III. TAX OPINION LETTERS RELATING TO PROJECT STEELE

AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.
ATTORNEYS AT LAW

AUSTIN
BRUSSELS
HOUSTON
LONDON
MOSCOW
NEW YORK
PHILADELPHIA
SAN ANTONIO
WASHINGTON

A REGISTERED LIMITED LIABILITY PARTNERSHIP
INCLUDING PROFESSIONAL CORPORATIONS

1700 PACIFIC AVENUE
SUITE 4100
DALLAS, TEXAS 75201-4675
(214) 969-2800
FAX (214) 969-4343

December 16, 1997

PRIVILEGED ATTORNEY
CLIENT COMMUNICATION

R. Davis Maxey, Esq.
Enron Corporation
1400 Smith Street, EB-4627
Houston, Texas 77002-7361

Dear Dave:

You have requested our opinion as to certain federal income tax consequences of the transaction summarized in this paragraph (the "Transaction") in which various subsidiaries of Enron Corp. (the "Company"), Bankers Trust (Delaware) ("BTDel"), and Bankers Trust Company ("BTCo") (BTDel and BTCo, collectively the "BT Entities") have contributed certain assets to ECT Investing Partners, L.P. ("ECT"), a newly-formed Delaware limited partnership that will elect to be classified as a corporation for federal income tax purposes, in exchange for all of the general and limited partnership interests in ECT.

In preparing our opinion, we have examined such documents related to the Transaction as we deemed necessary and have assumed that they represent the true, accurate, and entire agreement of the parties with respect to the matters described therein, that they have been and will be respected by the parties as such, and that the parties will act in accordance with the form of such documents. Further, we have relied upon your representation that you have reviewed the factual matters set forth herein and that such factual matters are correct. In the event that the factual matters so relied upon are incorrect, our opinion could change.

Except as explicitly set forth herein, we express no opinion as to the tax consequences, whether federal, state, local, or foreign, of the Transaction to any party.

I. FACTS

A. *The Transaction*

The Certificate of Limited Partnership of ECT was filed with the Secretary of State of the State of Delaware and the Agreement of Limited Partnership of ECT was signed on October 27, 1997. Such Agreement of Limited Partnership admitted only ECT Investing Corp. ("Enron GP"), ECT Investments Holding Corp. ("Enron LP"), and Enron Pipeline Company ("Enron Pipeline") as Partners of ECT. On October 30, 1997, the Amendment to the Agreement of Limited Partnership of ECT (the "Amendment") was executed to provide for certain contributions from such Partners, the issuance of general partnership interests (Class A Shares) and limited partnership interests (Class B Shares), and the authorization of Enron GP to enter into short term borrowings on behalf of ECT. The First Amended and Restated Partnership Agreement of ECT was executed on October 31, 1997, and admitted BTCo and BTDel as limited partners of ECT.

The Transaction consists of the following steps, all of which occurred on October 30, 1997, or October 31, 1997, as indicated below:

(1) *Initial Capitalization of ECT*

(a) On October 30, 1997, Enron Pipeline, a wholly owned subsidiary of the Company, contributed $61.5 million of preferred stock of Enron Liquids Holding Corp. ("Enron Liquids") to Enron LP in exchange for 100% of Enron LP preferred stock. In addition, Enron Capital & Trade Resources Corp. ("ECTR") contributed $2,532,648 of cash to Enron LP in exchange for 100% of the common stock of Enron LP. Enron LP then contributed the preferred stock of Enron Liquids to ECT[1] in exchange for Class A Shares of approximately $61.5 million.

(b) On October 30, 1997, Enron Pipeline contributed $32 million of the preferred stock of Enron Liquids to ECT in exchange for Class B Shares of ECT of $32 million.

---

1 As indicated *supra*, while ECT has been formed as a limited partnership under Delaware law, it will timely elect, on IRS Form 8832, to be classified from its inception (October 27, 1997) as an association taxable as a corporation for federal income tax purposes. *See also* Reg. § 301.7701-3. Accordingly, for tax purposes, the general and limited partnership interests in ECT (*i.e.*, the Class A Shares and the Class B Shares) will effectively be treated as common and preferred stock interests for federal income tax purposes.

Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder.

(c) On October 30, 1997, ECTR contributed $1,366,138 of cash to Enron GP in exchange for 100% of the common stock of Enron GP, and Enron GP contributed $683,069 of cash to ECT in exchange for Class A Shares of the same amount.

(d) Prior to the foregoing contributions, on October 29, 1997, ECT borrowed $51,208,736 from ECTR on a short term basis (the "Short Term Borrowing").

(e) On October 30, 1997, ECT purchased bonds from Bankers Trust New York Corporation ("BTNY") for $51,208,736 in cash. Such bonds are hereinafter referred to as the "Corporate Bonds".

(2) *Formation of ECT Equity Corp.*

(a) On October 31, 1997, ECT contributed the $93.5 million of preferred stock of Enron Liquids to a newly formed entity, ECT Equity Corp. ("ECT Equity"), in exchange for 100% of the preferred stock of ECT Equity representing 20 percent of the total vote and value of ECT Equity.

(b) On the same date, ECTR contributed a $110 million note (the "Enron Reserve Acquisition Corp. Note") in exchange for 100% of the common stock of ECT Equity, representing 80% of the total vote and value of ECT Equity. The Enron Reserve Acquisition Corp. Note is a recently executed note replacing a like amount of an intercompany obligation that Enron Reserve Acquisition Corp. has owed to ECTR for over two years.

(3) *Transfer of Preferred Stock of Enron Liquids*

On October 31, 1997, ECT Equity then transferred the $93.5 million of preferred stock of Enron Liquids to the Company in exchange for an existing $93.5 million note receivable from Houston Pipeline Company, another wholly owned subsidiary of the Company.

(4) *Additional Contributions of Enron GP, Enron LP and Enron Pipeline*

On October 31, 1997, the First Amended and Restated Partnership Agreement of ECT (the "Partnership Agreement") was executed, with the following additional contributions being made to the Partnership by Enron GP, Enron LP, and Enron Pipeline:

(a) Enron GP contributed $683,069 of cash in exchange for $683,069 of Class A Shares.

(b) Enron Pipeline contributed $4 million of cash in exchange for Class A Shares of the same value.

(c) Enron LP contributed the beneficial interest in certain leased assets with an aggregate fair market value of $42,645,177 (the "Leased Assets") and cash in the amount of $42,763,555 in exchange for $42,763,555 of Class A Shares. For tax purposes, the Leased Assets are subject to $42,645,177 of debt and the beneficial interests in the Leased Assets were leased back to the Company pursuant to terms constituting a true lease for tax purposes. The Leased Assets and $40,230,907 of cash were contributed to Enron LP by ECTR for additional common stock of Enron LP on October 30, 1997.

(5) *Formation of ECT Diversified Investments*

On October 31, 1997, ECT contributed the Corporate Bonds to a newly-formed, wholly owned limited liability company, ECT Diversified Investments, L.L.C. ("EDI LLC") in exchange for (i) approximately $2,532,648 of membership interests representing 100 percent of the total vote and value of EDI LLC, and (ii) $48,676,088 million of debt of EDI LLC. EDI LLC is a single member limited liability company.

(6) *Contributions of BT Entities to ECT*

(a) On October 31, 1997, BTCo contributed (i) approximately $1,760,982 in cash, (ii) a 40 percent participation interest in Goldman Sachs REMIC Residual Interests ("Residual Interests") with a fair market value of $2,998,018 and a tax basis of approximately $83,898,288, and (iii) Citibank REMIC Residual Interests with a fair market value of $100,000 and a tax basis of approximately $24,018,322, to ECT in exchange for (i) Class B Shares of ECT with a fair market value of approximately $3,049,531, and (ii) debt securities of ECT ("Debt Securities") with a fair market value of approximately $1,809,469. The Class B Shares received by BTCo represent, after the completion of each of the steps of the Transaction, approximately 2.04447 percent of the total vote and value of ECT's then-outstanding stock.

(b) On October 31, 1997, BTDel contributed (i) approximately 2,641,973 in cash, and (ii) Goldman Sachs Residual Interests (subject to the 40 percent participation interest described above) with a fair market value of approximately $4,497,027 and a tax basis of approximately $125,847,433 to ECT in exchange for (i) Class B Shares of ECT with a fair market value of approximately $4,480,469, and (ii) Debt Securities with a fair market value of approximately $2,658,531. The Class B Shares received by BTDel represent, after the completion of each of the steps of the Transaction, approximately 3.00381 percent of the total vote and value of ECT's then-outstanding stock.

(5) *Additional Steps in Transaction*

(a) Immediately after the foregoing exchanges, BTCo contributed its Class B Shares and Debt Securities in ECT to BT Green, Inc., a wholly-owned subsidiary of BTCo ("BT Green"), in exchange for additional voting common stock in BT Green.

(b) Also, immediately after the foregoing exchanges, ECT paid $50,532,648 in cash to ECTR in satisfaction of a portion of the Short Term Borrowing. The remaining $676,088 will be repaid within six (6) months from the date of borrowing.

(c) Immediately after each of the foregoing steps in the Transaction, each of BTCo and BTDel purchased two put options for $500 per option (*i.e.*, each of BTCo and BTDel will pay $1,000 for its respective options). Such options allow BTCo and BTDel to put their New Debt Securities to the Company at specified times (2 years and 6 1/2 years, respectively).

The Class B Shares will provide a preferred dividend return equal to 79 percent of the product of the initial value of such interests and a floating market dividend rate. In addition, the Class B Shares have a liquidation preference equal to 79 percent of the initial value of such interests plus any undistributed preferred dividends upon liquidation of ECT. The preferred dividend return is cumulative and payable on a quarterly basis. The Class A Shares and Class B Shares are also entitled to a special distribution on October 31, 2001 (the "Special Payment Amount") in the aggregate equal to the excess of (i) the net fair market value of ECT over (ii) the sum of the amount of equity contributions made by the Partners in exchange for their Class A Shares and Class B Shares plus $12 million. The Special Payment Amount may be satisfied, at the option of each Partner, in cash or by the issuance of a third class of stock senior in preference to the Class B Shares.

The Debt Securities are zero coupon notes with a 20 year term to maturity, and the stated principal amount of each note is equal to the accreted value of such note at maturity. The Debt Securities are not prepayable or callable.

As a result of the Transaction, Enron Pipeline, Enron LP, and Enron GP (together, the Enron Subsidiaries) owns Class A Shares and Class B Shares in ECT representing approximately 94.95172 percent of the total vote and value of the entity's then outstanding stock, and BTDel and BTCo (subsequently BT Green) own Class B Shares in ECT representing 5.04828 of the total vote and value of the entity's then outstanding stock and Debt Securities.

ECT, in turn, owns Residual Interests with an aggregate fair market value and tax basis of approximately $7,595,045 and $233,764,043, respectively, 20 percent of the stock of ECT Equity, 100 percent of the membership interests of EDI LLC, a $48,676,088 million note of EDI LLC, $2 million cash, and $42,645,177 in Leased Assets with a zero tax basis and subject to an equal amount of debt.

ECT will join the consolidated group (as defined in Reg. § 1.1502-1(h)) of which the Company is the common parent.

B. *Purposes of the Transaction*

The Company, the Enron Subsidiaries and ECT are engaging in the Transaction for the principal purpose of generating financial accounting benefits to the Company. Such benefits will arise as a result of anticipated tax losses generated from the residual interests held by ECT. These anticipated losses will allow the Company's financial accounting group to either immediately reduce a deferred tax liability or record a deferred tax asset on its books. In addition, the Transaction is expected to reduce federal income taxes owed by the Company and ECT in future years. The financial accounting benefits, however, will precede the anticipated reduction in federal income taxes (resulting from the recognition of built-in tax losses) by a substantial period of time. Further, the Transaction is expected to generate investment profits for the Company, the Enron Subsidiaries and ECT. Finally, the acquisition of the Corporate Bond portfolio and access to Bankers Trust's investment expertise is an additional purpose for the Transaction.

C. *Potential Future Events*

At any time after five years from the date of the Transaction, any equity owner of ECT may cause a recapitalization of ECT (the "Recapitalization"), pursuant to which the Class B Shares and Debt Securities held by BTDel and BTCo (subsequently BT Green) would be exchanged for new debt securities of ECT with a 10 year term to maturity and a current cash pay LIBOR-based rate of return (the "New Debt Securities"). The New Debt Securities would not be prepayable or callable.

Additionally, after the Recapitalization, and pursuant to two separate Put Agreements purchased each by BTDel and BTCo on the date of the Recapitalization, BTDel and BTCo (subsequently BT Green) will have the right to require a non-tax consolidated subsidiary of the Company to purchase the New Debt Securities at their fair market value. The first put option will be exercisable 2 years subsequent to the Recapitalization and will not be transferable. The second put option will be exercisable 6 1/2 years subsequent to the Recapitalization and will be transferable. Both put options will be guaranteed by the Company.

The Transaction would be undertaken regardless of whether either of these potential future events occur, and no contracts, agreements, understandings or arrangements exist with respect to such future events apart from the provisions of the Partnership Agreement of ECT relating to the Recapitalization and the provisions of the Put Agreements.

PRIVILEGED ATTORNEY
CLIENT COMMUNICATION

II. REPRESENTATIONS

You have represented to us the following additional facts, which we have relied upon in forming our opinion with respect to the Transaction:

(1) The Company, the Enron Subsidiaries and ECT would not have entered into the Transaction in the absence of the anticipated *accelerated* accounting benefit of reducing a deferred tax liability or recording a deferred tax asset.[2] Furthermore, the Company, the Enron Subsidiaries and ECT would have entered into the Transaction even if no net cash benefit was anticipated to arise as a result of an excess of net present value tax savings over transaction costs.

(2) The Company and the Enron Subsidiares undertook the Transaction for the principal purpose of generating financial accounting benefits to the Company's financial accounting group and generating investment profits. Those accounting benefits are attributable to a reduction in the group's deferred tax liability or the recording of a deferred tax asset. Such accounting benefits will precede any anticipated reduction of actual tax liabilities by a substantial period of time.

(3) All steps in the Transaction have been and will be undertaken at arm's length and with arm's length pricing.

(4) The documents reflecting the above described exchanges will be respected and adhered to by all parties hereto.

(5) Other than as part of a contribution from BTCo to BT Green, or as part of the Recapitalization, there is no plan or intention on the part of the Enron Subsidiaries or the BT Entities to dispose of any of the ECT shares received in the Transaction.

(6) The Enron Subsidiaries anticipate that the Class A Shares and the Class B Shares received in the Transaction will appreciate in value during the period such parties hold such Shares.

(7) The Transaction is not being undertaken by the Company or the Enron Subsidiaries in order (i) to use an intercompany transaction to create, accelerate, avoid or defer consolidated taxable income and the anti-abuse rule of Treas. Reg. § 1.1502-13(h), (ii) to make it likely that a distribution by the Company will be treated as a return of basis under section 301(b)(2) of the Code to the shareholders of the Company, rather than as a taxable dividend, or

---

[2] For this purpose, an accounting benefit is *accelerated* to the extent that the year the accounting benefit is recorded under GAAP on the income statement of the Company's financial accounting group precedes the year the corresponding tax benefit results in a reduction of federal income taxes.

(iii) to obtain any benefit for the Company's consolidated group under or in connection with the Treasury regulations dealing with investment adjustments (principally Reg. § 1.1502-32).

(8) Other than as part of the Recapitalization, there is no plan or intention by ECT to redeem or otherwise reacquire any stock or indebtedness issued in the Transaction.

(9) Each of the Enron Subsidiaries and, to the best of the Company's knowledge, the BT Entities, will receive in the Transaction stock and other property with a fair market value approximately equal to that of the property contributed to ECT by that party.

(10) The Company intends for ECT to remain in existence and to retain (directly or through subsidiaries) and to use the property contributed to it.

(11) There is no plan or intention by either the Company or ECT to dispose of, or cause to be disposed, the property contributed to ECT other than in the normal course of its business operations.

(12) The Leased Assets represent more than 20 percent of the value of the assets of ECT on October 31, 1997. ECT has no intention to take any actions that would make the preceding sentence untrue.

(13) No election will be filed to treat EDI LLC as an entity separate from ECI for federal tax purposes.

III. OPINION

Based upon the facts set forth above, the representations given to us by the Company and the existing law:

(1) We believe that the Enron Subsidiaries' contribution of cash, Leased Assets and preferred stock of Enron Liquids to ECT in exchange for the Class A Shares and Class B Shares, and each of the BT Entities' contribution of cash and Residual Interests to ECT in exchange for Class B Shares and other property, should constitute transfers governed by section 351 of the Code.

(2) We believe that ECT's basis in the Residual Interests contributed to it by the BT Entities should equal the basis of such assets in the hands of the respective contributors.

(3) We believe that the deductibility by ECT of the net losses "(Net Losses") (determined without regard to the Transaction) attributable to the Residual Interests contributed

by BTDel and BTCo should not be disallowed, including pursuant to the business purpose doctrine, section 269, the step transaction doctrine, or Treas. Reg. §1.1502-13(h).

(4) We believe that the Net Losses realized during the five year period after the closing of the Transaction more likely than not will be subject to limitation under the SRLY rules of the consolidated return regulations.

(5) We believe that ECT should be eligible to join the consolidated group of which the Company is the common parent.

Our opinion is based on the Code in effect on date hereof, and applicable Treasury regulations, case law, administrative rulings and pronouncements, and other authoritative sources. In the event of any change in the body of law upon which our opinion is based, our opinion on the matters expressed herein may change. We disclaim any undertaking to advise you of any subsequent changes in applicable law.

Our opinion represents our best legal judgment as to the ultimate outcome if the issues addressed herein were presented to a court of law. Our opinion is not binding on the Internal Revenue Service (the "Service") or the courts, however, and there can be no assurance that the Service or the courts would agree with our opinions on the issues discussed herein if those issues were presented to them.

IV. ANALYSIS

A. *Application of Section 351*

1. *General Overview*

Under section 351, gain or loss generally is not recognized if property is transferred to a corporation (other than an investment company) by one or more persons solely in exchange for stock in such corporation if, immediately after the transfer, such persons are in control (within the meaning of section 368(c)) of the corporation (such persons a "control group"). If nonstock consideration or "nonqualified preferred stock" (as defined below) (*i.e.*, boot) also is received in the exchange, gain (if any) realized on the transferred property is recognized but not in an amount that exceeds the value of the boot. Section 351(b). In addition to these statutory requirements, a transfer to a controlled corporation should be supported by a valid, non-tax business purpose in order to qualify for nonrecognition treatment.

In the instant case, all the requirements for the application of section 351 as summarized above should be satisfied. In particular, the cash, the Leased Assets, the preferred stock of Enron Liquids, and the Residual Interests contributed to ECT by the Enron Subsidiaries

and the BT Entities should constitute property for purposes of section 351. Further, the ECT equity interests owned by the Enron Subsidiaries and the BT Entities immediately after the Transaction will represent 100 percent of the stock (by both vote and value) of ECT. Finally, and as discussed in more detail below, the reasons for undertaking the Transaction should satisfy the business purpose requirement, and section 351 treatment should not be impaired by the investment company, accommodation transferor, or other rules discussed below.

2. *Residual Interests as Property*

Section 351 of the Code generally provides that no gain or loss shall be recognized if "property" is exchanged solely for stock of a controlled corporation. Other than specifically excepting certain items from the definition of "property" (including services, indebtedness of the transferee corporation which is not evidenced by a security, and certain accrued interest on indebtedness of the transferee corporation), section 351 does not define the term. The courts and the Service have broadly interpreted the term "property" to include (without limitation) tangible and intangible items such as cash, stock, industrial know-how, partnership interests, and contracts.[3] Accordingly, the cash, the Leased Assets, and the preferred stock of Enron Liquids contributed by the Enron Subsidiaries and the BT Entities should constitute property for purposes of section 351.

While no direct authority addresses the treatment of REMIC residual interests as property for purposes of section 351, the Residual Interests should be so treated. In this regard, the legislative history underlying the statutory enactment of REMIC residual interests provides that "[r]esidual interests generally are treated as stock for Federal income tax purposes." H.R. Rep. No. 841, 99th Cong., 2d Sess. II-224 (1986). As noted above, stock is considered property for purposes of section 351.

To the extent that a REMIC residual interest has a positive value based on a holder's entitlement to a significant share of cash flow, such REMIC residual interest should be characterized as property. Conversely, to the extent that a holder of a REMIC residual interest

---

[3] *See, e.g.*, Rev. Rul. 81-38, 1981-1 C.B. 386 (interest in a partnership considered property under section 351); Rev. Rul. 74-503, 1974-2 C.B. 117 (stock of a corporation, including stock in the transferor, considered property for purposes of section 351); Priv. Ltr. Rul. 8107099 (November 21, 1980) (working interests in oil and gas properties and interests in oil and gas reserves are property under section 351).

Private letter rulings and Technical Advice Memoranda cannot be used or cited as precedent (other than by the particular taxpayer to whom the ruling was directed). Section 6110(j)(3). They may provide useful insight as to the views of the Service, however, and if issued after October 31, 1976, also constitute "authority" for purposes of the "substantial authority" exception to the accuracy-related penalty for a substantial understatement of tax. Section 6662(a), (b)(2), (d)(2)(B)(i); Reg. § 1.6662-4(d)(3)(iii).

has little or no expected cash flow from such interest and has liabilities for future tax costs greater than the future tax benefits, a REMIC residual interest has a negative economic value and, therefore, represents a net liability of the holder. *See* Van Brunt, Kirk, "Tax Aspects of REMIC Residual Interests," 94 Tax Notes Today 219-77. Nevertheless, such a REMIC residual interest should be considered property because even though an asset may be encumbered by obligations for a period of time, the right to future tax losses is a positive tax attribute (as are net operating losses) and, thus, such interest is not purely a liability. Further, even though a REMIC residual interest may have a positive or negative value during any given period, financial products such as interest rate swaps have been held to constitute interests in personal property for purposes of section 1092 of the Code despite the fact that an interest rate swap may be an asset or a liability depending on the movement of interest rates. Treas. Reg. § 1.1092(d)-1(c).[4]

Finally, the tax basis provisions of the Code consistently refer to the basis of "property." Section 1011 of the Code determines the taxpayer's adjusted basis for determining the gain or loss from the sale or other disposition of "property." Section 1012 of the Code determines the taxpayer's basis in "property" (other than in a substituted or carryover basis transaction). It is clear that these provisions would apply to the purchaser and seller of a REMIC residual interest. As a consequence, these sections strongly imply that a REMIC residual interest should be considered property.

For the foregoing reasons, we believe the Residual Interests contributed by the BT Entities should be considered property for purposes of section 351.

3. *Business Purpose Requirement*

While a non-tax business purpose requirement is not specified in section 351 or the regulations promulgated thereunder, the Service has long taken the position that such a requirement exists.[5] The case law is somewhat mixed, but substantial authority supports the existence of a business purpose requirement and it would be hazardous to disregard it.

---

[4] While the value of a typical interest rate swap may vary from positive to negative and vice versa from one period to the next based on interests rate movements, a Residual Interest will usually be negative in the early years (because the present value of any cash flow and tax benefits arising in the later years of the REMIC is outweighed by the tax costs of the income inclusion in the early years), but will typically turn positive and stay positive. Thus, a strong argument exists that if an interest rate swap, which may continually fluctuate in value, is property when negative, then a Residual Interest should also be property.

[5] Indeed, the private letter ruling guidelines for section 351 require that the taxpayer explain the business reasons for the transfer, state whether the corporation will remain in existence and use the property after the transfer, and identify any transferred property that the transferee expects to dispose of in other than normal business operations. Rev. Proc. 83-59, 1983-2 C.B. 575.

a. *Transitory Ownership Authorities*

Most of the earlier authorities addressing the business purpose issue in the section 351 context did so somewhat tangentially in the context of fact patterns in which stock acquired in the purported section 351 transaction was held for only a short period. Consequently, the adverse results in certain of these authorities appear to be more attributable to the transitory ownership factor than to non-compliance with a business purpose requirement.

One such authority is Rev. Rul. 55-36, 1955-1 C.B. 340, in which one-sixth of the shares of a corporation (Oldco) were transferred to a new corporation (Newco) for stock and securities of Newco. The stock of Newco was contributed to a charitable corporation, which immediately liquidated Newco and assumed Newco's liability on the securities. The securities of Newco were later donated to the charity. The Service ruled that the transfer of the Oldco stock to Newco did not qualify under section 351 and was fully taxable due to the absence of any business purpose for the transfer, in that Newco did not engage in the conduct of any trade or business and remained in existence only long enough to implement the donation of Newco to the charity.

In Rev. Rul 70-140, 1970-1 C.B. 73, individual A owned a sole proprietorship as well as X corporation. Unrelated Y corporation was willing to acquire both the sole proprietorship and X corporation in exchange for Y stock. In order for A to obtain tax-free exchange treatment on the disposition of the sole proprietorship as well as on the disposition of his X corporation stock, *and all pursuant to a prearranged agreement with Y*, A (i) transferred the proprietorship assets to X in a purported section 351 transaction, and (ii) transferred the X stock to Y in exchange for Y stock (in a purported reorganization under section 368(a)(1)(B)). Ruling that section 351 did not apply to A's transfer of assets to X due to noncompliance with the control "immediately after" requirement (since all the steps in the overall transaction "were part of a prearranged integrated plan and may not be considered independently of each other for federal income tax purposes"), the Service went on to disregard A's dropdown of assets altogether, ruling instead that A would be treated as if he had sold the proprietorship assets to Y in a taxable exchange for Y stock (the actual exchange of X stock for Y stock otherwise was held to qualify as a B reorganization).

Some courts have supported the Service's position. In *West Coast Marketing Corp. v. Commissioner*, 46 T.C. 32 (1966), the Tax Court applied the business purpose doctrine to disregard a transfer to a transitory corporation. There, the taxpayer had contracted to sell certain property to a corporation ("X") in exchange for preferred stock in X. Instead of effectuating that transaction, however, the taxpayer transferred the property to a new corporation ("Y") in exchange for Y's stock, and then transferred that Y stock to X in exchange for the preferred stock of X. The latter exchange complied with the literal requirements for a B

reorganization. X dissolved Y shortly after the acquisition. The court treated the transaction as a taxable acquisition of the property for preferred stock because Y, the new corporation, was not organized and would not be used for any business purpose.

Weikel v. Commissioner, 51 TCM (CCH) 432 (1986), should be contrasted with *West Coast Marketing*. In *Weikel*, a dentist transferred a patent to a new corporation (Newco) and four months later transferred the stock of Newco to a publicly traded corporation in a B reorganization. The incorporation occurred in contemplation of a later sale or exchange of Newco but prior to a definitive agreement, and it was not contingent on such a sale or exchange. Newco remained in existence for three years before the acquirer liquidated it. Thus, its corporate existence was not transitory. Moreover, the court found that the initial formation of Newco would not have been fruitless if the acquisition had not occurred. Newco was engaged in business both before and after the acquisition. The Tax Court's prior decision in *West Coast Marketing* was distinguished on the grounds that a disposition of the underlying property in the latter case "was imminent and was in fact prearranged," the acquirer of the new corporation having previously made a formal offer.

b. *Other Section 351 Authorities*

In cases in which ownership of stock received in the purported section 351 transaction is not transitory, the courts appear to be quite liberal in finding compliance with the business purpose requirement. In *Caruth v. United States*, 688 F. Supp. 1129, 1138 (N.D. Tex. 1987), *aff'd*, 865 F.2d 644 (5th Cir. 1989), the taxpayer transferred stock in one wholly-owned corporation to another; the first corporation planned to declare and pay a dividend, and the taxpayer wanted the second corporation to receive additional capital. *Id.* at 1140. Noting the close relationship of section 351 to the reorganization provisions, the *Caruth* court states that "the business purpose requirement should be applied to section 351, just as it has been applied to section 368." The *Caruth* court held, however, that the provision of additional funds to the second corporation constituted a valid business purpose. In this regard, the court pointed out that "there was no evidence that the [corporation] was a meaningless, shell corporation which was merely being used for tax avoidance purposes." *Id.* at 1142.[6]

[6] It is somewhat difficult to reconcile *Caruth* with Rev. Rul. 60-331, 1960-2 C.B. 189, in which the individual shareholders of a personal holding company (PHC) sought to avoid imposition of the PHC tax by causing the corporation to distribute a deficiency dividend in a manner that did not result in dividend income to them. To that end, they transferred all of the shares in the PHC to a second corporation wholly-owned by those transferors *before* the PHC distributed the deficiency dividend. Had the transfer been respected, the deficiency dividend received by the second corporation would have been eligible for the dividends received deduction, rather than fully taxable to the individual transferor shareholders. Concluding in reliance upon *Gregory v. Helvering*, 293 U.S. 465 (1935) and *Higgins v. Smith*, 308 U.S. 47 (1940), that no purpose other than tax avoidance existed for the transfer of

The Service does not always find a business purpose lacking, however. In T.A.M.. 8045001 (Oct. 25, 1978), for example, the Service ruled that a valid business purpose existed when the owner of two corporations transferred the stock of those corporations to a new corporation in exchange for common stock, preferred stock, and bonds. The purpose of the transaction was to keep the business in the family, to pass voting control to the children active in the business, and to provide financial security to children not active in the business. In analyzing this transaction, the Service stated that the regulations under the tax-free reorganization provisions are "equally applicable in determining whether a transaction qualifies as a tax-free transaction under section 351."

c. *Business Purpose Requirement in the Section 368 Context*

The business purpose requirement under section 351 can be traced to the business purpose requirement applicable to reorganizations governed by section 368. The regulations under section 368 refer to the business purpose requirement in three instances. First, according to Treas. Reg. § 1.368-1(b), the purpose of the reorganization provisions is "to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interests in property under modified corporate forms." Second, "a scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization." Treas. Reg. § 1.368-1(c). Finally, "the transaction or transactions embraced in a plan of reorganization must not only come within the specific language of section 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization." Treas. Reg. § 1.368-2(g).

It is well-established in the tax-free reorganization context that the taxpayer must prove the existence of a non-tax business purpose. *Laure v. Commissioner*, 653 F.2d 253, 259 (6th Cir. 1981). Further, "[i]t is not enough for the transaction to meet the 'inert language' of the statute"; rather, it must satisfy the purpose of Congress in postponing tax liability. *Wortham*

---

the PHC stock to the second corporation, the Service ignored that transfer for purposes of taxing the deficiency dividend to the individual shareholders (and therefore, technically, did not reach the issue of whether the transfer of PHC stock to the second corporation was governed by section 351). In both *Caruth* and Rev. Rul. 60-331, a corporate level benefit was achieved in a manner that avoided dividend income to the individual shareholders--in Rev. Rul. 60-331, that benefit was avoidance of a PHC tax (in a statutorily permissible manner) by the acquired corporation, whereas in *Caruth* the benefit was a needed capital infusion into the acquiring corporation.

Machinery Co. v. United States, 521 F.2d 160, 163 (10th Cir. 1975). *Wortham* concerned a "C" reorganization in which the Wortham corporation acquired all of the Madera corporation's assets in exchange for some of Wortham's stock. *Id.* at 163. Although the transaction therefore fell within the "inert language" of section 368(a)(1)(C), Madera had no business, and "the only attraction . . . for the acquisition of Madera was the net operating loss carryover which Wortham used in its tax return to reduce its tax liability." *Id.* Thus, the court held that there was no valid business purpose for the transaction. *Id.*

In *Continental Sales & Enterprises, Inc. v. United States*, 63-2 U.S.T.C. (CCH) ¶9506 (N.D. Ill. 1963), the court held that Continental Sales & Enterprises, Inc.'s inclusion in a merger was to be disregarded. Prior to the merger of Continental with two other companies, Continental was "a mere corporate shell" and consisted of virtually "nothing other than a net operating loss accumulation." *Id.* The court stated that the "sole reason for including Continental . . . in the merger was to attempt to utilize the net operating loss accumulation," and thus its inclusion in the merger "was a 'sham' without reality or substance and should be disregarded." *Id.* Similarly, in Priv. Ltr. Rul. 8941004 (Oct. 13, 1989), the taxpayer placed one income-producing building into a loss corporation via a "C" reorganization. The Service stated that absent any other reason, "an objective of maximizing the use of net operating losses through a reorganization would not satisfy the business purpose requirement." *Id.* Based on the facts presented to it, the Service rejected several purported business purposes, including, for example, the placement of the building in the legal entity responsible for its management because the building was managed by an independent management concern. *Id.*

In *Laure*, two brother-sister corporations, W-L (a plastics manufacturing business) and Lakala (an airline charter and maintenance business), merged. *Laure*, 653 F.2d at 254. After the merger, W-L sold off many of Lakala's assets and claimed net operating loss carryover deductions attributable to Lakala; the Service disallowed these deductions on the grounds that the reorganization was not valid. *Id.* at 255-56. Reversing the trial court, the appellate court held that either (1) the assurance of continued charter and repair services or (2) the preservation of goodwill and business reputation was by itself a sufficient business purpose for a valid reorganization. *Id.* at 258-59. Thus, a non-tax business reason that was not quantifiable into a dollar amount of pre-tax cash flow to the survivor of the merger was a valid business purpose for the merger.

While it is well-established in the tax-free reorganization context that the taxpayer must prove the existence of a non-tax business purpose, only *one* satisfactory purpose generally is required. *Id.* at 259. Simply because a transaction is undertaken in part to decrease or avoid taxes does not preclude compliance with the business purpose requirement if the transaction serves a genuine and legitimate corporate business purpose. *See e.g., Munroe v. Commissioner*, 39 B.T.A. 685, 699 (1939) (tax-free reorganization treatment in applicable if the *sole* purpose is

"to effect a transfer of property . . . in such a way as to decrease or avoid taxes"). *See also Riddlesbarger v. Commissioner*, 200 F.2d 165, 171-75 (7th Cir. 1952); *Coca-Cola Co. v. United States*, 47 F. Supp. 109, 117-18 (Ct. Cl. 1942).

d. *The ACM Decision*

In *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the Tax Court analyzed whether the tax treatment afforded a transaction in which notes were purchased and sold in a short period of time under the installment sales provisions of section 453 should be respected for Federal income tax purposes. In *ACM Partnership*, Colgate (through a newly-formed, wholly-owned subsidiary, Southampton) together with Kannex (a newly-formed, wholly-owned foreign subsidiary of a foreign bank) and MLCS (a newly-formed, wholly-owned subsidiary of Merrill Lynch) formed a partnership which purchased certain private placement debt obligations and sold those obligations after 24 days for cash and certain floating rate LIBOR notes. The partnership reported the transaction under the contingent payment sale provisions of section 453, thereby creating a gain which was allocated primarily to Kannex. Thereafter, Kannex's partnership interest was liquidated and, when the LIBOR notes were sold for a loss, the bulk of such loss was allocated to Southampton. The Tax Court disallowed the loss upon its finding that the investment strategy of the partnership had no economic substance. The taxpayer argued that the partnership "was rationally designed to address genuine liability management needs." *Id.*

The Tax Court stated that "[w]hether a transaction has economic substance is a factual determination . . . . Key to this determination is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions." The court further stated that "[a] rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs." The court analyzed each step of the transaction and found that no rational profit motive existed on the part of the partnership. With respect to the need for a profit motive in the economic substance analysis, the court stated that "the strategy must have provided [Southampton] a realistic possibility of recovering [the transaction costs] for the section 453 investment strategy to be deemed profitable." The court found that only in the most extreme of circumstances could the partnership have expected to make a profit. Thus, the court concluded that "the partnership, and ultimately Colgate, would almost certainly lose money."

The Tax Court derived support for its position from a number of leading business purpose doctrine cases. For example, the Tax Court pointed to *Frank Lyon Co. v. United States, 435 U.S. 561 (1978)*, for the dividing line between a transaction with economic substance as compared to one without economic substance. The Tax Court cited *Frank Lyon* for the

proposition "that the Government should honor the allocation of rights and duties effectuated by the parties 'where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached', [*Frank Lyon] at 583-584.*" *ACM Partnership,* 73 T.C.M at 2215. The Supreme Court in *Frank Lyon* had upheld the tax treatment of the purported lessor-owner of a building as the owner for tax purposes, where the lessee was prohibited by banking regulations from owning the building but the panoply of agreements placed virtually all the burdens and benefits of appreciation and depreciation of the building with the lessee. Among the factors considered relevant by the Supreme Court in establishing that the "economic substance" of the transaction was in fact consistent with its form was the adverse impact of carrying mortgage debt on the balance sheet of the owner-lessor. The Supreme Court stated "[The owner-lessor] has disclosed this liability on its balance sheet for all the world to see. Its financial position was affected substantially by the presence of this long-term debt, despite the offsetting presence of the building as an asset." Thus, this controlling Supreme Court authority, upon which the *ACM Partnership* court relied as authority, specifically accepts the financial accounting implications of business transactions as having independent and real significance.

In the instant case, the Company, the Enron Subsidiaries and ECT have sound non-tax business reasons, as detailed above, for entering into the Transaction (*i.e.*, obtaining certain accelerated accounting benefits as well as generating investment profits). You have represented to us that the Transaction is being undertaken for these business reasons, and that the Transaction would *not* be undertaken but for those business reasons. Thus, the transaction is fundamentally unlike the ACM case because the desire of the Company to pursue the transaction is not contingent upon any present value tax savings but rather is predicated on non-tax considerations. Accordingly, based on the foregoing authorities, we believe the Transaction should satisfy the business purpose requirement as applied to section 351.

4. *The Accommodation Transfer Rule*

Under the "accommodation transferor" rule of the section 351 regulations, a transferor that must be included in the "control group" of transferors in order to ensure compliance with the 80 percent control requirement will be disregarded in certain (*but not all*) cases in which the transferor is participating primarily to permit other transferors to obtain tax-free section 351 treatment. If the rule applies, the other transferors are not entitled to tax-free exchange treatment by reason of the accommodating party's transfer. The regulation reads as follows:

> [S]tock or securities issued for property which 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, shall not be treated as having been issued in return for property *if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property.*

Treas. Reg. § 1.351-1(a)(1)(ii) (emphasis added). The accommodation transferor rule literally has no application where, as here, the transferee is a newly formed entity taxed as a corporation and assuming the contributions on October 30 and October 31 are considered together. While the Service on occasion has made references to the accommodation transferor rule, or has applied similar concepts, in the newly formed corporation context, the facts at issue in those cases are clearly distinguishable in key respects from those at issue here. *See* Rev. Rul. 79-194, 1979-1 C.B. 145; Rev. Rul. 68-349, 1968-2 C.B. 143. Even if the contributions on October 31 are treated separately, each of the five shareholders transferred to ECT on October 31 more than a "relatively small value in comparison to the value of the stock and securities already owned." *See* Rev. Proc. 77-37, 1977-2 C.B. 565, where the Service sets forth its advance ruling requirement that a shareholder transfer property with a value equal to at least 10 percent of the value of the stock of the transferee already held to avoid the accommodation transfer rule.

5. *Disproportionate Stock Issuances*

The section 351 regulations provide that if stock received in a section 351 transaction involving two or more transferors is disproportionate to the value of contributed property, appropriate ancillary adjustments will be made, *e.g.*, the transferors may be treated as having received the correct proportionate interests, and to have then engaged in some other transaction between themselves. Treas. Reg. § 1.351-1(b)(1). In the instant case, a constructive transfer between the Enron Subsidiaries and either of the BT Entities would be inappropriate because the parties received equity interests in ECT with a value substantially in proportion to the value of the property that each contributed to ECT.

6. *Control Immediately After the Transfers*

The Service conceivably could take the position, based on general step transaction principles, that the potential future events described above (*i.e.*, the Recapitalization) cause the section 351 control requirement not to be satisfied.

The leading case describing the step transaction doctrine in the context of section 351 is *American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3rd Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). As relevant here, the court reasoned that a series of formally separate steps will be treated as a single transaction if the steps are

"mutually interdependent" and without independent significance, *i.e.*, if "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." 11 T.C. at 405.

In the instant case, you have represented to us that the Enron Subsidiaries' contribution of cash, Leased Assets and preferred stock of Enron Liquids to ECT in exchange for Class A Shares and Class B Shares, and each of the BT Entities' contribution of cash and Residual Interests to ECT in exchange for Class B Shares and Debt Securities, would be undertaken whether or not any of the potential future events occur. Accordingly, we do not believe the Service would prevail if it were to assert that the potential future events precluded compliance with the control requirement.

Further, the transfer of the shares acquired by BTCo to BT Green should not adversely impact the qualification under section 351 of the transfer by any party. With respect to the transfers by partners in ECT other than BTCo, the number of shares held by the partners other than BTCo are sufficient to constitute control within the meaning of section 368(c) without considering the shares received by BTCo. Thus, each of those transfers should satisfy the control requirement of section 351.

With respect to the transfer by BTCo, Treas. Reg. section 1.1502-34 provides as follows

> For purposes of sections 1.1502-1 through 1.1502-80, in determining the stock ownership of a member of the group in another corporation (the "issuing corporation") for purposes of determining the application of section...332(b)(1)...[or] 351(a)...in a consolidated return year, there shall be included stock owned by all other members of the group in the issuing corporation. Thus, assume that members A, B, and C each own 331/3 % of the stock issued by D. In such case, A, B, and C shall each be treated as meeting the 80-percent stock ownership requirement for purposes of section 332, and no member can elect to have section 333 apply.

In Rev. Rul. 89-46, 1989-1 C.B. 272, P was the parent of an affiliated group that filed consolidated returns and the sole shareholder of X and Y. X transferred property to Y in exchange for a security of Y (at a time when a security as well as stock could be received tax free under section 351). The Service observed that the transaction satisfied the then applicable requirements of section 351(a) except that X, which owned no stock of Y was not in *control* of

PRIVILEGED ATTORNEY
CLIENT COMMUNICATION

Y. The ruling addressed the application of Treas. Reg. section 1.1502-34 to the facts and held that "even though X had no actual stock ownership in Y, X is considered, for purposes of section 351(a), the owner of the Y shares held by P." Consequently, section 351(a) applied to the transfer of the property from X to Y.

Thus, for purposes of applying section 351(a) to BTCo, it shall be deemed to hold the stock held by BT Green. As a result, we believe that the transfer by BTCo to ECT should satisfy the control requirement of section 351(a) since such transferor ("BTCo") actually received ECT stock and, after its transfer of such stock to BT Green, constructively continued to hold such stock for purposes of such section.

Finally, we note that the transferors on October 30, the Enron Subsidiaries, retained 80% control after the transactions of October 31. Thus, even if the transfers on October 30 and October 31 are not stepped together, the Enron Subsidiaries retained control after the transactions of October 31.

7. *Investment Company Status*

Under section 351(e)(1) of the Code, non-recognition treatment under section 351(a) does not apply to transfers of property to an investment company. The Code, however, does not specifically define an investment company for this purpose. Rather, the regulations promulgated thereunder provide that a transfer of property will be considered to be made to an investment company if:

> (i) The transfer results, directly or indirectly, in diversification of the transferor's interests [the "diversification requirement"], *and*
>
> (ii) The transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts [the "80 percent test"].

Treas. Reg. § 1.351-1(c)(1) (emphasis added).

For purposes of the 80 percent test, recently enacted amendments to section 351(e) as part of the Taxpayer Relief Act of 1997 (the "1997 Act") have the effect of including in the numerator non-marketable stocks and securities and other enumerated financial assets. These

assets include equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives, any foreign currency, any interest in a real estate investment trust, a common trust fund, a regulated investment company, a publicly-traded partnership (as defined in section 7704(b)) or any other equity interest (other than in a corporation) which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any assets described above.

The legislative history to the 1997 Act states, however, that the amendments to section 351(e) were only intended to change the types of assets to be considered for purposes of the 80 percent test. The amendments were not intended to override any of the other regulatory provisions concerning investment companies, including, for example, the diversification requirement. Further, the amendments were not intended to override the "look through" rule pursuant to which stock of a subsidiary is disregarded and its parent is considered to own its ratable share of the subsidiary's assets. Treas. Reg. § 1.351-1(c)(4). Finally, the amendments were not intended to override the rule that excluded stock and securities from the numerator of the 80 percent test if they are "(i) held primarily for sale to customers in the ordinary course of business or (ii) used in the trade or business of banking, insurance, brokerage or a similar trade or business."

Accordingly, two tests must be satisfied in order for a transfer to be considered to be made to an investment company. First, the transfer must result in diversification to the transferee. Second, the transfer must be to a corporation, 80 percent of the value of whose assets are held for investment and are readily marketable stocks or securities. For purposes of the 80 percent test, the focus is on gross assets rather than net assets. *See generally* H. Rep. No. 1445, 95th Cong., 2nd Sess. 15-16 (1978).

In the instant case, ECT will acquire certain non-financial assets in the Transaction (*i.e.*, the Leased Assets), and these assets represented more than 20 percent (by value) of the assets of ECT after the Transaction. As a result, the 80 percent test should not be satisfied.

Based on the foregoing, we do not believe that ECT should be considered an investment company for purposes of section 351.

8. *Nonqualified Preferred Stock*

The 1997 Act amended section 351 to treat certain preferred stock (*i.e.*, "nonqualified preferred stock") as boot (subject to a few exceptions). Section 351(g). As a result, if a taxpayer transfers appreciated property to a corporation in exchange for nonqualified preferred stock, the taxpayer will recognize gain to the extent of the fair market value of the

nonqualified preferred stock received in the transaction. However, nonqualified preferred stock continues to be treated as stock for purposes of qualifying a transaction under section 351, unless and until regulations under section 351(g) may provide otherwise. *See* H. R. Conf. Rep. No. 148, 105th Cong., 1st Sess (1997).

In general, new section 351(g) of the Code defines "nonqualifed preferred stock" as preferred stock (*i.e.*, stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent) with respect to which (i) the holder has the right to require the issuer or a related person (within the meaning of sections 267(b) or 707(b)) to redeem or purchase the stock, (ii) the issuer or related person is required to redeem or purchase the stock, (iii) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (iv) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices or other similar indices. For this purpose, items (i), (ii) and (iii) above apply only if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

Based on the foregoing, the Class B Shares should not be treated as nonqualified preferred stock because, as noted above, such stock shares in the growth of ECT to a significant extent through the Special Payment Amount, other dividend rights, and its valuation at liquidation or recapitalization.

Further, even if the Class B Shares are considered nonqualified preferred stock, the Class B Shares should nonetheless be considered stock for purposes of qualifying each of the contributions of cash and Residual Interests by the BT Entities to ECT under section 351 of the Code. Thus, the transfer by the BT Entities of property as to which no gain was realized (*i.e.*, the Residual Interests), should be unaffected by the status of the Class B Shares as nonqualified preferred stock. In addition, because the BT Entities did not transfer appreciated property to ECT, they should not recognize any gain in the Transaction by virtue of section 351(g).

In summary, new section 351(g) should not cause any of the contributions to ECT to fail to qualify under section 351 and should not cause gain recognition to any of the transferors in the Transaction.

9. *Bifurcation of the Transaction*

The Service might assert that the Transaction does not qualify for tax-free treatment under section 351 because the receipt of stock and non-stock consideration (*i.e.*, boot) by the BT Entities should be treated as two distinct transactions. Dividing the transaction into

two parts is referred to herein as "bifurcation." Under a bifurcation analysis, the Service might argue that the BT Entities should be treated as (i) having received Class B Shares in exchange for the contribution to ECT of a portion of each asset contributed of equal value in a transaction governed by section 351, and (ii) having transferred the balance of the assets as consideration for the Debt Securities in a transaction that does not qualify for nonrecognition under section 351.

(a) *Section 351*

In any case in which nonstock consideration (including the assumption of liabilities) is received by a transferor in a section 351 transaction, the Service potentially could assert a bifurcation argument. The courts and the Service have analyzed the bifurcation issue both in the context of the issuance of "other property" to the transferors and the assumption of contingent liabilities of the transferors. These authorities support the position that a single transaction cannot be bifurcated but instead must be analyzed entirely under section 351 since section 351 is not an optional section of the Code. Where its terms are met (*i.e.*, property is transferred in exchange for stock or stock and other property), exchange treatment under section 351 applies. A leading treatise describes the mandatory application of section 351 as folows:

> Even if the transaction is cast in the form of a "sale" of property for stock plus cash or other property, its tax consequences are governed by 351(a) and 351(b), so that the transferor will recognize gain (but not loss) to the extent of the boot [i.e., property received other than stock of the transferee]. Again a contrary construction would endow the transferor with an option that was not intended by Congress . . . .

B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 3-75 (6th ed. 1994).

The Fifth Circuit addressed the preeminence of section 351 in a case where the taxpayer argued that section 351 did not apply to a note issued as boot in a transaction otherwise governed by section 351 because the note was of such a speculative nature that its receipt may have given rise to an "open transaction" had section 351 not been found to control. *Clement O. Dennis v. CIR*, 473 F.2d 274 (5th Cir. 1973). There the court stated, in response to the taxpayer's attempts to wriggle free of the grasp of section 351, that:

> Section 351 operates automatically and mandatorily whenever its factual prerequisites are met . . . . Although our Internal Revenue Code is not free of incongruities, it does not foster or sanction a simultaneous right hand taxable sale or exchange with a left hand

> tax-free transaction. A section 351 transaction is not a non-taxable transaction for some purposes and a taxable transaction for others . . . . The note that [the transferor received in the section 351 transaction] was a section 351 security. We are not at liberty to denominate it otherwise.

Id. at 286.

Other courts also have reviewed the application of section 351 to a transaction styled as a distinct sale transaction but that occurred in close proximity to a transaction clearly described in section 351. Those cases address whether factually distinct steps should be integrated and assume, in the event of integration, that the transaction as a whole will be governed by section 351. In some cases integration is found and in other cases it is not.

For example, in *Houck v. Hinds*, 215 F.2d 673 (10th Cir. 1954), the taxpayer was a partner in a partnership which sold its assets to a newly formed corporation. Such corporation was formed on September 26, 1943, by a third party ("X") who became the sole shareholder. X's intent with respect to the corporation was (i) to sell the remaining shares to outsiders, (ii) to purchase the assets of the partnership, and (iii) to then sell either his stock or the assets of the corporation. A bill of sale was executed on October 1, 1943, to purchase the partnership's assets in exchange for notes issued to the partners in proportion to their partnership interests. At such time, X had no intention of selling shares to the partners. However, as of October 17, 1943, X concluded that there was no reasonable prospect of selling the remaining shares or assets of the corporation and, therefore, X sold his stock to the partners. The Tenth Circuit concluded that although the parties intended to have two distinct transactions (a section 351 transaction followed by a sale), the result in substance was a single integrated transaction and the payments made to the partners/shareholders pursuant to the notes were actually dividends.

On the other hand, in *Murphy Logging Co. v. U.S.*, 378 F.2d 222 (9th Cir. 1967), the court determined that two formally distinct transactions should not be integrated in a single transaction qualifying under section 351. In such case, three brothers in a partnership formed a new corporation by contributing $1,500 cash for the stock. The corporation was formed for the purpose of obtaining a new logging contract and purchasing logging equipment from the partnership in exchange for a note. The agreement to sell the equipment was made shortly after the corporation was formed. Several months later, the new corporation borrowed money from a third party to pay off the note. The Ninth Circuit was unwilling to collapse the transaction into an integrated section 351 transaction.

Thus, the case law has explored whether two factually distinct steps should be integrated for purposes of applying the Code and, where integration is considered to be appropriate, has then applied section 351 to the entire transaction.

(b) *Bifurcation as a Matter of Law of a Single Transaction*

Although the generic rubric of bifurcation is used in this discussion, the bifurcation argument the Service would have to make with respect to the Transaction goes beyond that previously examined by the cases. The cases deal with the potential integration of two steps that are distinct in form because the steps are or are not, as a matter of *fact*, a part of a single transaction. The bifurcation argument the Service would need to make in order to attack the Transaction, by contrast, would have to be legally rather than factually based. Specifically, the Service would have to argue that a single transaction must be bifurcated as a matter of law. In none of the cases or rulings we have reviewed has a single, integrated section 351 type transaction been divided into two transactions.[7]

In non-binding authority, the Service has rejected the proposition that integrated steps in a section 351 type transaction should be analyzed separately for tax purposes. G.C.M. 38873 (July 7, 1982), cited favorably in G.C.M. 39413 (September 25, 1985). The relevant passage of G.C.M. 38873, which addresses the incorporation of a partnership ("P"), reads as follows:

> If several transfers are parts of a single integrated plan to effect a unified transaction of the type described in section 351, they will not be analyzed independently. Rather, they will be treated as elements of the unified transaction. The principles that normally would apply to each transfer accordingly will not apply; rather, each will be governed by part III of subchapter C (section 351-85) . . . . For example, a transfer of property to a corporation that would otherwise be treated as a sale will instead be treated as a transfer under section 351, thereby limiting the corporation's basis in the property to that of the transferor . . . . Similarly, a corporation's note that would normally be treated as an evidence of indebtedness received in a loan transaction may be considered "other property" for purposes of section 351.

[7] We note that the factual pattern of a number of cases and rulings in the captive insurance subsidiary area may have presented the Service with the argument that a premium paid to the captive insurance subsidiary contemporaneously with the initial capitalization of that subsidiary must be integrated with the section 351 transaction, so as to preclude an insurance premium deduction to the parent company without recourse to an analysis of whether the arrangement constituted true "insurance." The failure of the Service to make such an argument should not be viewed as support for the proposition that *legal* bifurcation would have overridden any factual integration.

EC2 000033891

> P's incorporation conceivably could be fragmented into two parts -- 1) a transfer of $800x to the corporation to compensate it for assuming the remaining liability under the membership contracts, and (2) a section 351 transfer to the corporation of P's other assets and liabilities in return for stock and securities. If the incorporation could be so fragmented, under the principles of Rev. Rul. 68-112 P would be entitled to a section 162 deduction in the amount of $800x. We believe, however, that under the authorities cited above those two parts must be viewed as elements in a single integrated plan to effect a unified transaction—the incorporation of P's business. The principles that would normally apply to the transfer of $800x (i.e., the principles of Rev. Rul. 68-112) accordingly will not apply; rather, part III of subchapter C will govern. As a result, the $800x cannot be deducted under section 162. Instead, this amount will be treated as property transferred to the corporation under section 351, and under section 358(a) it will be part of the basis in the stock or securities received in return.

(c) *Rev. Rul. 95-74 and Rev. Rul. 94-45*

Consistent with the discussion of the foregoing cases and G.C.M., the two recent revenue rulings issued by the Service involving the assumption of contingent liabilities squarely support the preeminence of section 351 and confirm the inapplicability of a bifurcation argument to the Transaction. First, in Rev. Rul. 95-74, the section 351 transferor benefited from the assumption of certain contingent environmental obligations by the transferee corporation. If bifurcation were appropriate, some portion of the assets transferred by the transferor could be deemed to have been exchanged for the assumption of the contingent environmental liabilities. Instead, bifurcation is not raised as an argument and section 351 governs the entire transaction.

Similarly in Rev. Rul. 94-45, a life insurance company transferred its contingent liabilities pursuant to certain insurance contracts issued to it by a subsidiary. Despite the application of several specialized insurance company regulations that ordinarily would have required both the recognition of taxable income and the allowance of deductions, the Service held that section 351 preempted the specific and otherwise applicable insurance company regulations and that the transaction would not be bifurcated to accommodate such rules.

We believe that each of these rulings supports the opinion we have reached. Each involves the assumption of contingent liabilities. In Rev. Rul 95-74, section 351 was preeminent, precluding any bifurcation as a result of the assumption of contingent liabilities. Rev. Rul. 94-45 goes even farther and holds, in the context of the shifting of insurance risks, that

section 351 both applies to the entire transaction and preempts other sections of the Code that would ordinarily have resulted in gain recognition in the transaction.

The approach to bifurcation taken in these two published rulings recently was reaffirmed by the Service in Tech. Adv. Mem. 9716001 (June 17, 1996). In particular, that TAM reaffirms the exclusivity of section 351 for purposes of determining the tax consequences of integrated transactions that might, from an economic perspective, be separated into component parts.[8]

10. *Conclusion*

We believe the case law and the various Service pronouncements summarized above are supportive of our opinions with regard to the application of section 351. More specifically, we believe the Enron Subsidiaries' contribution of cash, Leased Assets and preferred stock of Enron Liquids to ECT in exchange for the Class A Shares and Class B Shares, and each of the BT Entities' contribution of cash and Residual Interests to ECT in exchange for Class B Shares and other property, should constitute transfers governed by section 351 of the Code. Further, and as a consequence, we believe ECT's basis in the Residual Interests contributed to it by the BT Entities should equal the basis of such assets in the hands of the respective contributors.

B. *Application of Section 269*

Section 269(a)(1) provides that if any person acquires, directly or indirectly, control of a corporation, and the principal purpose for such acquisition was the evasion or avoidance of Federal income tax, then the deduction, credit or other allowance obtained by such acquisition may be disallowed. For purposes of section 269, "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."

---

[8] Tech. Adv. Mem. 9716001 involved a section 351 transaction in which the transferee ("S") assumed the transferor's ("P's") not-yet-deducted but economically accrued vacation pay liabilities. Two facts that caused the examining agent to challenge the deduction of S of the amounts it ultimately paid with respect to the vacation pay liabilities were (i) that P would not have benefited from the deduction because P had operating losses, and (ii) that P effectively made a cash payment to S specifically to compensate S for assuming the vacation pay liabilities. Relying on the principles of Rev. Rul. 95-74, the Tech. Adv. Mem. holds that S was entitled to deduct its payment of the vacation pay liabilities.

The creation of ECT represents an acquisition of "control" of that entity (by the Enron Subsidiaries and the BT Entities) for purposes of section 269(a)(1). *See* Reg. § 1.269-3(b)(2) and (3).

Because the Transaction therefore satisfies the threshold control requirement for the application of section 269(a)(1), an analysis of the "principal purpose" requirement is necessary. A purpose is considered to be the "principal purpose" if it outranks or exceeds in importance any other purpose. *See* S. Rep. No. 627, 78th Cong., 1st Sess. 59 (1943) (legislative history of prior section 129, statutory predecessor of current section 269); Treas. Reg. § 1.269-3(a)(2). *See also Pepi v. Commissioner*, 448 F.2d 141 (2d Cir. 1971); *Scroll Inc. v. Commissioner*, 447 F.2d 612 (5th Cir. 1971); *Commodores Point Terminal Corp. v. Commissioner*, 11 T.C. 411 (1948). Courts generally compare the tax-avoidance purposes of a particular transaction (as a class) with the non-tax-avoidance purposes of the transaction (as a class) and apply section 269 only to the extent that the former class exceeds the latter class. *See e.g. Bobsee Corp. v. United States*, 411 F.2d 231 (5th Cir. 1969). Whether a tax-avoidance purpose outranks the non-tax-avoidance business motivation for a particular transaction requires "scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom." Treas. Reg. § 1.269-3(a)(2).

Accordingly, a determination as to whether the principal purpose for the acquisition by ECT of the Residual Interests was the evasion or avoidance of Federal income tax is an inherently factual undertaking. Based on the facts described above, and in particular, the business purposes for engaging in the Transaction, we do not believe that ECT should be viewed as having made the acquisition of the Residual Interests for the principal purpose of evading or avoiding federal income tax. However, while the principal purpose standard turns on the subjective intent of the parties, a court is likely to consider objective factors in determining intent. In this regard, we note that the greater the present value of the tax benefits obtained by ECT (and the Company's financial accounting group) as a result of the Transaction, the greater the possibility that a court would question the evidentiary value of the factual assertions that there was no principal purpose to avoid tax. Further, a court is likely to view the present value cash flow benefits, if any, of the Transaction as observable economic reality, but may view the benefit of the upfront creation of pre-tax GAAP income as a more intangible economic reality that is not readily quantifiable into real cash dollars. However, as indicated in the discussion of *Laure* and *Frank Lyon* above, a business purpose need not be readily quantifiable into cash flow.

Based on the foregoing, we believe that the business purposes for the Transaction set forth above, including the principal purpose of obtaining certain accelerated accounting benefits apart from any net cash benefits and investment profits, should be sufficient to satisfy the principal purpose test under section 269. Accordingly, we believe that the deductibility of Net Losses by

ECT should not be limited by the principal purpose test under section 269. This result is consistent with our conclusion regarding business purpose above.

C. *The Consolidated Return Regulations*

1. *The Separate Return Limitation Year Rules*

Losses of ECT that are generated from the phantom deductions inherent in the Residual Interests may be subject to certain limitations under the SRLY rules of the consolidated return regulations. Under Treas. Reg. § 1.1502-21T(c) the net operating losses of a member of an affiliated group that arose in a SRLY, as defined in the consolidated return regulations, may effectively be used to offset only the income generated by such member. As relevant here, Treas. Reg. § 1.1502-15T(a) provides that a "built-in loss" is treated as a "hypothetical net operating loss carryover . . . arising in a SRLY." Under Treas. Reg. § 1.1502-15T(b)(1):

> If a corporation has a net unrealized built-in loss under section 382(h)(3) . . . on the day it becomes a member of the group . . . , its deductions and losses are built-in losses under this section to the extent they are treated as recognized built-in loss under section 382(h)(2)(B) . . . .

And under Treas. Reg. § 1.1502-15T(b)(2)(ii):

> In the case of an asset acquisition by a group, the assets and liabilities acquired directly from the same transferor pursuant to the same plan are treated as the assets and liabilities of a corporation that becomes a member of the group . . . on the date of the acquisition.

Treas. Reg. § 1.1502-15T draws from the operating rules and definitions under section 382(h) of the Code, [9] including generally treating the date a member joins a group or the date an asset acquisition occurs as the date of an "ownership change" for purposes of determining the amount of the net unrealized built-in losses and the amount of the recognized built-in losses. Interestingly, under the new Treas. Reg. § 1.1502-15T, the SRLY limitation effectively extends for only five years for built-in losses. A ten year SRLY limitation applied to built-in losses under the predecessor regulation.

[9] Section 382 itself is not implicated given that ECT is a newly created entity.

PRIVILEGED ATTORNEY
CLIENT COMMUNICATION

Sections 382(h)(2)(B) and 382(h)(6)(B) of the Code provide the three occasions where a loss or deduction will be treated as a "recognized built-in loss" -- (i) the "disposition of any asset" held by the loss corporation on the date of the ownership change to the extent of the built-in loss on such asset on such date (section 382(h)(2)(B)), (ii) any "depreciation, amortization, or depletion" that is attributable to such built-in loss on such date (section 382(h)(2)(B) flush language), and (iii) "any amount which is allowable as a deduction during the recognition period but which is attributable to periods before the change date . . ." (section 382(h)(6)(B)).

In the instant case, if ECT were to "dispose" of the Residual Interests, the loss should be considered a built-in loss under the "disposition of any asset" rule described in clause (i) of the preceding paragraph. However, ECT is not expected to dispose of the Residual Interests, but, rather, is expected to take into account significant net losses of the REMIC as a result of and during its ownership of the Residual Interests. Section 860C(a)(1). The net loss (or taxable income) of a REMIC is determined under the accrual method of accounting. Section 860C(b). The principal deduction of the REMIC that will generate the net loss will be the amounts treated as interest deductions on the regular interests in the REMIC, which deductions are determined based on the accrual method (or under the original issue discount rules). Such deductions to ECT do not appear to be built-in losses by virtue of being a "disposition of any asset" or "depreciation, amortization, or depletion." These concepts have specific meaning in the Code that would not appear to include the pass through of annually incurred interest deductions from a flow through entity. Thus, if the net losses that are to be taken into account by ECT as the holder of the Residual Interests are to be considered built-in losses subject to the SRLY rules, the losses will need to result from "deductions during the recognition period...which [are] *attributable* to periods before the change date . . . ." Section 382(h)(6)(B).

There is scant authority as to the meaning of deductions that are *attributable* to a prior period, and none with respect to the application of the concept in a flow through entity or a residual interest.[10] The expected stream of net losses to the holder of a residual interest similar to the Residual Interests (which losses represent a recovery of tax basis in excess of fair market

[10] Neither the legislative history to section 382 nor the preamble to Treas. Reg. § 1.1502-15T provide any helpful guidance on the issues discussed in the accompanying text. The most illustrative private letter ruling of the breadth of the term *attributable* under section 382(h) is Priv. Ltr. Rul. 9328021 (April 16, 1993). In that ruling, the Service found that cancellation of indebtedness income that was realized by a loss corporation after an ownership change under section 382 should be treated as *attributable* to the period prior to the ownership change. The loss corporation had undergone a financial restructuring that resulted in the ownership change that included the grant of rights to creditors to have long term debt retired in advance at a discount. When these rights were executed, cancellation of indebtedness income resulted to the issuer. This ruling shows the Service's broad view of income attributable to a prior period. In the ruling, no asset of the issuer was involved in the circumstances that gave rise to the income that was treated as a built-in gain item under the income corollary to section 382(h)(6)(B).

value) are surely the sort of losses that the policy of the built-in loss rules were intended to limit (under section 382 after an "ownership change") or isolate (under the SRLY rules of the consolidated return regulations). On the other hand, as outlined in the preceding paragraph, the language of section 382(h) is poorly designed to encompass the pass through of annually incurred interest deductions that are being taken into account by a REMIC as they accrue. However, the future phantom net losses of a holder of the residual interest in a typical multiclass REMIC can be distinguished from the accrual of interest deductions over time on a debt instrument. Generally, the phantom losses are a direct function of the preexisting relationship of the tax "liability" represented by the adjusted issue price of the regular interests and the adjusted tax basis of the underlying assets held by the REMIC. With respect to REMICs that have turned to phantom loss generators, the difference in these amounts is ordinarily expected to result in phantom losses to the holder of the residual interest, so long as the residual interest is held by such person, regardless of the prepayment rate of such interests.

Consequently, with respect to the Residual Interests, ECT can expect to receive a determinable amount of phantom deductions that are not attributable to the passage of time. As a result, a strong argument could be made that these phantom deductions, when realized, are more appropriately *attributable* to the time period that created the disparity between the adjusted issue price of the regular interests and the adjusted tax basis of the underlying assets held by the REMICs rather than any subsequent period of time. Under such an argument, the phantom losses would be subject to the SRLY rules in the hands of ECT during the five year recognition period. Further, in the event of a sale of the Residual Interests, ECT would recognize a loss on the disposition of the Residual Interests that would be a built-in loss within the meaning of section 382(h)(2)(B). Accordingly, the pre-contribution build-up of the high basis with respect to the Residual Interests will result either in a "disposition" loss to ECT that is a built-in loss in the event that the Residual Interests are disposed of or a stream of net losses (from interest deductions) that operates to recover the high basis if the Residual Interests are retained. Thus, the loss may have sufficient certainty apart from future results of the operation of the REMIC to make the loss *attributable*, in whatever form it takes, to the period before the contribution to ECT.

On balance, therefore, we believe that a court would more likely than not find that the word *attributable* is broad enough to encompass the anticipated net losses to be allocated to ECT with respect to the Residual Interests. Thus, such net losses will more likely than not be limited to use by the Company's affiliated group under the SRLY rules during the five year recognition period.

2. *Anti-Abuse Rules*

The consolidated return regulations contain several anti-avoidance rules that can impact the treatment of certain transactions under those regulations. These rules should not impact the treatment of the Transaction so long as (i) the Company and ECT have no intent to achieve tax benefits through the use of "intercompany transactions," (ii) the Company and ECT have no intent to benefit members of the Company's affiliated group or its shareholders as a result of the impact of the Transaction on the earnings and profits of members of the Company's affiliated group, and (iii) the Company and ECT have no intent to achieve a tax benefit as a result of any "investment adjustment" arising from the Transaction.

(a) *Intercompany Transaction Anti-Avoidance Rule*

The intercompany transaction anti-avoidance rule must be considered in determining whether the Transaction would be treated as an intercompany transaction. "An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction." Treas. Reg. § 1.1502-13(b)(1)(i). Intercompany transactions include contributions to the capital of another member. Treas. Reg. § 1.1502-13(b)(1)(i)(A).

Treas. Reg. § 1.1502-13(h)(1) states that "if a transaction is engaged in or structured with a *principal purpose* to avoid the *purposes* of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section". Treas. Reg. § 1.1502-13(a)(1) states that "this section provides rules for taking into account items of income, gain, deductions, and loss of members *from intercompany transactions*. The *purpose* of this section is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding or deferring consolidated taxable income (or consolidated tax liability)." (Emphasis added).

Based on the foregoing, the Transaction is an intercompany transaction, but its tax treatment is dictated by section 351 of the Code. In this regard, we note that the Transaction was effected for the principal purpose of obtaining accelerated accounting benefits by reducing a deferred tax liability or recording a deferred tax asset and for the generation of investment profits. Also, you have represented that the Transaction was not undertaken in order to use an intercompany transaction to create, accelerate, avoid or defer consolidated taxable income and the anti-avoidance rule of Treas. Reg. § 1.1502-13(h) in forming our opinion set forth above.

PRIVILEGED ATTORNEY
CLIENT COMMUNICATION

(b) *Earnings and Profits Anti-Avoidance Rule*

A second anti-avoidance rule governing earnings and profits under the consolidated return regulations provides that "if any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or [to] apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section." Treas. Reg. § 1.1502-33(g). The purpose of the section is to treat the earnings and profits of all of the members as being earned by a single entity and thereby consolidate the group's earnings and profits in the common parent of the group. Treas. Reg. § 1.1502-33(a)(1). The Preamble to the regulations, when proposed, defined the function of the earnings and profits anti-avoidance rule as "measuring dividend paying capacity." T.D. 8560, 1994-2 C.B. 200, 201. Generally, the earnings and profits flow up the chain of members, beginning with the lowest tier member, until they ultimately are included in the common parent's earnings and profits.

The Service could implement this anti-avoidance rule only if the members of the Company's affiliated group entered into the Transaction with a *principal purpose* to avoid the effect of the rules of "this section or to apply the rules of" this section to avoid the effect of any other provision of the consolidated return regulations. With respect to the rules of this section, because intra-group dividends are eliminated, any change in the earnings and profits of any member of the Company's affiliated group will not impact the taxable income or tax liability of the group. Further, you have represented that the Transaction was not undertaken in order to make it likely that a distribution made by the Company would be treated as a return of basis under section 301(b)(2) to the shareholders of the Company rather than a taxable dividend.

We have considered your representation to us and the anti-avoidance rule of Treas. Reg. § 1.1502-33(g) in forming our opinion set forth above.

(c) *Investment Adjustment Anti-Avoidance Rule*

A third anti-avoidance rule is a part of Treas. Reg. § 1.1502-32, the investment adjustment regulation. Thereunder, "if any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section." Treas. Reg. § 1.1502-33(e)(1). The purpose of the investment adjustment regulation is to adjust the basis of the upstream entities for the items of income, gain, deduction, and loss taken into account for the period that ECT is a member of the consolidated group. The purpose of the adjustment is to treat the members as a single entity so that consolidated taxable income reflects the group's income, in

particular by not having income of ECT taken into account a second time on the Company's disposition of ECT's stock. Treas. Reg. § 1.1502-32(a)(1).

The regulatory examples of this anti-avoidance each illustrate situations in which transactions were entered into for the principal purpose of an upward distortion in the tax basis of the stock of a member of a consolidated group.

We have considered your representation that the Transaction was not undertaken in order to gain any benefit under the investment adjustment regulations and the anti-avoidance rule of Treas. Reg. § 1.1502-32(e) in forming our opinion set forth above.

D. *Affiliation: Section 1504 Implications*

In order for ECT to be included in the Company's consolidated group (as defined in Reg. § 1.1502-1(h)), the Class A Shares and the Class B Shares held by the Enron Subsidiaries must represent at least 80 percent of the total vote and value of the outstanding stock of ECT. Because the Enron Subsidiaries will hold more than 94 percent of the total vote and value of the outstanding stock of ECT after the Transaction, ECT should be eligible to join the Company's consolidated group.

1. *Beneficial Ownership of Stock*

The affiliation rules of section 1504 are applied by reference to the beneficial owner of stock; mere legal title is not sufficient. *See, e.g., Macon, Dublin & Savannah Railroad Co. v. Commissioner*, 40 B.T.A. 1263, 1272 (1939), *acq.*, 1940-1 C.B. 3 (stock ownership for affiliation purposes "is not merely possession of the naked legal title, but beneficial ownership, which carries with it dominion over the property"); *Miami National Bank v. Commissioner*, 67 T.C. 793, 801 (1977) (section 1504 is concerned with beneficial ownership, and contrary to the contention of the Commissioner, such beneficial ownership did not exist merely in the context of "nominee or escrow arrangements"). In the instant case, the Enron Subsidiaries will hold the Class A Shares and Class B Shares for their own account and will exercise full rights of ownership over such shares. Such holders therefore will be the beneficial as well as the legal owners of such shares

2. *Status as Voting Stock*

The Class A Shares and the Class B Shares also must be respected as possessing at least 80 percent of the total vote of all the outstanding stock of ECT. In general, stock is treated as "voting" stock for purposes of section 1504 if it carries the current right to participate in the corporation's management, which typically is achieved through the right to vote for directors of the corporation. *Erie Lighting Company v. Commissioner*, 93 F.2d 883, 885 (1st Cir. 1937)

(concluding that stock was nonvoting stock if it did not carry "the right to vote for directors who control the management of the corporation"); Rev. Rul. 69-126, 1969-1 C.B. 218 ("participation in the management of the subsidiary through election of the board of directors is the criterion of the voting power in this case"); Rev. Rul. 71-83, 1971-1 C.B. 268 (actual voting power when affiliation is tested is the key; existence of nonvoting stock that is convertible to voting stock is irrelevant to the analysis).

The Service has taken the position that the mechanical right to elect directors is not dispositive if, by reason of special arrangements, those directors do not have normal management authority. In TAM 9452002 (August 26, 1994), the Service ruled that while the 80-percent voting power requirement for affiliation *normally* is determined on the basis of the mechanical right to elect directors, such right is not dispositive "where substantial restrictions are placed on the authority of those directors." In that case, a consolidated group holding a class of subsidiary stock representing 50 percent of the voting power of that subsidiary sought to recapitalize the subsidiary so that it would be includible in the consolidated group. Another class of subsidiary stock held by three entities outside the consolidated group held the remaining voting power. The TAM implies that the restructuring was motivated by the fact that the consolidated group was generating significant losses that could shelter the subsidiary's income in the consolidated return.[11]

In order to include the subsidiary in the consolidated group, the subsidiary was recapitalized so that consolidated group members acquired a class of subsidiary stock (Class C) that carried the right to elect 4 directors, each of whom possessed two votes. The non-consolidated group members continued to hold a separate class of stock (Class B) that carried the right to elect two directors, each of which had a single vote. Consequently, the Class C stock satisfied the 80 percent voting power requirement as determined by the mechanical right to elect directors ((2x4)/[(2x4) + 2] = 80 percent). However, certain "significant corporate decisions" (or "restricted matters") traditionally within the discretion of a majority of the board required the approval of the Class B shareholder and/or the Class B directors.[12] In addition, two of the three Class B

---

[11] The TAM notes that an alternative contention made by the Appeals Office was that the recapitalization "was a sham that should be disregarded for tax purposes." Appeals believed that the sole reason for undertaking the recapitalization was to permit losses of the existing consolidated group to offset gains of the subsidiary, and that "there was no intention [to give the consolidated group] . . . managerial control . . . in light of the restrictions imposed on the Board." In view of its voting power analysis, the Service did not find it necessary to reach the sham theory.

[12] These decisions consisted of (i) any acquisition or disposition of material (five percent of book value) assets, (ii) any appropriation or asset disposition equal to at least 1.8 percent of the value of the corporation's assets, (iii) selection/dismissal of the CEO, (iv) any merger of the corporation, and (v) any loan to an affiliate of the corporation that was not in the ordinary course of business. Items (i) and (iii) were the most significant to the Service's analysis.

shareholders (designated "Corp. XY") had the right to purchase Class C stock at any time after the occurrence of certain specified events that could jeopardize the investment of those shareholders, except that the Class C shareholders had a prior right to convert their shares to a class of stock having the same voting power as the Class B stock (thereby causing a reversion to the 50/50 voting power existing before the recapitalization) (the "call-or-convert" provision, or the "objectionable action provision"). Finally, the Board was required to declare dividends in an amount equal to at least 35 percent of the subsidiary's net income, with those dividends distributed 80 percent to the Class B shareholders and 20 percent to the Class C shareholders (the "mandatory dividend provision"). This feature was described as "a further restriction on the Board and on [the consolidated group's] . . . ability under the Charter to control the management of [the subsidiary]."

With regard to the call-or-convert provision, the taxpayer asserted that "the Service consistently disregards the fact that a subsidiary's stock is subject to a call or to dilution upon the exercise of conversion rights by other persons," and that such result obtained "even where voting power necessarily will change over time."[1] The Service responded as follows:

> We do not suggest that the ability of Corp XY to purchase the [subsidiary] . . . shares owned by [the consolidated group] . . . nullified [the consolidated group's] . . . ownership of the shares under the law and regulations applicable to the years in issue. Nor do we maintain that the call right itself destroyed affiliation. The importance of the call-or-convert provision in this case results from its trigger and price elements and their effect on the . . . Board [of the subsidiary] throughout the years in issue -- even before their exercise. Presumably, the provision's net effect was to require the Board AT ALL TIMES to act in a manner not materially adverse to Corp XY's economic interests.
>
> (Emphasis in original).

Under these circumstances, the Service ruled that the subsidiary was not affiliated with the consolidated group notwithstanding that the stock owned by group members carried 80 percent of the directors' votes as a mechanical matter. This followed because actual management control was not possessed by the Class C stock.

The Class C shareholders subsequently litigated the Service's conclusion in TAM 9452002 in Tax Court. In *Alumax Inc. v. Commissioner*, 109 T.C. No. 8 (September 30, 1997), the Tax Court similarly held that voting power under section 1504 is not to be determined mechanically based on the shareholder's ability to elect directors under circumstances where there are substantial restrictions placed on the authority of those directors. In particular, the Tax Court

EC2 000033902

could not disregard the special voting rights with respect to restricted matters, the mandatory dividend provision, and the objectionable action provision. The Tax Court concluded that the cumulative effect of these provisions reduced the voting power of the Class C stock below 80 percent, and therefore that the subsidiary was not affiliated with the consolidated group.

In the instant case, the Transaction was structured so that the Enron Subsidiaries hold more than 94 percent of the total vote of all of the ECT stock. Further, no formal or informal arrangements will cause the Enron Subsidiaries to have a voice in management that is less meaningful than is normally possessed by a shareholder with the same voting rights. In fact, the Enron Subsidiaries possess more than the typical voting power since the general partner of ECT, a subsidiary of the Company, is imbued with the full control of the business of the Partnership. In addition, the Enron Subsidiaries own at least 80 percent of each of the two classes of stock. These two factors (the general partner status of the Company subsidiary and the formal voting rights possessed by the Company subsidiaries) are consistent with the Enron Subsidiaries having in excess of 80 percent of the vote and value of the equity of ECT.

On the fourth anniversary of the capitalization of ECT, the Partnership Agreement provides that ECT shall cause its assets to be marked-to-market and a Special Payment to perhaps be made. In *Alumax* the Tax Court held that an automatic dividend provision caused some change in the voting power of the shares of that corporation. Because in *Alumax* the voting power of the purported common parent was otherwise at 80 percent the Tax Court did not need to determine the percentage amount of the change in the voting power from 80 percent as any percentage change was sufficient. We believe that a one-time dividend provision should not under existing authority cause the Enron Subsidiaries to be treated as having less than 80 percent of the vote and value of ECT.

Accordingly, we believe that the Enron Subsidiaries should be respected as possessing at least 80 percent of the total vote of ECT.

VI. CONCLUSION

The foregoing opinions of the Firm represent our best legal judgment on the issues discussed and are subject to the limitations discussed herein, including changes in law or the inaccuracy of any factual matter relied on herein.

Very truly yours,

Akin, Gump, Strauss, Hauer & Feld, LLP

Akin, Gump, Strauss, Hauer & Feld, L.L.P.

#74268v2
076409-0002

AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.
ATTORNEYS AT LAW

AUSTIN
BRUSSELS
HOUSTON
LONDON
LOS ANGELES
MOSCOW
NEW YORK
PHILADELPHIA
SAN ANTONIO
WASHINGTON

A REGISTERED LIMITED LIABILITY PARTNERSHIP
INCLUDING PROFESSIONAL CORPORATIONS

1700 PACIFIC AVENUE
SUITE 4100
DALLAS, TEXAS 75201-4675
(214) 969-2800
FAX (214) 969-4343

WRITER'S DIRECT DIAL NUMBER (214) 969 - 2800

December 16, 1997

PRIVILEGED ATTORNEY
CLIENT COMMUNICATION

R. Davis Maxey, Esq.
Enron Corporation
1400 Smith Street, EB-1445
Houston, Texas 77002-7361

Dear Dave:

You have requested our opinion as to whether the accuracy-related penalty under section 6662 of the Internal Revenue Code of 1986, as amended (the "Code"),[1] would be imposed in the event that the Internal Revenue Service (the "Service") disallowed tax deductions for the net losses generated from the REMIC residual interests contributed by Bankers Trust (Delaware) ("BTDel") and Bankers Trust Company ("BTCo") to ECT Investing Partners, L.P. ("ECT") in the transaction (the "Transaction") that is the subject of our separate opinion dated the same date herewith (the "REMIC Opinion"). In addition, you have requested our opinion as to whether the tax shelter registration requirements of section 6111 will apply to the Transaction.

I. FACTS AND REPRESENTATIONS

The facts and representations set forth in the REMIC Opinion are incorporated herein by reference, as is the description, in the second paragraph on page one of the REMIC Opinion, of the scope of our review and of the matters upon which we have relied in preparing our opinion.

Except as explicitly set forth herein and in the REMIC Opinion, we express no opinion as to the tax consequences, whether federal, state, local, or foreign, of the Transaction to any party.

[1] All section references herein are to the Code or the Treasury regulations promulgated thereunder.

II. OPINION

Based upon the facts and representations incorporated herein and the existing law:

(1) We believe that the accuracy-related penalty under section 6662 should not apply in the event that the net losses otherwise generated from the REMIC residual interests contributed by BTDel and BTCo to ECT are disallowed.

(2) We believe that no person principally responsible for, or participating in, the organization and management of ECT should be required to register ECT as a tax-shelter under section 6111.

Our opinion is based on the Code in effect on the date hereof, and applicable Treasury regulations, case law, administrative rulings and pronouncements, and other authoritative sources. In the event of any change in the body of law upon which our opinion is based, our opinion on the matters expressed herein may change. We disclaim any undertaking to advise you of any subsequent changes in applicable law.

Our opinion represents our best legal judgment as to the ultimate outcome if the issues addressed herein were presented to a court of law. Our opinion is not binding on the Service or the courts, however, and there can be no assurance that the Service or the courts would agree with our opinions on the issues discussed herein if those issues were presented to them.

III. ANALYSIS

A. *The Accuracy-Related Penalty*

Under section 6662, if any portion of an underpayment of tax is attributable to, *inter alia*, "negligence or disregard of rules or regulations" (the "negligence component") or a "substantial understatement of income tax" (the "substantial understatement component"), then, subject to certain exceptions discussed below, an accuracy-related penalty equal to 20 percent of such portion of the underpayment is imposed. Section 6662(a) and (b)(1), (2).[2]

1. *The Negligence Component*

With regard to the negligence component of the accuracy-related penalty, the regulations provide that "[a] position with respect to an item is attributable to negligence if it

[2] The accuracy-related penalty also applies to underpayments attributable to substantial valuation misstatements, substantial overstatements of pension liabilities, and substantial estate or gift tax valuation understatements, but none of those are relevant under the instant facts.

lacks a reasonable basis." Reg. § 1.6662-3(b). The "reasonable basis" standard is "significantly higher than the not frivolous standard," Reg. § 1.6662-3(b)(3)(ii),[3] but less stringent than the "substantial authority" standard (discussed *infra*). *See* Reg. § 1.6664-4(d)(2); Prop. Reg. § 1.6662-3(b)(3). The regulations further provide that "'disregard' includes any careless, reckless or intentional disregard of rules or regulations." Reg. § 1.6662-3(b)(2).

2. *The Substantial Understatement Component*

a. *Overview*

With regard to the substantial understatement component of the accuracy-related penalty, an "understatement" is defined as the excess of (i) the amount of tax required to be shown on the taxpayer's return for the taxable year, *over* (ii) the amount of tax actually shown on that return (reduced by certain credits, refunds, or other payments). Section 6662(d)(2); Reg. § 1.6662-4(b)(2). An understatement is "substantial" if it exceeds the greater of 10 percent of the tax required to be shown on the taxpayer's return for the taxable year or $10,000. Section 6662(d)(1); Reg. § 1.6662-4(b)(1).[4] The accuracy-related penalty for a substantial understatement does not apply to any portion of the understatement that is attributable to a tax position for which the taxpayer has "substantial authority," *except that* any portion of the understatement that represents a "tax shelter" item is subject to the penalty. Section 6662(d)(2)(B)(i) & (C)(ii).[5]

b. *Substantial Authority Defined*

Under the regulations, the "substantial authority" standard is less stringent than the "more likely than not" standard (*i.e.*, a greater than 50 percent likelihood of success if litigated) but, as noted *supra*, more stringent than the "reasonable basis" standard. Reg. § 1.6662-4(d). A taxpayer's tax treatment of an item is supported by substantial authority if the weight of authorities supporting such tax treatment "is substantial in relation to the weight of

---

3 Reg. § 1.6694-2(c)(2) provides that a frivolous position "is one that is patently improper."

4 Only the statutory provisions applicable to C corporations (other than personal holding companies) are reviewed herein.

5 Additionally, the understatement may be reduced by the portion thereof that is attributable to any item (other than a tax shelter item) if the facts relevant to the tax treatment of that item are adequately disclosed on the taxpayer's return (or on an attached statement) *and* there was a "reasonable basis" for the tax treatment of the item. Section 6662(d)(2)(B)(ii); Reg. § 1.6662-4(a), -4(e), -4(f). Pursuant to a 1997 Act amendment to section 6662, a corporation does not have a "reasonable basis" for the tax treatment of an item attributable to a "multi-party financing transaction" if the treatment does not clearly reflect the income of the corporation. Section 6662(d)(2)(B)(ii).

EC2 000033907

authorities supporting contrary tax treatment." Reg. § 1.6662-4(d)(3)(i). The weight of an authority depends on its relevance, persuasiveness, and source. Reg. § 1.6662-4(d)(3)(ii). Substantial authority may exist for more than one position on an item. In addition, substantial authority may exist despite the absence of certain types of authority. Accordingly, a taxpayer may have substantial authority for a position that is "supported only by a well-reasoned construction of the applicable statutory provision." *Id.*

The substantial authority exception applies if substantial authority exists either at the time the taxpayer's return is filed or on the last day of the taxpayer's taxable year. Reg. § 1.6662-4(d)(3)(iv)(C).

c. *Tax Shelter Items*

Prior to the enactment of the Taxpayer Relief Act of 1997 (the "1997 Act"), a "tax shelter" was defined as any entity, plan or arrangement "*the principal* purpose" of which was to avoid or evade federal income tax. Section 6662(d)(2)(C)(iii) (prior to amendment).[6] As part of the 1997 Act, and effective for items with respect to transactions entered into after August 5, 1997, Congress amended the definition of a "tax shelter" for purposes of the accuracy-related penalty. A tax shelter is now defined as any entity, plan or arrangement that has "a significant purpose" (rather than *the principal* purpose) of tax avoidance or evasion.

Regulations interpreting the pre-1997 Act definition of a "tax shelter" state that a purpose to obtain a tax benefit "in a manner consistent with the statute and Congressional purpose" is not a tainted tax avoidance or evasion purpose. Reg. § 1.6662-4(g)(2)(ii). Nothing in the recent legislation indicates that this provision was intended to be overridden.

d. *Summary*

To summarize, an underpayment attributable to an item for which the taxpayer has substantial authority is not subject to the substantial understatement component of the accuracy-related penalty unless that item is a tax shelter item. Such an item also would not be subject to the negligence component of the accuracy-related penalty, since a position for which the taxpayer has substantial authority necessarily is a position that satisfies the "reasonable basis" standard.[7]

---

[6] The regulations promulgated under that provision provide that a purpose is the principal purpose if it "exceeds any other purpose." Reg. § 1.6662-4(g)(2)(i). In addition, those regulations provide that an item is a "tax shelter item" if it "is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade Federal income tax." Reg. § 1.6662-4(g)(3).

[7] Under a literal reading of the regulations, the "disregard of rules or regulations" prong of the negligence component could be satisfied if the taxpayer knowingly disregarded, and took a position contrary to, a regulation, even if that contrary position was supported by substantial authority. (A regulatory exception for a contrary position

3. *The Reasonable Cause and Good Faith Exception*

a. *General Rules*

An underpayment that satisfies all the requirements for the imposition of the accuracy-related penalty under section 6662 nonetheless will not be subject to that penalty to the extent that the taxpayer had reasonable cause for the position taken and acted in good faith (the "reasonable cause and good faith exception"). Section 6664(c)(1); Reg. § 1.6664-4(a). Set forth below is a review of the general rules for the operation of this exception. Special rules applicable to tax shelter items are discussed separately thereafter.

The reasonable cause and good faith exception is applied on a case-by-case basis and requires a review of "all pertinent facts and circumstances." Reg. § 1.6664-4(b). The regulations specify that the most important consideration in determining whether the exception applies "is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." Reg. § 1.6664-4(b)(1). In addition, the regulations provide the following guidance:

> Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional (such as an appraiser, attorney or accountant) does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

Reg. § 1.6664-4(b).

Accordingly, the regulations governing the reasonable cause and good faith exception expressly state that reliance on professional advice "constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." *Id.* This rule is illustrated in the regulations by the following example:

---

that "has a realistic possibility of being sustained on its merits" literally applies only to revenue rulings or notices. Reg. § 1.6662-3(b)(2).) However, the overriding "reasonable cause and good faith" exception, described below, should apply in such circumstances.

> *Example 1.* A, an individual calendar year taxpayer, engages B, a tax professional, to give him advice concerning the deductibility of certain state and local taxes. A provides B with the full details concerning the taxes at issue. B advises A that the taxes are fully deductible. A, in preparing his own tax return, claims a deduction for the taxes. Under these facts, A is considered to have demonstrated good faith by seeking the advice of a tax professional, and to have shown reasonable cause for any underpayment attributable to the deduction claimed for the taxes. However, if A had sought advice from someone that he knew, or should have known, lacked knowledge in federal income taxation, A would not be considered to have shown reasonable cause or to have acted in good faith.

Reg. § 1.6664-4(b)(2) *Ex.* 1.

The scope of the reasonable cause and good faith exception, however, is limited by Reg. § 1.6664-4(c), which provides as follows:

> (c) *Reliance on opinion or advice*—(1) *Facts and circumstances; minimum requirements.* All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. However, in no event will a taxpayer be considered to have reasonably relied in good faith on advice unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.
>
> (i) *All facts and circumstances considered.* The advice must be based upon all the pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the

> requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item.
>
> (ii) *No unreasonable assumptions*. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.[8]

b. *Tax Shelter Items*

A corporation generally is considered to have acted with reasonable cause and in good faith with respect to a tax shelter item (as defined *supra*) *if* (i) there is substantial authority for the tax treatment of the item (the "authority requirement") *and* (ii) "the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more

---

[8] In addition to the foregoing regulatory provisions regarding reliance on a tax professional, the courts have long recognized that a taxpayer's bona fide reliance on the advice of a tax professional constitutes "reasonable cause" sufficient to preclude the imposition of tax penalties. The Supreme Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985), although involving the penalty for failure to file a return rather than the substantial understatement penalty, frequently is cited in this regard:

> Courts have frequently held that "reasonable cause" is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney that it was unnecessary to file a return, even when such advice turned out to have been mistaken . . . .
>
> *When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether liability exists, it is reasonable for the taxpayer to rely on that advice.* Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. *To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. . . . "Ordinary business care and prudence" do not demand such actions.*

469 U.S. at 251 (emphasis added). In *Boyle*, the Court concluded that the taxpayer there at issue could not avoid the failure to file penalty by blaming his attorney, since "one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due." *Id.*

likely than not the proper tax treatment" (the "belief requirement"). Reg. § 1.6664-4(e)(2)(A) & (B). Further:

> [A] corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or than an issue will be settled)--
>
> *(1)* The corporation analyzes the pertinent facts and authorities . . . and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or
>
> *(2)* The corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service. . . .

Reg. § 1.6664-4(e)(2)(B). The regulations describe the foregoing rules for tax shelter items as "minimum requirements," and reserve to the Service broad discretion to disallow the reasonable cause and good faith exception in cases of perceived abuse:

> For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter
>
> that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.

Reg. § 1.6664-4(e)(3).

4. *Application of the Accuracy-Related Penalty to Losses Attributable to the Transaction*

Focusing first on the rules applicable to items other than tax shelter items, the accuracy-related penalty should not apply to any underpayment attributable to a disallowance of losses on the REMIC residual interests held by ECT as a result of the Transaction if and to the extent that such disallowance is based on a position contrary to one of the opinions set forth in the REMIC Opinion. This follows because each of those opinions is expressed in terms of the tax result that "should" or that "more likely than not" would obtain. Each of those standards is more stringent than the "substantial authority" standard applicable to the substantial understatement component of the accuracy-related penalty. As seen, moreover, the substantial authority standard is itself more stringent than the "reasonable basis" standard applicable to the negligence component of the penalty. With regard to the "disregard" prong of the negligence component, none of the opinions set forth in the REMIC opinion is premised on the disregard of any rule or regulation.

Even if "substantial authority" were deemed *not* to exist for the positions taken in the REMIC Opinion, the reasonable cause and good faith exception properly should apply by reason of the taxpayers' reliance on an opinion of counsel (the REMIC Opinion) that takes into account all of the relevant facts and that is not premised upon any unreasonable factual or legal assumptions or representations.

Even if the Transaction were characterized as a tax shelter, moreover, the reasonable cause and good faith exception should apply if the losses were disallowed on the basis of a position contrary to one of the express opinions set forth in the REMIC Opinion. This follows because (i) substantial authority exists for each of the opinions set forth in the REMIC Opinion, (ii) the taxpayer-recipients of the REMIC Opinion properly should be considered to have reasonably relied in good faith on the REMIC Opinion, and (iii) the REMIC Opinion unambiguously concludes that the likelihood that the opinions expressed therein will be upheld is greater than 50 percent.

B. *Tax Shelter Registration*

Section 6111(a)(1) of the Code requires a "tax shelter organizer" to register a "tax shelter" with the Service no later than the day on which the first interest in the tax shelter is offered for sale.

For this purpose, a "tax shelter" is defined to include any investment with respect to which an investor could reasonably infer from representations made, or to be made, in connection with the offering for sale of interests in the investment, that the "tax shelter ratio" is greater than 2 to 1 for any investor as of the close of any of the first 5 years ending after the date on which such investment is offered for sale. Section 6111(c)(1)(A). Additionally, the

investment must (i) be required to be registered under a federal or state securities law, (ii) be sold pursuant to a registration exemption that requires the filing of a notice with the appropriate federal or state securities regulators, or (iii) involve a substantial investment (*i.e.*, the aggregate amount offered for sale exceeds $250,000 and 5 or more investors are expected). Section 6111(c)(1)(B); Section 6111(c)(4).

The "tax shelter ratio" for any year is the ratio that (i) the aggregate amount of deductions and 350 percent of the credits which are represented as potentially allowable to any investor for all periods through the close of such year, bears to (ii) the "investment base" for such year. Section 6111(c)(2). The "investment base," in turn, for any year generally is the amount of money and the basis of any property (less any liabilities to which such property is subject) contributed by the investor as of the close of such year. Section 6111(c)(3).

In addition to the foregoing, the Taxpayer Relief Act of 1997 recently expanded the definition of a "tax shelter" to include certain confidential arrangements. Under new section 6111(d) of the Code, a "tax shelter" also includes any entity, plan, arrangement or transaction (i) a significant purpose of which is the avoidance or evasion of federal income tax by a direct or indirect corporate participant, (ii) that is offered to any potential participant under conditions of confidentiality, and (iii) for which the tax shelter promoters may receive aggregate fees in excess of $100,000. Section 6111(d)(1).

In this regard, a transaction is considered to be offered under conditions of confidentiality if a potential participant (or person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to limit disclosure of the transaction or any of its significant tax features. Section 6111(d)(2)(A). In addition, a transaction is considered to be offered under conditions of confidentiality if any promoter "(i) claims, knows or has reason to know, (ii) knows or has reason to know that any other person (other than the potential participant) claims, or (iii) causes another person to claim, that the tax shelter (or any aspect thereof) is proprietary to the promoter or any person other than the potential participant or is otherwise protected from disclosure to or use by others. Section 6111(d)(2)(B).

The Transaction might be analyzed in one of two ways as a "tax shelter" under section 6111. The first, and the better, reading of section 6111 is that the Residual Interests are themselves the object of a tax shelter investment by ECT. In that event, while the 2 to 1 tax shelter ratio test for registration is likely met, the tax shelter does not appear to meet the remaining part of the conjunctive test for registration. Specifically, (i) no securities registration is required for such investment, (ii) no exemption requiring the filing of a notice with securities regulators was employed, and (iii) no "substantial investment" is present because ECT is the sole investor (and five investors are required for a substantial investment).[9] Thus, where the Residual

[9] Reg. § 301.6111-1T Q&A 22 provides that similar investments involving fewer than 5 investors will be "aggregated solely for the purpose of determining whether investments involving fewer than 5 investors...are

Interests are themselves treated as the object of the tax shelter, registration should not be required.

The second mode of analysis that might be applied is that the investments in ECT are themselves the investment in the tax shelter. This mode does not appear appropriate because since ECT is not a flow through entity, the investors in fact receive no deductions from the Residual Interests. Those deductions are all realized by ECT.[10] However, Bankers Trust has prepared a calculation of the tax shelter ratio that includes the very conservative assumption that the deductions of ECT should be compared to the outside investment base of the Enron-affiliate investors in ECT. The computation of the tax shelter ratio is also conservative in that it uses a series of assumptions as to the rate at which deductions would be generated by the Residual Interests that is far in excess of the projected rate of deductions and that was presented to Enron as a sensitivity analysis rather than as a projection. Even at this unanticipated rate of deductions from the Residual Interests, a tax shelter ratio of less than 2 to 1 was determined.[11] The rules in calculating the tax shelter ratio, especially the investment base, are not elaborately established. However, the calculation of the investment base utilized, which included the contribution to ECT of the preferred stock of Enron Liquids Holding Corp. as the only contribution increasing the investment base, is a conservative calculation under the rules. Thus, although we do not believe that this second mode of analysis is the appropriate analysis under section 6111, we believe that the tax shelter ratio calculation under such scenario should sustain a determination that no registration was required.

In addition, the newly added provisions relating to corporate tax shelters should not be applicable. We understand and assume that Enron and its affiliates have not entered into any agreement with nor have any understanding with any person that directly or indirectly restricts Enron's disclosure of the Transaction. Further, we understand and assume that Enron does not believe that the Transaction is proprietary to any person.

---

substantial investments." In Section 3.3(c) of the Contribution Agreement between BTDel, BTCo and ECT, BTDel and BTCo have represented that each of them and their affiliates will not be involved in more than 3 additional similar investments. Thus, even with aggregation of future similar transactions, the Transaction should not be a substantial investment if it is analyzed as though the Residual Interests were the tax shelter.

[10] Even if the Service were to take the position that ECT is a flow through entity by virtue of the consolidated return rules, the deductions from the Residual Interest are subject to the SRLY rules.

[11] The greatest amount of potential deductions under the Residual Interests was used inasmuch as the regulations refer to deductions represented as "potentially allowable." *See* Reg. § 301.6111-1T Q&A 6.

The foregoing opinions of the Firm represent our best legal judgment on the issues discussed and are subject to the limitations discussed herein, including changes in law or the inaccuracy of any factual matter relied on herein.

Very truly yours,

Akin, Gump, Strauss, Hauer & Feld, LLP

#79546v2
76409-0002