and amount.

A variety of provisions were adopted in order to preserve the timing and amount of phantom income inclusions with respect to a REMIC residual interest. For example, phantom income cannot be offset by net operating losses, phantom income in the hands of a tax-exempt entity is treated as unrelated business taxable income ("UBTI"), and a tax is imposed on any transfer of a residual interest to an entity that is exempt from federal income taxes unless the entity is subject to the tax on UBTI. See I.R.C. § 860E. The regulations also restrict certain transfers that may interfere with the timely collection of the tax liability attributable to phantom income inclusions. For example, a transfer of a residual interest is disregarded if the transferor knows or should have known that the transferee would be unwilling or unable to pay taxes due on its share of the taxable income of the REMIC. See Treas. Reg. § 1.860E-1(c)(1). In addition, transfers to a foreign person of a residual interest that has tax avoidance potential are prohibited. See Treas. Reg. § 1.860G-3(a)(1). A residual interest has tax avoidance potential unless the transferor reasonably expects that the REMIC will distribute to the transferee an amount that will equal at least 30 percent of each inclusion of phantom income no later than the close of the calendar year following the calendar year in which the phantom income accrues. See Treas. Reg. § 1.860G-3(a)(2). Presumably this regulation is directed at preserving the timing of the collection of taxes with respect to phantom income by preventing transfers to foreign persons unless the distributions from the REMIC to the foreign person are sufficient to cover the withholding tax liability with respect to such phantom income.

The congressional purpose in enacting the REMIC tax regime was to provide an exclusive vehicle for the issuance of multiple class securities backed by real property mortgages that would be flexible enough to accommodate most legitimate business concerns while also providing rules that produced both appropriate income tax treatment of such securities and certainty as to such treatment. See S. Rep. No. 99-313, at 791-92 (1986). We believe that the statutory provisions, as described above, demonstrate that the mechanism for achieving these results was to allow the pass-through and shifting of a REMIC's interest income among its interest holders provided that the timing of inclusions of such interest income in the gross income of the interest holders and the payment of tax liabilities with respect to such inclusions are preserved. Consistent with this mechanism, and as reflected in the provisions of section 860E and section 1.860G-3 of the Treasury Regulations, we believe that whether an acquisition of a residual interest in a REMIC effects a distortion of tax liability and, therefore, has a tax-avoidance purpose should be determined by reference to the timing of phantom income inclusions and phantom deductions with respect to such inclusions prior to the acquisition.

ii. Analysis

The timing and the amount of the phantom income and phantom deductions attributable to the Residual Interests after their acquisition by Maliseet will be the same as they would have been had the Residual Interests been retained by the London Branch. Therefore, Maliseet's acquisition of the Residual Interests should not effect a distortion of tax liability and the acquisition should not be regarded as having a tax-avoidance purpose. Nonetheless, it is possible that the Service would argue that the acquisition of the Residual Interests did cause a distortion of liability that was inconsistent with the legislative plan. The following paragraphs discuss those arguments.

(a) Phantom Deductions Are Allowable Only to the Taxpayer That Was Taxed on the Corresponding Phantom Income

The Service might argue that the REMIC provisions, by limiting the amount of deductions allowable with respect to a residual interest to the amount of the holder's basis in the residual interest, reflect an intention that phantom deductions be allowed only to the taxpayer that was taxed on the corresponding phantom income. Based on such a view, the Service might claim that a nontaxable transfer that provides the transferee with a carryover basis that enables

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the transferee to use phantom deductions distorts the liability of the transferee when the transfer is examined in light of the legislative plan of the REMIC provisions.

The REMIC provisions contain a number of very specific rules designed to prevent transfers of residual interests that would permit the deferral or elimination of phantom income inclusions with respect to such interests. There are no rules that address transfers of residual interests that would alter the identity of the taxpayer that is entitled to, or the timing of, phantom deductions. In fact, the critical policy reflected in the REMIC provisions appears to be the preservation of the amount and timing of collections of tax liabilities with respect to phantom income inclusions. The REMIC provisions reflect no concern for the identity of the holder that receives phantom deductions or the ability of the holder to utilize phantom deductions. Moreover, regulations relating to a transition rule for the exclusion of REMIC residual interests from the mark-to-market rules of section 475 provide a special rule for determining the acquisition date of certain REMIC residual interests that are acquired by a transferee with a basis determined by reference to the transferor's basis. See Treas. Reg. § 1.475(c)-2(c)(2).

Based on the lack of any statutory provision suggesting a concern with the identity of the holder that is entitled to phantom deductions and the implicit acknowledgment in the mark-to-market regulations that there can be carryover-basis transfers of REMIC residual interests (including residual interests with negative value), we believe that a section 351 transfer of a residual interest that results in a carryover basis to the transferee should not be considered to distort the tax liability of the holder in a manner that is inconsistent with the basic policies of section 351 when viewed in light of the legislative plan underlying the REMIC provisions.[17] Accordingly, we believe that the Service should not prevail with an argument that Maliseet's acquisition of the Residual Interests effected a distortion of liability because Maliseet was entitled to claim phantom deductions, without including in income the corresponding phantom income.

(b) Net Losses With Respect To Residual Interests

If the Carryover Basis Deductions from one Residual Interest sheltered taxable income from another Residual Interest, the Service might argue that the sheltering of such taxable

[17] The transfer of the Residual Interests to Maliseet duplicates in the Additional Common Stock issued to the London Branch the basis/value difference that existed in the Residual Interests immediately before the transfer. Section 269(a)(2) on its face is concerned only with the benefits obtained by the corporation that acquires assets with a carryover basis, not with the benefits that may be retained by the transferor of the assets. Moreover, the duplication of built-in gains and losses on the transfer of assets in a section 351 transaction is inherent in the two-tier system of taxation of shareholders and corporations. Accordingly, we believe that the duplication in the Additional Common Stock issued to the London Branch of the built-in loss in the Residual Interests should not be considered to be tax avoidance within the scope of section 269.

income distorts the tax liability of Maliseet with respect to the Residual Interests. That distortion, the Service would argue, is a tax benefit that is relevant to the section 269 analysis.

The taxable income of the holder of residual interests in one or more REMICs for any taxable year must equal at least the sum of the "excess inclusions" attributable to that holder's residual interests for such taxable year. See I.R.C. § 860E(a)(1); Treas. Reg. § 1.860E-1(a)(1). The term "excess inclusion" means the excess (if any) of the amount taken into account by the holder under section 860C(a) over the daily accruals with respect to the residual interest. See I.R.C. § 860E(c). The amount taken into account by the holder under section 860C(a) is the holder's daily portion of the taxable income or net loss of the REMIC for each day during the taxable year on which the holder held the REMIC interest. See I.R.C. § 860C(a). The daily accrual with respect to a residual interest is a ratable portion of a return equal to 120 percent of the long-term Federal rate on the adjusted issue price of the residual interest. See I.R.C. § 860E(c)(2). We believe that the issue price of a residual interest that had a negative value (i.e., a transferee would be paid to acquire the interests) at the time it was issued would be zero. See I.R.C. § 860E(c)(2)(B)(ii) (disallowing the reduction of adjusted issue price below zero); Notice of Proposed Rulemaking, Real Estate Mortgage Investment Conduits, FI-88-86, 1991-2 C.B. 926, 932 (preamble) (recognizing that existing tax rules do not accommodate negative basis and negative issue price concepts). While the amount taken into account by the holder under section 860C(a) is the holder's daily portion of the taxable income or net loss of the REMIC, there could be no excess of a net loss with respect to a residual interest over the daily accrual for such an interest. Accordingly, we believe that the excess inclusion for a Residual Interest for any taxable year should be equal to the taxable income (if any) of the REMIC allocated to the holder of such Residual Interest for such taxable year. If a Residual Interest is allocated a net loss for a taxable year, we believe the excess inclusion for such Residual Interest should be zero.

The amount of an excess inclusion is determined separately for each residual interest. Accordingly, we believe that net losses with respect to a Residual Interest are not taken into account in determining the minimum taxable income of Maliseet (i.e., the sum of the excess inclusions of all of the Residual Interests) for a taxable year, as mandated by section 860E(a). Given our belief that the Carryover Basis Deductions can be used only to offset Maliseet's taxable income from sources other than the Residual Interests and cannot affect the timing or amount of Maliseet's income from any other Residual Interest, we believe that the acquisition of the Residual Interests with a carryover basis should not be considered to distort the taxable income of Maliseet with respect to the Residual Interests in a manner that is inconsistent with the legislative plan of the REMIC provisions.

(c) Distortion With Respect to Other Taxable Income

The Residual Interests will generate phantom income and phantom deductions over time. The amount of the phantom deductions generated by the Residual Interests will exceed the phantom income by the amount of the Carryover Basis Deductions. Accordingly, the dollar amount of Maliseet's aggregate tax liability over the life of the Residual Interests may be less than it would have been if Maliseet had not acquired the Residual Interests.

7. Conclusion

While held by Maliseet, the Residual Interests are expected to generate approximately $268 million of income, which will give rise to an equal amount of deductions (the "Other Deductions"). The Other Deductions in the amount of approximately $268 million will substantially exceed the Carryover Basis Deductions in the amount of approximately $119,835,000, which in addition will arise later in time and are thus less valuable. Under these circumstances we believe that the Carryover Basis Deductions should not be considered "the principal purpose" for which the acquisition was made. We reach our conclusion because the purposes for the acquisition that were not tax motivated (or could have been obtained without the acquisition of the Residual Interests with a carryover basis) exceeded all the purposes that might be viewed as tax motivated purposes that could only be obtained through the acquisition of the Residual Interests with a carryover basis. Moreover, even if the Carryover Basis Deductions are considered the principal purpose for Maliseet's acquisition of the Residual Interests, because that benefit arguably is not inconsistent with the legislative plan underlying the REMIC provisions, there is a good argument that there has been no tax avoidance that triggers the application at section 269.

E. Section 382

1. Background

Section 382, as in effect prior to 1986, had been criticized for limiting the amount of loss carryovers without focusing on the ability (or inability) of the loss corporation to use its losses. See Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., The Subchapter C Revision Act of 1985, 47 (Comm. Print 1985) ("Finance Staff Subchapter C Report"). This pre-1986 approach was considered undesirable because it completely disallowed carryforwards after a change of ownership (potentially interfering with economically motivated sales of businesses) and because it allowed carryforwards to the extent of the continuing interests of shareholders of the loss corporation (presenting opportunities for tax motivated sales). See H.R. Rep. No. 99-426, at 256-57 (1985); S. Rep. No. 99-313, at 232 (1986); Finance Staff Subchapter C Report, at 47-48.

Section 382, as amended in 1986, retains the basic requirement that there be a change of ownership of a corporation before the provision applies, reflecting the conclusion that changes in a loss corporation's stock ownership are the best indicators of potentially abusive transactions. See H.R. Rep. No. 99-426, at 256 (1985); S. Rep. No. 99-313, at 232 (1986). In response to the concerns described above, however, Congress changed the consequences of a change of ownership, adopting a rule that limited the earnings against which carryforwards could be used to an amount equal to a specified return on the value of the corporation's stock. See H.R. Conf.

Rep. No. 99-841, at II-172 (1986); H.R. Rep. No. 99-426, at 257-58 (1985); S. Rep. No. 99-313, at 232 (1986). This limitation amount was intended to provide an objective approximation of the income that would be generated by the assets of the loss corporation. See H.R. Rep. No. 99-426, at 257 (1985); S. Rep. No. 99-313, at 232 (1986). Congress also expanded the scope of section 382 to limit the use of built-in losses in cases where a corporation has built-in losses in excess of a threshold amount because such losses were viewed as economically equivalent to loss carryforwards. See H.R. Rep. No. 99-426, at 260-61 (1985); S. Rep. No. 99-313, at 235 (1986); see also H.R. Conf. Rep. No. 99-841, at II-190-91 (1986).

As currently in effect, section 382 limits a loss corporation's ability to use net operating loss carryforwards that are attributable to years prior to the year of the ownership change and net operating losses attributable to the year of the ownership change that are allocable to the period in such year before the ownership change. See I.R.C. § 382. Section 382 also limits a loss corporation's ability to use its taxable income after an ownership change to offset certain built-in losses recognized during the five years following the ownership change. See id.

Loss Corporation. For purposes of section 382, a loss corporation includes a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs. See I.R.C. § 382(k)(1). The term loss corporation also includes any corporation with a NUBIL. See id. In general, a corporation has a NUBIL if the excess of (A) the sum of the aggregate adjusted basis of the assets of such corporation immediately before an ownership change plus the "built-in deductions" of such corporation at such time, over (B) the sum of the fair market value of such assets at such time plus the built-in income items of such corporation at such time is greater than a threshold amount. See I.R.C. § 382(h). Built-in deduction items are amounts allowable as deductions during the recognition period (i.e., the five-year period following the ownership change) that are attributable to periods before the ownership change. See I.R.C. § 382(h)(6). Finally, the term loss corporation includes "[a]ny predecessor or successor to a loss corporation." See Treas. Reg.§ 1.382-2(a)(1)(i)(C); see also I.R.C. § 382(*l*)(8). Section 1.382-2(a)(5) of the Treasury Regulations defines a successor corporation as

> a distributee or transferee corporation that succeeds to and takes into account items described in section 381(c) from a corporation as the result of an acquisition of assets described in section 381(a). A successor corporation also includes, *as the context may require*, a corporation which receives an asset or assets from another corporation if the corporation's basis for the asset(s) is determined, directly or indirectly, in whole or in part, by reference to the other corporation's basis and the amount by which basis differs from value is, in the aggregate, material.

Treas. Reg. § 1.382-2(a)(5) (emphasis added).

In the event a corporation is a successor, the rules of section 1.382-2(a)(1) of the Treasury Regulations apply, as the context may require. <u>See</u> Treas. Reg. § 1.382-2(a)(1)(v). These rules generally provide that:

(1) a successor to a loss corporation is also treated as a loss corporation (Treas. Reg. § 1.382-2(a)(1)(i));

(2) in the event of certain section 381(a) transactions, stock of the acquiring corporation is treated as stock of the acquired loss corporation for purposes of determining whether an ownership change occurs with respect to certain pre-change losses and NUBILs of the acquired loss corporation (Treas. Reg. § 1.382-2(a)(1)(ii)); and

(3) certain losses of a loss corporation that is acquired in a section 381(a) transaction must be accounted for separately until the later of certain "fold-in" events or five years after the acquisition (Treas. Reg. § 1.382-2(a)(1)(iii), (iv)).

<u>See</u> Treas. Reg. § 1.382-2(a)(1).

<u>Ownership Change</u>. An ownership change generally is triggered by an increase of more than 50 percentage points in stock ownership by one or more five percent shareholders during the "testing period," which is generally the three-year period ending on the date on which a corporation is tested for an ownership change. <u>See</u> I.R.C. § 382(g), (i).

<u>The Section 382 Limitation</u>. Subject to certain adjustments, the limitation under section 382 for any year following a change in ownership is generally an amount equal to the product of (1) the value of the loss corporation on the date of the change of ownership, and (2) the "long-term tax-exempt rate." <u>See</u> I.R.C. § 382(b)(1). For this purpose, the long-term tax-exempt rate is the highest of the adjusted Federal long-term rates in effect for any month in the three-month period ending with the month in which the ownership change occurred. <u>See</u> I.R.C. § 382(f).

2. <u>Application of Section 382 to the Phantom Deductions Generated by the Residual Interests</u>

For purposes of this discussion, we have assumed that phantom deductions generated by the Residual Interests are treated as attributable to the period during which a corresponding amount of phantom income was generated by such interests. Further, we have assumed that the phantom income to which the phantom deductions are attributable arises prior to January 28, 1999 or, in analyzing whether the DB Acquisition caused a change of ownership, the income arises prior to the date of the DB Acquisition. Based on these assumptions, some or all of the phantom deductions generated by the Residual Interests would constitute built-in losses subject to limitation under section 382 if (i) Maliseet has a NUBIL, (ii) Maliseet undergoes an ownership change, and (iii) the phantom deductions arise in the five-year period following the ownership change.[18]

You have asked us to consider whether either or both of (1) the transfer of the Residual Interests and the Mortgage Securities to Maliseet, and (2) the DB Acquisition, caused the phantom deductions generated by the Residual Interests to become subject to a limitation under section 382. Such events would have triggered such a limitation under section 382 only if Maliseet were a loss corporation (by reason of having a NUBIL) or a successor to a loss corporation at the time of such events and such events caused, or were treated as causing, Maliseet to experience an ownership change.[19] The following sections analyze whether Maliseet was a loss corporation (by reason of having a NUBIL) at the time of the transfer of the Residual Interests and the Mortgage Securities or at the time of the DB Acquisition, and whether such events caused an ownership change of Maliseet that triggered a limitation under section 382 on Maliseet's use of the phantom deductions generated by the Residual Interests. The discussion also analyzes whether, assuming Maliseet is a successor to Bankers Trust, the transfer of the Residual Interests and the Mortgage Securities to Maliseet or the DB Acquisition caused an ownership change of Maliseet that triggered a limitation under section 382 on Maliseet's use of the phantom deductions.

The discussion set forth below concludes as follows: although there is no guidance specifically addressing whether Maliseet should be treated as a successor to Bankers Trust, we think the better view is that Maliseet should not be treated as a successor. Further, even if

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18 The built-in deduction items that are potentially subject to a limit under section 382 include only certain depreciation, amortization, or depletion deductions and any amount allowable as a deduction during the five years following the ownership change that is attributable to periods before the change of ownership. See I.R.C. § 382(h)(2)(B), (h)(6). We believe phantom deductions generated by the Residual Interests are not depreciation, amortization, or depletion deductions. Accordingly, we believe a limitation under section 382 would be applicable to such deductions only if the deductions were "attributable to" periods before an ownership change of Maliseet. For purposes of providing you with a worst-case analysis, as discussed above we have assumed that phantom deductions would be attributable to the period occurring prior to the date of an ownership change. You have not requested our advice on the period to which phantom deductions are properly attributable, and this assumption is not intended to reflect any determination by us of the appropriateness of such treatment.

19 In determining whether the transfer of the Mortgage Securities and the Residual Interests or the DB Acquisition caused an ownership change of Maliseet, we have not taken into account the changes in ownership, if any, by Maliseet's five percent shareholders (within the meaning of section 382) other than changes that occur solely as a result of the transfer of the Marketable Securities and the Residual Interests and the DB Acquisition. It is possible that Maliseet underwent an ownership change by reason of *other* changes in the stock ownership of one or more of its five percent shareholders (within the meaning of section 382). For example, changes in ownership by persons who own five percent or more of Enron stock could contribute to an ownership change of Maliseet. For purposes of our analysis, we have assumed that, except for changes solely and directly attributable to the transfer of the Residual Interests and the Mortgage Securities and the DB Acquisition, the ownership percentage of each of Maliseet's five percent shareholders (within the meaning of section 382) has not changed during the three-year testing period preceding the transfer or the DB Acquisition.

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Maliseet were treated as a successor, we believe the transfer of the Residual Interests and the Mortgage Securities and the DB Acquisition should not cause Maliseet to experience a change of ownership for section 382 purposes. Due to the lack of authority addressing the scope and application of the successor rules, however, these conclusions are not free from doubt. Finally, even if Maliseet were treated as a successor to Bankers Trust, and Maliseet were treated as experiencing an ownership change as a result of the transfer of the Residual Interests and the Mortgage Securities or the DB Acquisition, the consequences should have limited effect. Specifically, if Maliseet experienced such an ownership change, Maliseet's use of the phantom deductions should be subject to a section 382 limitation during the five-year period following any such change of ownership (i.e., January 28, 1999 or the date of the DB Acquisition). We understand that the Residual Interests are not expected to generate any phantom deductions until after January 1, 2004, and thus, for example, if Maliseet experienced an ownership change on January 28, 1999, only the phantom deductions generated during January 2004 should be subject to limitation under section 382.

a. Result if Maliseet is not a Successor

i. The Transfer of the Residual Interests and the Mortgage Securities

Immediately prior to its acquisition of the Mortgage Securities and the Residual Interests, Maliseet was not entitled to use a net operating loss carryover, did not have a net operating loss for the taxable year that included January 28, 1999, and did not have a NUBIL within the meaning of section 382(h).[20] Thus, Maliseet was not a loss corporation immediately before it acquired the Residual Interests and the Mortgage Securities in exchange for its stock. Moreover, immediately prior to Maliseet's acquisition of the Residual Interests and the Mortgage Securities, Enron owned 100 percent of the total value of all classes of stock of Maliseet. Immediately after Maliseet's acquisition of the Residual Interests and the Mortgage Securities, Enron owned, directly and indirectly, approximately 95 percent of the total value of all classes of stock of Maliseet. Because Maliseet was not a loss corporation immediately before its acquisition of the Residual Interests and the Mortgage Securities and such acquisition only caused a five percent shift in the ownership of Maliseet stock, Maliseet's use of the phantom deductions attributable to the Residual Interests should not be subject to a limitation under section 382 solely as a result of its acquisition of the Residual Interests and the Mortgage Securities, unless the "successor" rules (discussed below) alter this result.

[20] Because Maliseet was a REIT for the entire 1999 calendar year, it was not eligible to be a member of the Enron consolidated group on January 28, 1999. Thus, the determination of whether Maliseet has a NUBIL should be made by reference to Maliseet's assets and not those of the Enron consolidated group.

ii. The DB Acquisition

For purposes of this analysis we have assumed that, at the time of the DB Acquisition, Maliseet was a loss corporation because its ownership of the high basis-low value Residual Interests caused it to have a NUBIL. The DB Acquisition altered the ownership of only five percent of the outstanding stock of Maliseet, i.e., the same five percent interest that was transferred to Bankers Trust in exchange for its contribution of the Residual Interests and the BT Mortgage Securities. Thus, the DB Acquisition should not have produced a sufficient shift in the ownership to cause an ownership change of Maliseet. Accordingly, Maliseet's use of the phantom deductions attributable to the Residual Interests should not be subject to a limitation under section 382 solely as a result of the DB Acquisition, unless the "successor" rules (discussed below) alter this result.

b. Maliseet's Status as a Successor Corporation

As described above, the regulations provide that, when a transferee corporation receives an asset (or assets) in a carryover basis transaction and there is a material difference between the basis and the fair market value of the transferred asset (or assets), the transferee is a successor "as the context may require." See Treas. Reg. § 1.382-2(a)(5). Because Maliseet acquired the Residual Interests from Bankers Trust in a transaction in which Maliseet's basis in the interests was determined by reference to Bankers Trust's basis in the interests, and the value of the Residual Interests was lower than their basis, it is possible that Maliseet is a "successor corporation."

Neither the preamble to the proposed or final regulations nor subsequent guidance explains when the context may require a corporation to be treated as a successor for purposes of the regulation.[21] Consequently, there is no authority that provides guidance regarding when the context may or may not require Maliseet to be treated as a successor to Bankers Trust. In the absence of authority, arguably a determination of when the context requires a transferee corporation to be treated as a successor should be guided by the underlying purposes of section

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21 The broadened successor rules were first published in the 1991 proposed section 382 regulations. At the same time the proposed section 382 regulations were issued, the Service issued proposed regulations addressing the application of section 382 to consolidated groups (including subgroups) as well as proposed regulations addressing the application of the separate return limitation year rules ("SRLY") in the context of subgroups, and both regulations contained successor rules. See 1991-1 C.B. 728; 1991-1 C.B. 757. A principal reason for the successor rules in the consolidated section 382 and the SRLY proposed regulations apparently was to assist in the determination of the corporations that are members of the relevant subgroups following certain reorganizations or asset transfers, and these regulations contain a number of additional, more specific rules that address the treatment of successors and their effects on the subgroup and other rules. However, the intended purpose and scope of the successor rules of the section 382 regulations in question is unclear.

382.[22] As described above, a principal feature of the amendments to section 382 in 1986 was the imposition of a "section 382 limitation" on the use of the loss corporation's loss carryovers or built-in losses. The limitation is intended to approximate the income that the loss corporation could generate in the absence of an acquisition, and thus is designed to eliminate the incentive to acquire a loss corporation for the purpose of enabling the acquiror to increase the use of the loss corporation's loss carryovers or built-in losses.

Under an interpretation of "as the context may require" that is guided by this underlying purpose of section 382, Maliseet should be a successor to Bankers Trust only if the transfer of the Residual Interests to Maliseet enables Maliseet or the Enron Affiliated Group to use the phantom deductions to a greater extent than if the Residual Interests had not been transferred. Put another way, unless the transfer increases the use of the phantom deductions, arguably the transfer is consistent with the fundamental concept of the section 382 limitation that is the cornerstone of section 382. We understand that, if Bankers Trust had retained the Residual Interests that were transferred to Maliseet, any federal income tax deductions or losses generated by such Residual Interests could have been utilized both by Bankers Trust if it were to file federal income tax returns as a separate company and by the Bankers Trust Affiliated Group if Bankers Trust were to file consolidated federal income tax returns with such consolidated group. Because the transfer of the Residual Interests in such circumstances does not contravene the neutrality principles underlying section 382, the better view is that the context should not require Maliseet to be treated as a successor to Bankers Trust.

We note further that, in view of the lack of authority addressing when the context requires a corporation to be treated as a successor, several other arguments exist to support the view that Maliseet should not be treated as a successor to Bankers Trust.[23] Nonetheless, in view

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22 The proposed SRLY regulations issued at the same time as the proposed section 382 regulations contained similar "as the context may require" language in determining whether a corporation is a successor. See Prop. Treas. Reg. § 1.1502-21(e); 1991-1 C.B. 757, 767. The preamble to the regulations noted that the successor rule was intended to cause corporations to be treated as successors in circumstances that were consistent with the underlying purposes of the SRLY rules. See 1991-1 C.B. 757, 759 (In order to prevent one member's inappropriate use of the historic contribution to consolidated taxable income by another member, predecessors will be taken into account only as the context may require.).

23 For example, arguably a transferee of built-in loss assets should not become a successor by reason of the transfer of the built-in loss assets unless the transferor corporation had a NUBIL. Interpreting the successor rule to apply to a transferee of a corporation that did not have a NUBIL would impose a more restrictive limitation on the successor corporation than would have applied to the transferor corporation had there been no such transfer and the transferor had undergone an ownership change. We understand that neither Bankers Trust nor a BT Loss Group had a NUBIL immediately prior to the transfer of the Residual Interests or the DB Acquisition.

In addition, arguably a transferee of assets should be treated as a successor only in circumstances where the transferee acquires a meaningful portion of the transferor's assets such that the transferee can reasonably be viewed as an extension or continuation of the transferor corporation. We understand that the Residual Interests comprised a very small fraction of the assets of Bankers Trust.

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of the lack of any authority addressing the issue, we have assumed that there is sufficient risk that Maliseet could be treated as a successor to warrant consideration of the potential consequences of treating Maliseet as a successor. Thus, as set forth below, we have considered the application of section 382 in the event that Maliseet is treated as a successor of Bankers Trust as a result of Maliseet's acquisition of the Residual Interests.

The consequences of treating Maliseet as a successor to Bankers Trust depends in part on the application of section 382(*l*)(8). Section 382(*l*)(8) provides that, "[e]xcept as provided in regulations, any entity and any predecessor or successor entities of such entity shall be treated as 1 entity." I.R.C. § 382(*l*)(8). In contrast, section 1.382-2(a)(1)(i)(C) of the Treasury Regulations provides that "[a]ny . . . successor to a loss corporation . . . is <u>also</u> a loss corporation." Treas. Reg. § 1.382-2(a)(1)(i)(C) (emphasis added). By stating that any successor is <u>also</u> a loss corporation, section 1.382-2(a)(1)(i)(C) of the Treasury Regulations suggests that a successor is treated as a loss corporation separate from any other corporation, including the corporation from which it acquired built-in loss assets. It is not clear, however, that this regulation was intended to override the single-entity treatment prescribed by section 382(*l*)(8).

Because of this uncertainty, we have considered the possible application of section 382 and the successor rules to Maliseet in two cases: First, if Maliseet is a successor that is treated as an entity separate from Bankers Trust and, alternatively, if Maliseet is a successor and is treated as a single entity with Bankers Trust.

i. <u>Maliseet Treated as an Entity Separate from Bankers Trust</u>

(a) <u>The Transfer of the Residual Interests and the Mortgage Securities</u>

As described above, provided Maliseet is not a successor to Bankers Trust, a potential ownership change of Maliseet is determined by reference to the ownership of the stock of Maliseet, including indirect owners of the stock by reason of attribution. In such circumstances, no section 382 limitation should apply to Maliseet's use of the phantom deductions solely as a result of the transfer of the Residual Interests and the Mortgage Securities.

The question then becomes whether the result is different if Maliseet is treated as a successor to Bankers Trust. The regulations provide that, "paragraph (a)(1) [of Treas. Reg. § 1.382-2] also applies, as the context may require, to successor corporations other than successors in section 381(a) transactions." Treas. Reg. § 1.382-2(a)(1)(v). The regulation further provides that, "for example, if a corporation receives assets from the loss corporation that have basis in excess of value, the recipient corporation's basis for assets is determined, directly or indirectly, in whole or in part, by reference to the loss corporation's basis, and the amount by which basis exceeds value is material, the recipient corporation is a successor corporation subject to this paragraph (a)(1)." <u>Id</u>. If paragraph (a)(1) applies, <u>i.e.</u>, if the context so requires, arguably the regulations could cause Maliseet to experience an ownership change – at least with respect to the Residual Interests -- as a result of the transfer of the Residual Interests and the Mortgage Securities. Specifically, the regulations provide that, "following [certain section 381 transactions] described in the preceding sentence, the stock of the acquiring corporation shall be treated as the stock of the loss corporation for purposes of determining whether an ownership change occurs with respect to the pre-change losses and net unrealized built-in losses that may be treated as pre-change losses of the distributor or transferor corporation." Treas. Reg. § 1.382-2(a)(1)(ii).

Although it is far from clear how this provision operates when both the transferor and transferee corporation continue in existence (as in the case of Bankers Trust and Maliseet), it could be argued that it requires that the occurrence of an ownership change be determined by comparing the ownership of the built-in loss assets prior to the transaction with the ownership of such assets after the transaction. In such a case, the transfer of the Residual Interests to Maliseet would cause the assets to change from being wholly owned by Bankers Trust to being only five percent owned by Bankers Trust, which is a greater than 50% change in ownership.

There is no authority that addresses when the context requires the provisions of paragraph (a)(1) of the regulation to apply. Moreover, there is no guidance specifically addressing whether, as described above, a transfer of an asset (and not stock) in a transaction not described in section 381(a) can cause an ownership change with respect to the transferred asset. For the reasons set forth below, however, we do not believe that the regulation should apply to treat Maliseet as if it experienced an ownership change as a result of its acquisition of the Residual Interests and the Mortgage Securities.

First, as in the case of determining whether Maliseet is a successor corporation, the context should not require paragraph (a)(1) of the regulation to apply to cause an ownership change of Maliseet where the transfer of the Residual Interests to Maliseet does not increase the utilization of the phantom deductions generated by the Residual Interests. Absent an increase in utilization of the phantom deductions, arguably the transfer of the Residual Interests does not contravene the neutrality principles underlying section 382.[24] Second, section 1.382-2(a)(1)(ii) of the Treasury Regulations treats the stock of an acquiring corporation as the stock of the acquired loss corporation to determine whether an ownership change occurs with respect to the NUBIL of the transferor. Although there is no guidance on point, we believe this provision is intended to ensure that, if the acquired loss corporation has a NUBIL, such corporation's built-in losses become subject to a section 382 limitation if there is a subsequent ownership change with respect to the acquired loss corporation. See Treas. Reg. § 1.382-2(a)(1)(ii). This interpretation

[24] The transfer of the Residual Interests also duplicates the built-in loss inherent in the interests. Such duplication, however, is a fundamental consequence of a section 351 transfer, and section 382 was not intended to prevent such duplication. But cf. I.R.C. § 382(g)(4)(D) (imposing a section 382 limitation of zero where a 50 percent shareholder claims a worthless stock deduction).

is consistent with the basic concept that built-in losses are not subject to limitation under section 382 unless the corporation has a NUBIL. In the case at hand, neither Bankers Trust nor a BT Loss Group had a NUBIL within the meaning of section 382(h) at the time the Residual Interests were transferred to Maliseet.

As described above, recognized built-in losses are subject to a limitation under section 382 only where the loss corporation had a NUBIL at the time of a prior ownership change. Where, as here, neither Bankers Trust nor a BT Loss Group had a NUBIL at the time the Residual Interests were transferred to Maliseet,[25] application of a section 382 limit to the transferred assets solely as a result of a transfer of the interests in a carryover-basis transaction arguably would not further the purposes of the NUBIL rules. Compare I.R.C. § 382(h)(9) (providing authority to prescribe regulations to address circumstances in which property (e.g., built-in loss property) is transferred in a carryover basis transaction *after* an ownership change). Indeed, because the transferor did not have a NUBIL at the time of the transfer of the Residual Interests, the deductions attributable to the interests would not have been limited under section 382 if Enron had acquired 100 percent of the stock of Bankers Trust or BT Corp. Accordingly, it seems inappropriate for section 382 to limit the deductions attributable to the Residual Interests where only a small portion of the assets of Bankers Trust were acquired by Maliseet.

Also, the example in section 1.382-2(a)(1)(v) of the Treasury Regulations provides that a corporation that receives built-in loss assets from "the loss corporation" is subject to the rules of paragraph (a)(1) of the regulations. This language is consistent with the view that a corporation that receives built-in loss assets from another corporation should be subject to the rules of paragraph (a)(1) only if the transferor corporation is a *loss* corporation. Because section 382 imposes a limit on built-in losses only with respect to loss corporations that have NUBILs, we believe the appropriate interpretation of "loss corporation" in this context is that the transferor corporation must have a NUBIL – not that the transferor corporation have a loss carryforward.

In addition, treating the transfer of the Residual Interests as causing such interests to experience an ownership change would be equivalent to applying section 382 to an ownership change of individual assets (the Residual Interests) in circumstances where the assets comprise only a fraction of the total assets of the transferor corporation, Bankers Trust. If a loss corporation transfers substantially all of its assets in a tax-free reorganization, section 382 clearly

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[25] Even if Bankers Trust or a BT Loss Group had a NUBIL at the time the Residual Interests were transferred and such fact were sufficient to warrant application of the successor rules in a manner that caused Maliseet to experience an ownership change, the consequences should be limited. Specifically, Maliseet's use of the phantom deductions should be subject to a section 382 limitation only during the five-year period following such change of ownership (i.e., January 28, 1999). We understand that the Residual Interests are not expected to generate any phantom deductions until after January 1, 2004. Thus, only the phantom deductions generated during January 2004 should be subject to a section 382 limitation if Maliseet were treated as undergoing a change of ownership on January 28, 1999.

applies, because all or substantially all of the attributes (including built-in losses) of the loss corporation generally carry over to the acquiror. If, however, a loss corporation transfers only an insignificant portion of its assets, application of section 382 would significantly broaden the scope of section 382 and require every transfer of an asset in a section 351 transaction to be analyzed separately under section 382. The legislative history provides no indication that section 382 was intended to apply in the context of a transfer of a small portion of the assets of a corporation that has not experienced a change of ownership. Although there is no authority directly on point, we believe the better view is that in such cases section 382 generally should not apply to cause an ownership change with respect to transfers of individual assets that comprise a small fraction of the transferor's total assets. Compare I.R.C. § 382(h)(9).

In summary, there is no guidance that addresses whether the context requires the rules of paragraph (a)(1) of the regulation to apply or, even if such paragraph applies, whether application of the rules therein would cause an ownership change with respect to Maliseet or the Residual Interests. Although the issue is not free from doubt, for the reasons set forth above, we believe the successor rules of sections 1.382-2(a)(1)(v), (a)(5) of the Treasury Regulations should not cause the phantom deductions to become subject to a limitation under section 382 solely as a result of the transfer of the Residual Interests and the Mortgage Securities to Maliseet.

(b) The DB Acquisition

At the time of the DB Acquisition, Bankers Trust owned approximately five percent of Maliseet, and Enron owned approximately 95 percent of Maliseet. The DB Acquisition altered the ownership of Maliseet's five percent shareholders only to the extent of Bankers Trust's five percent interest in Maliseet. Where Maliseet is respected as a separate corporation for section 382 purposes, such shift of ownership should be insufficient to cause a change of ownership of Maliseet for purposes of section 382. Accordingly, provided Maliseet is treated as an entity separate from Bankers Trust, the DB Acquisition should not have resulted in a limitation under section 382 to Maliseet's use of the phantom deductions generated by the Residual Interests.

It might be argued that, if Maliseet is a successor to Bankers Trust, even if Maliseet is treated as a separate corporation for section 382 purposes, a change of ownership of Bankers Trust should cause a change of ownership of Maliseet with respect to the Residual Interests. As discussed above, however, even if such argument prevailed to cause an ownership change of Maliseet, we believe such ownership change should not cause the phantom deductions attributable to the Residual Interests to be subject to a section 382 limitation in circumstances where neither Bankers Trust nor a BT Loss Group has a NUBIL at the time of the DB Acquisition.

ii. Maliseet as a Single Entity with Bankers Trust

Set forth below is a discussion of the application of section 382 in the event that Maliseet is a successor to Bankers Trust and, pursuant to section 382(*l*)(8), Maliseet is treated as a single entity with Bankers Trust.

(a) The Transfer of the Residual Interests and the Mortgage Securities

Neither section 382 nor the Treasury Regulations promulgated thereunder provide guidance regarding how to determine whether a successor entity that is treated as one entity with the transferor of built-in loss assets has experienced an ownership change. However, we believe that the rules that govern the application of section 382 in the consolidated return context should, by analogy, provide guidance regarding the appropriate method for that determination.

The consolidated return regulations provide that a consolidated group that is a loss group has an ownership change if the loss group's common parent has an ownership change under section 382 and the regulations promulgated thereunder. See Treas. Reg. § 1.1502-92(b)(1). The consolidated return regulations also set forth a supplemental rule for determining whether there is an ownership change of a consolidated group that is a loss group in certain cases where a five-percent shareholder of the common parent increases its percentage ownership interest in the stock of both the common parent and a subsidiary of the consolidated group (other than by increasing its interest in the common parent). See Treas. Reg. § 1.1502-92(c). In such cases, the common parent is treated as if it had issued to the shareholder that acquires stock of the subsidiary its own stock with a value equal to the value of the subsidiary stock represented by the percentage increase of that shareholder's ownership of the subsidiary. See Treas. Reg. § 1.1502-92(c)(4).

Under the model set forth in the consolidated return rules, whether Bankers Trust and Maliseet, treated as a single entity, experienced an ownership change solely in connection with the transfer of the Residual Interests and the Mortgage Securities to Maliseet should be determined by treating Bankers Trust or BT Corp as having issued stock of Bankers Trust or BT Corp, respectively, to Enron with a value equal to the value of the Enron Shares on the date of the transfer of the Residual Interests and the Mortgage Securities to Maliseet. We understand that neither Bankers Trust nor BT Corp would undergo a change of ownership on the date of Maliseet's acquisition of the Residual Interests and the Mortgage Securities in the event that either Bankers Trust or BT Corp were treated as issuing to Enron its stock with a value equal to the value of the Enron Shares on the date of such acquisitions. Therefore, if Maliseet is treated as a single entity with Bankers Trust, the transfer of the Residual Interests and the Mortgage Securities to Maliseet should not cause an ownership change of Maliseet or trigger a limitation under section 382 to Maliseet's use of the phantom deductions generated by the Residual Interests.[26]

(b) The DB Acquisition

We understand that the DB Acquisition caused an ownership change of BT Corp. Therefore, if Maliseet were treated as a single entity with Bankers Trust, Maliseet likely also would be treated as experiencing an ownership change on the date of such acquisition. Accordingly, it is possible that Maliseet's recognition of phantom deductions subsequent to the DB Acquisition became subject to a limitation under section 382 if Bankers Trust and Maliseet, treated as a single entity, or Maliseet and a BT Loss Group, treated as a single entity, had a NUBIL on the date of the DB Acquisition. We understand that, on the date of the DB Acquisition, neither Bankers Trust nor any BT Loss Group had a NUBIL. Maliseet likely did not have significant built-in loss assets other than the Residual Interests. Accordingly, we have assumed that if Maliseet were combined with and treated as a single entity with Bankers Trust or a BT Loss Group, such single entity also would not have a NUBIL. Accordingly, if Maliseet and Bankers Trust or a BT Loss Group are treated as a single entity under section 382(l), the DB Acquisition should not have resulted in the application of a limitation under section 382 to Maliseet's use of phantom deductions generated by the Residual Interests.[27]

F. Tax Shelter Registration

Section 6111(a) requires that any tax shelter organizer register a tax shelter with the Secretary of the Treasury not later than the day on which such interests are offered for sale. See I.R.C. § 6111(a). For purposes of this registration requirement, the statute provides that the term "tax shelter" includes any investment that is a substantial investment if the investment is one with respect to which a person could reasonably infer, from the representations made in connection with any offer for sale of any interest in the investment, that the "tax shelter ratio" for any investor may be greater than 3.5 to 1 as of the close of any of the first five taxable years after the date on which the investment is offered for sale (the "Five-Year Period"). See I.R.C. § 6111(c)(1), (c)(2); Treas. Reg. § 301.6111-1T, A-4(l) (describing the tax shelter ratio), A-7

[26] In addition, neither Bankers Trust nor a BT Loss Group had a NUBIL on the date of the transfer of the Residual Interests to Maliseet, and thus it is unlikely that either Bankers Trust or a BT Loss Group, when combined with Maliseet and treated as a single entity, had a NUBIL on such date. In such case, the transfer should not cause the phantom deductions to be subject to a limitation under section 382 even if the transfer of the Residual Interests somehow caused Maliseet to undergo a change of ownership.

[27] Even if Maliseet and Bankers Trust or a BT Loss Group, treated as a single entity, had a NUBIL on the date of the DB Acquisition and such acquisition caused an ownership change of Maliseet, the phantom deductions that are subject to a section 382 limitation should be only those deductions that are both (i) "attributable" to the period before the date of the ownership change, and (ii) recognized by Maliseet in the five-year period following the acquisition.

(defining "year").[28] An investment is a substantial investment if the aggregate amount, which may be offered for sale, exceeds $250,000 and there are expected to be five or more investors. See I.R.C. § 6111(c)(4). Under certain circumstances, similar investments offered by the same person or related persons are aggregated together to determine whether an investment is substantial. See Treas. Reg. § 301.6111-1T, A-22. The tax shelter ratio means, with respect to any year, the ratio that the aggregate amount of deductions and 350 percent of the credits that are or will be represented as potentially allowable to an investor for all periods up to (and including) the close of such year, bears to the investment base for such investor as of the close of such year. See I.R.C. § 6111(c)(2); Treas. Reg. § 301.6111-1T, A-5. The term "amount of deductions" means the amount of gross deductions and other similar tax benefits potentially allowable with respect to the investment. See Treas. Reg. § 301.6111-1T, A-9. The amount of deductions is not offset by any gross income derived or potentially derived from the investment. See id. The term investment base generally means, with respect to any year, the cumulative amount of money and the adjusted basis of other property (reduced by any liability to which such property is subject) that is unconditionally required to be contributed or paid directly to the tax shelter on or before the close of such year by an investor. See Treas. Reg. § 301.6111-1T, A-13. The investment base must be reduced by certain amounts including: (1) certain amounts borrowed from persons, or persons related within the meaning of section 168(e)(4) to persons ("related persons"), who participated in the organization, sale or management of the investment or who has an interest (other than as a creditor) in the investment ("participating persons"); (2) certain amounts borrowed if the loan was arranged by a related person or a participating person; (3) certain amounts borrowed, directly or indirectly, from a lender located outside the United States of which a participating person or a related person knows or has reason to know; (4) amounts to be held for the benefit of investors in cash, cash equivalents, or marketable securities; and (5) any distributions that will be made without regard to the income of the tax shelter, but only to the extent such distributions exceed the amount to be held as of the close of the year in cash, cash equivalents, or marketable securities. See Treas. Reg. § 301.6111-1T, A-14.

The tax shelter registration requirement, however, is suspended with respect to certain tax shelters. In particular, if a tax shelter is a "projected income investment," it is not required to be registered before the first offering for sale of an interest in the tax shelter occurs, but may become subject to the registration requirements if it ceases to be a projected income investment. See Treas. Reg. § 301.6111-1T, A-57, A-57G. For this purpose, a tax shelter is a projected income investment if (1) it is not expected to reduce the cumulative tax liability of any investor

[28] Section 6111(d) defines a tax shelter to include any entity, plan, arrangement, or transaction that has a significant purpose of avoidance or evasion of federal income tax, which is offered under conditions of confidentiality, and for which the tax shelter promoter may receive fees in excess of $100,000. See I.R.C. § 6111(d). Section 6111(d) is effective for tax shelters, interests in which are offered for sale after the Secretary of the Treasury prescribes guidance with respect to meeting the requirements added by that section. See Taxpayer Relief Act, Pub. L. No. 105-34, 111 Stat. 788. No such guidance had been issued as of January 28, 1999. Accordingly, we believe section 6111(d) is not applicable to the transactions considered herein.

for any year during the Five-Year Period; and (2) not more than an incidental amount of the assets of the tax shelter include or relate to any interest in a collectible (as defined in section 408(m)(2)), a master sound recording, motion picture or television film, videotape, lithograph plate, copyright, or a literary, musical, or artistic composition ("Prohibited Assets"). See Treas. Reg. § 301.6111-1T, A-57A, A-57E. A tax shelter will be treated as not expected to reduce the cumulative tax liability of any investor for any year during the Five-Year Period only if

> (a) A written financial projection or other written representation that is provided to investors before the sale of interests in the investment states (or leads a reasonable investor to believe) that the investment will not reduce the cumulative tax liability of any investor with respect to any [taxable year of the tax shelter] in such 5-year period; and
>
> (b) No written or oral projections or representations, other than those related to circumstances that are highly unlikely to occur, state (or lead a reasonable investor to believe) that the investment may reduce the cumulative tax liability of any investor with respect to any such year.

Treas. Reg. § 301.6111-1T, A-57B; see Treas. Reg. § 301.6111-1T, A-7. An investment will be treated as reducing the cumulative tax liability of an investor with respect to a year during the Five-Year Period if, "as of the close of such year, cumulative projected deductions for the investor exceed cumulative projected income for the investor."[29] Treas. Reg. § 301.6111-1T, A-57C(a).

For this purpose, the "cumulative projected deductions" for an investor as of the close of a year are "the gross deductions of the investor with respect to the investment, for all periods up to (and including) the end of such year, that are included in the financial projection or upon which the representation is based. The deductions with respect to an investment include all deductions explicitly represented as being allowable and all deductions typically associated . . . with the investment." Treas. Reg. § 301.6111-1T, A-57C(b). The "cumulative projected income" for an investor as of the close of a year is "the gross income of the investor with respect to the investment, for all periods up to (and including) the end of such year, that is included in the financial projection or upon which the representation is based. For this purpose, income attributable to cash, cash equivalents, or [securities that are part of an issue any portion of which is traded on an established securities market and any securities that are regularly quoted by

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[29] An investment will also be treated as reducing the cumulative tax liability of an investor with respect to a year during the Five-Year Period if cumulative projected credits for the investor exceed cumulative projected tax liability (without regard to credits) for the investor. See Treas. Reg. § 301.6111-1T, A-57C(a). Based on your representation that the Enron Affiliated Group's investments in Maliseet and the Leased Equipment will not produce credits, we have concluded that such investments should not be treated as reducing the cumulative tax liability of the Enron Affiliated Group on such basis.

brokers or dealers making a market] may not be treated as income from the investment." Treas. Reg. § 301.6111-1T, A-57C(c); see Treas. Reg. § 301.6111-1T, A-14(4).

We have considered the potential application of the tax shelter registration requirement to (1) the investment by Maliseet in the Residual Interests, (2) the investments in Maliseet, and (3) the investments in Maliseet and the Leased Equipment (taken together). The following sections set forth our analysis and conclusions.

1. Maliseet's Investment in the Residual Interests

If an investment in the Residual Interests, when aggregated with other similar investments offered by the London Branch and members of the Bankers Trust Affiliated Group, were a substantial investment with respect to which an investor could reasonably infer that the tax shelter ratio for any investor may be greater than 3.5 to 1 as of the close of any taxable year during the Five-Year Period, it would have to be registered under section 6111(a).[30] Again, a substantial investment is one with respect to which there are expected to be five or more investors. In Section 4.3(c) of the Bankers Trust Contribution Agreement, the London Branch represented that

> Neither the Contributor nor any Affiliate has offered or participated in, nor will they offer or participate in, any transactions that are required to be integrated, combined or aggregated with the Contemplated Transactions, and that by reason of such integration, combination or aggregation, require registration of the Contemplated Transactions under any Federal or state securities or other law.

Based on the representation of London Branch, we believe that Maliseet should be considered the only expected investor in the Residual Interests. Accordingly, viewing the Residual Interests as the relevant investment, Maliseet's investment in the Residual Interests was not a tax shelter and was not required to be registered as such as of January 28, 1999.

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[30] Section 6111 speaks mostly in terms of "sales" of tax shelters, which by its terms might not include a contribution by a potential tax shelter promoter to a corporation. However, section 6111(b)(1) (identifying certain obligations of "sellers, etc.") speaks of any person "who sells (*or otherwise transfers*) an interest in a tax shelter" and an "investor who purchases (*or otherwise acquires*) an interest in such tax shelter." I.R.C. § 6111(b)(1) (emphasis supplied). Moreover, Treasury regulation section 301.6111-1T, Q-42, defines "sale of an interest in a tax shelter," to include "a consulting, management or other agreement for the performance of services." We believe a court would more likely than not be prepared to treat a contribution under these circumstances as possibly subject to the tax shelter registration rules of section 6111.

2. Investment in Maliseet

If Maliseet were viewed as the relevant investment, the investment would be a substantial investment within the meaning of section 6111. Accordingly, such investment could be a tax shelter if the tax shelter ratio for any investor in Maliseet might be greater than 3.5 to 1 as of the close of any of the first five taxable years of Maliseet.

Maliseet has elected to be treated as a REIT and Enron has agreed to maintain Maliseet's REIT status until January 1, 2004, as indicated in the Contribution Agreements and the Shareholders Agreement. Moreover, as a REIT, Maliseet must be a calendar year taxpayer pursuant to section 859. Therefore, Maliseet can be expected to be a REIT for the Five-Year Period. While Maliseet is a REIT, Maliseet's deductions will be allowable only on the federal income tax return filed by Maliseet. Therefore, as long as Maliseet is a REIT, no shareholder will be entitled to claim any deduction or credit incurred by Maliseet. Accordingly the tax shelter ratio for each shareholder of Maliseet would be less than 3.5 to 1. Therefore, Maliseet should not be treated as a tax shelter under section 6111.

3. Maliseet and the Leased Equipment

If Maliseet and the Leased Equipment, together, are viewed as the relevant investment, we again believe the investment would be a substantial investment. Moreover, in such a case it is possible that the tax shelter ratio for the Enron Affiliated Group would be greater than 3.5 to 1 as of the close of any of taxable year after January 28, 1999. Accordingly, we have considered whether, viewed together, Maliseet and the Leased Equipment is a projected income investment.

You have represented to us that the projections provided by Bankers Trust with respect to the Leased Equipment and anticipated accruals of items of income and deductions of investors in Maliseet, as a consequence of their investments in Maliseet, for taxable years ending before January 1, 2004, stated, or would lead a reasonable investor to believe, that the cumulative amount of all items of gross income (excluding items of gross income attributable to cash, cash equivalents, or marketable securities) that will be accrued by any investor in Maliseet or by the Enron Affiliated Group with respect to the Transactions for federal income tax purposes through the end of each taxable year ending before January 1, 2004, will exceed the cumulative amount of all items of gross deduction that will be accrued by any investor or by the Enron Affiliated Group for federal income tax purposes through the end of such year. No oral projections or representations provided or made to Enron stated, or would lead a reasonable investor to believe, that the cumulative amount of gross deduction that will be accrued by any investor in Maliseet or by the Enron Affiliated Group with respect to Maliseet and the Leased Equipment for federal income tax purposes through the end of each taxable year ending before January 1, 2004, will exceed the cumulative amount of all items of gross income (excluding items of gross income attributable to cash, cash equivalents, or securities that are part of an issue, any portion of which is traded on an established securities market, and any securities that are regularly quoted by brokers or dealers making a market) that will be accrued by any investor or by the Enron Affiliated Group for federal income tax purposes through the end of such year.

Based on this representation, as of the close of each year during the Five-Year Period, the cumulative projected income that will be accrued by any investor or the Enron Affiliated Group with respect to Maliseet and the Leased Equipment will exceed the cumulative projected deductions accrued by such investor or the Enron Affiliated Group with respect to Maliseet and the Leased Equipment. Therefore, an investment in Maliseet and the Leased Equipment, together, should not be viewed as reducing the cumulative tax liability of the Enron Affiliated Group for any taxable year during the Five-Year Period. In addition, the assets of Maliseet and the Leased Equipment will not include any Prohibited Assets. Accordingly, we have concluded that the investment in Maliseet and the Leased Equipment, viewed together, will be treated as a projected income investment, and, therefore, will not be required to register as a tax shelter under section 6111.

G. <u>Penalty Provision</u>

Section 6707(a) imposes a penalty on a person who is required to register a tax shelter under section 6111(a) and fails to do so. <u>See</u> I.R.C. § 6707(a). No penalty is imposed, however, with respect to any failure that is due to reasonable cause. <u>See</u> I.R.C. § 6707(a)(1). We believe that the Enron Affiliated Group should be determined to have reasonable cause for a failure to register either Maliseet or the Residual Interests as a tax shelter prior to the date of this letter, based on our advice to Enron that it is more likely than not that registration of Maliseet, the Residual Interests, and Maliseet and the Leased Equipment (taken together) is not required prior to the date of this letter.

H. <u>Consent Dividends</u>

1. <u>Generally</u>

Section 857(b)(2)(B) generally permits a REIT to deduct from its taxable income certain dividends paid (as provided in section 561), computed without regard to net income from foreclosure property. The deduction for dividends paid includes both dividends paid during the taxable year and consent dividends for the taxable year (determined under section 565). <u>See</u> I.R.C. § 561(a). A consent dividend is a hypothetical distribution (as distinguished from an actual distribution) made by certain specified corporations, including REITs, to any person who owns "consent stock" on the last day of the corporation's taxable year and who agrees (by properly filing an irrevocable consent) to treat the hypothetical distribution as an actual dividend. <u>See</u> I.R.C. § 565(a); Treas. Reg. § 1.565-1(a)(2).

2. Requirements for Dividends Paid Deduction

a. Dividend Described in Section 316

In order for a dividend to qualify for the dividends-paid deduction under section 561, the dividend must be a dividend described in section 316. See I.R.C. § 562(a). A dividend described in section 316 includes any distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. See I.R.C. § 316.

b. Dividend Not Preferential

In order to qualify for the dividends paid deduction of section 561, the dividend must not be a preferential dividend. Section 562(c) provides that the amount of any distribution will not be considered as a dividend for purposes of computing the dividends paid deduction, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class, except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference. See I.R.C. § 562(c); Treas. Reg. § 1.562-2(a). Section 1.562-2(a) of the Treasury Regulations provides:

> A corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated.

Treas. Reg. § 1.562-2(a).

The legislative history of the term "preferential dividend" states that:

> [s]ubsection (h) of the bill, relating to "preferential dividends," has the same purpose as section 27(g) of the existing law which disallows a dividends-paid credit for a distribution which is preferential. No dividends-paid credit should be allowed in the case of a distribution not in conformity with the rights of

> shareholders generally inherent in their stock holdings, whether the preferential distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance. The preference which prevents the allowance of a dividends-paid credit may be one in favor of one class of stock as well as one in favor of some shares of stock within one class. The provision has been expanded in this bill so as to leave no uncertainty as to its purpose in this respect. On the other hand, the words "equal in amount," being regarded by the committee as surplusage in existing law and apparently being productive of some confusion, have been eliminated in the new provision in the interest of clarity. The committee believes that <u>no distribution which treats shareholders with a substantial impartiality and in a manner consistent with their rights under their stock-holdings interests, should be regarded as preferential</u> by reason of minor differences in valuations of property distributed.

H.R. Rep. No. 1860, at 23 (1938), 1939-1 C.B. (Part 2) 728, 744 (emphasis added).

Based on section 1.562-2(a) of the Treasury Regulations and the legislative history of the term preferential dividend, it is clear that dividends that are not pro rata because they reflect rights inherent in certain classes of stock are not preferential dividends. That is, dividends paid to shareholders of one class of stock may be different than dividends paid to shareholders of another class of stock as long as the payments are made in accordance with the dividend rights of each class of stock as provided in the governing instruments of the corporation. <u>See</u> Priv. Ltr. Rul. 88-10-007 (ruling that the creation of an additional class of shares does not give rise to preferential dividends where the dividends will be paid in accordance with the rights of each class of shares); Priv. Ltr. Rul. 87-35-060 (interpreting Rev. Rul. 70-597, 1970-2 C.B. 146, <u>modified by</u>, Rev. Rul. 80-345, 1980-2 C.B. 204); Priv. Ltr. Rul. 85-48-014 (Aug. 28, 1985) (ruling that a dividend reinvestment plan on the common shares was not preferential and that the distributions would qualify for the dividends paid deduction because all shareholders of each class were treated the same except for minor differences due to some shareholders' participation in the dividend reinvestment plan; the holders of preferred shares were entitled to a fixed dividend and the holders of common shares were entitled to any other distributions).

Section 562(c) is clear that preferential dividends arise because shareholders within a class are treated in a different manner. Accordingly, an understanding of what constitutes a class is essential to application of section 562(c). The term "class" as used in section 562(c) is not defined in the Code, the Treasury Regulations, or the legislative history of section 562. Nonetheless, the Treasury Regulations and the legislative history, together with guidance issued by the Service, provide insight as to what should be considered a class.

The governing instruments and local law inform the determination of whether certain shares constitute a separate class of stock. <u>See</u> Priv. Ltr. Rul. 92-05-030. In Private Letter Ruling 92-05-030, the National Office concluded that certain shares that had no dividend or voting rights and shares that had voting rights and could receive dividends were distinct classes of shares.

Private Letter Ruling 95-35-041 (June 2, 1995) considered whether multiples classes of stock of several funds would be treated as separate classes of stock. Each share of a fund, regardless of class, represented an equal pro rata interest in the fund and had identical voting, dividend, liquidation, and other rights, except for their designation and rights related to expenses and distribution. The ruling states:

> The legislative history and regulations are clear that each shareholder within a class, as that term is used in section 562(c) of the Code, has certain inherent rights. The Revenue Act of 1936: Hearings on H.R. 12395 Before the Senate Comm. on Finance, 74th Cong., 2d Sess. 62 (1936); H.R. Rep. No. 1860, 75th Cong., 3d Sess. 23 (1938); Section 1.562-2 of the Income Tax Regulations. Each shareholder within a class has the right to receive the same distribution on each of his shares belonging to the class as every other shareholder within the class. In addition, the class has the right not to receive less than that to which it is entitled when compared to other classes. A class for purposes of section 562(c), then, is a group of shareholders whose rights are so closely aligned and so different from other shareholders' rights as to warrant a conclusion that members of the group should all be treated the same and should be protected against the infringement of shareholders outside the group with respect to distributions. For example, section 1.562-2(b), Example (3), of the regulations indicates that cumulative preferred and common stock may form two classes for these purposes. Among those characteristics that cause cumulative preferred shareholders to be viewed as a unit separate from common shareholders is their right to certain preferences on distributions, on redemption, and on liquidation, and their right to vote to protect those preferences.

In that ruling, the shareholders of each class had equivalent investments in the same funds; however, because different classes of shares had different arrangements for shareholder services or the distribution of shares, the fees for which varied, shareholders with equivalent investments in the same fund could receive different distributions. The ruling held that that these differences alone were insufficient to cause the shares to be classified as more than one class under section 562(c). See also Priv. Ltr. Rul. 94-26-031 (Mar. 31, 1994) (same).

Each of the Series A Preferred Stock, the Series B Preferred Stock and the Common Stock has different voting rights and economic rights with respect to distributions, redemptions, and liquidation.[31] The Series B Preferred Stock, unlike the Series A Preferred Stock and the Common Stock, has no voting rights. Moreover, the Series B Preferred Stock entitles its holders to receive dividends at an annual rate of 15 percent while the Series A Preferred Stock entitles its holders to receive dividends initially at an annual rate of 5.06788 percent. Finally, the holders of the Common Stock have a right to receive dividends only as declared and paid, but only after the holders of the Series A Preferred Stock and the Series B Preferred Stock have received the dividends to which they are entitled; similarly, the holders of the Common Stock have the right to receive liquidating distributions only after the liquidation preferences with respect to the Series A Preferred Stock and the Series B Preferred Stock.

Although the Series A Preferred Stock and the Common Stock have identical voting rights, we believe that their rights to distributions, including liquidation proceeds, are sufficiently distinct that they should be treated as separate classes of stock. Furthermore, because the Series A Preferred Stock and the Series B Preferred Stock have different economic and voting rights, we believe that they should be treated as separate classes of stock. Finally, the distinct voting rights and economic rights of the Series B Preferred Stock and the Common Stock support the conclusion that the Series B Preferred Stock and the Common Stock should be treated as separate classes of stock.

Accordingly, we believe that the Series A Preferred Stock, the Series B Preferred Stock and the Common Stock should be treated as separate classes of stock for purposes of section 562(c). Furthermore, provided dividends are paid on such outstanding shares of stock as provided in the Certificate of Incorporation, variances in dividends paid to shareholders of different classes should not be treated as preferential.

3. <u>Consent Dividends</u>

a. <u>Consent Stock</u>

"Consent stock" means "the class or classes of stock entitled, after payment of preferred dividends, to a share in the distribution (other than in complete or partial liquidation) within the

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[31] For purposes of this analysis concerning the availability of a deduction for dividends paid under section 561 and section 857(b)(2)(B), we have assumed that the Series B Preferred Stock is classified as equity for federal income tax purposes. This assumption is not intended to reflect any determination by us of the debt or equity classification of the Series B Preferred Stock for federal tax purposes.

A finding that the Series B Preferred Stock is classified as debt rather than equity for federal income tax purposes affects our analysis regarding the availability of deductions for consent dividends under section 561 only insofar as such deductions are available only if all dividends that would have been required to be paid through December 31 of such taxable year in respect of all classes of stock have been paid. If the Series B Preferred Stock were classified as debt, deductions for consent dividends would not be contingent on the payment of dividends required to have been paid in respect of the Series B Preferred Stock; instead, they would only be contingent on the payment of dividends required to have been paid in respect of the Series A Preferred Stock.

taxable year of all the remaining earnings and profits, which share constitutes the same proportion of such distribution regardless of the amount of such distribution." I.R.C. § 565(f)(1). For this purpose, "preferred dividends" means "distribution (other than in complete or partial liquidation), limited in amount, which must be made on any class of stock before a further distribution (other than in complete or partial liquidation) of earnings and profits may be made within the taxable year." I.R.C. § 565(f)(2).

Section 1.565-6(a)(1) of the Treasury Regulations further defines the term "consent stock" to include "what is generally known as common stock." Treas. Reg. § 1.565-6(a)(1). Common stock typically possesses the following rights: (1) vote, and thereby exercise control, (2) participate in current earnings and accumulated surplus, and (3) share in net assets on liquidation. See Himmel v. Commissioner, 338 F.2d 815, 817 (2d Cir. 1964).

Because the Common Stock receives 100 percent of the earnings and profits distributed in nonliquidating distributions after preferred distributions to the Series A Preferred Stock and the Series B Preferred Stock, and because the Common Stock possesses each of the other features that is typical of common stock, we believe that the Common Stock is consent stock.

b. Required Filings

A shareholder's consent to treat a hypothetical distribution as an actual distribution must be made on Form 972 in accordance with the instructions thereon. See Treas. Reg. § 1.565-1(b)(1). In such consent, the shareholder must agree to include in gross income for such shareholder's taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend. See id. The shareholder's consent must be filed with the distributing corporation's tax return not later than the due date (including extensions of time granted) for the filing of the return for the year in which the dividends paid deduction with respect to such hypothetical distributions is claimed. See Treas. Reg. § 1.565-1(b)(3); Rev. Rul. 78-296, 1978-2 C.B. 183. The filing of the consent is irrevocable. See Treas. Reg. § 1.565-1(c)(1).

4. Analysis

Based on the foregoing, we believe that provided that (a) Bankers Trust, as the sole owner of the Common Stock, properly consents to be treated as having received a consent dividend under section 565 with respect to such stock for any taxable year of Maliseet, (b) Maliseet timely files such consent with its federal income tax return for such taxable year, and (c) all dividends that would have been required to be paid through December 31 of such taxable year in respect of the Series A Preferred Stock and the Series B Preferred Stock if such consent dividend had actually been paid in cash to Bankers Trust on December 31 have been paid in full as of such date, then the amount of the consent dividend should be included within Maliseet's deduction for dividends paid, as defined in section 561, and be deductible by Maliseet under section 857(b)(2)(B).

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 is limited to the specific issues described above.

Sincerely,

McKEE NELSON, ERNST & YOUNG LLP

By: ______________________
William S. McKee

By: ______________________
James D. Bridgeman