REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS

VOLUME III: APPENDICES C & D

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

At the Request of
Senator Max Baucus
and
Senator Charles E. Grassley
of the
SENATE COMMITTEE ON FINANCE

February 2003

JCS-3-03

JOINT COMMITTEE ON TAXATION

108TH CONGRESS, 1ST SESSION

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APPENDIX C

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I. TAX OPINION LETTERS RELATING TO PROJECT TANYA

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Arthur Andersen LLP

Suite 1300
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December 21, 1995

Mr. Robert J. Hermann
Vice President Tax
Enron Corp.
1400 Smith Street, P.O. Box 1188
Houston Texas 77251-1188

Dear Bob:

You have requested that we provide our opinion regarding the federal income tax treatment to Enron Corp. ("Enron") and its Subsidiaries of a proposed transaction involving Enron Management, Inc. ("EMI"). EMI is a subsidiary that oversees the deferred compensation and postretirement benefit management functions of Enron Corp. and its affiliated group and administer all other Enron Corp. sponsored benefit and compensation plans, and certain related transactions. For a further description of the factual circumstances of these transactions see Appendix A, Facts and Assumptions As Provided By Management. Our opinions are limited to the following tax issues.

1. Enron's transfer of notes receivable to EMI, subject to the contractual assumption of Enron's deferred compensation and postretirement benefit obligations in exchange for all of the voting participating preferred stock of EMI should, more likely than not, qualify for nonrecognition of gain or loss under IRC Section 351(a).

2. Enron's tax basis in the voting participating preferred stock of EMI should, more likely than not, equal the tax basis in the notes receivable contributed to EMI, and should not be reduced by the amount of the deferred compensation and postretirement benefit obligations assumed by EMI.

3. Losses on the sale of the voting participating preferred stock of EMI should, more likely than not, not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1).

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

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

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

The opinions expressed herein are based on the facts and assumptions you have provided to us as summarized in Appendix A and you have represented to us that we have been provided all the facts and assumptions necessary for us to form our opinion. Any misstatement of a fact or omission of any fact or any amendment or change in any of the facts referred to may require a modification of all or a part of these opinions. We have no responsibility to update these opinions for events, transactions or circumstances occurring after the date of issuance of these opinions.

The opinions expressed herein are based upon our interpretation of the Internal Revenue Code and income tax regulations as interpreted by court decisions, and rulings and procedures issued by the IRS as of the date of this letter. The opinions expressed herein are not binding on the IRS, and there can be no assurance that the IRS will not take a position contrary to the opinions expressed herein.

We have not considered any nonincome tax, state or local income tax consequences and, therefore, do not express any opinion regarding the treatment that would be given the transactions of Enron and its Subsidiaries by the applicable authorities on any nonincome tax or any state or local tax issues. We also express no opinion on nonfederal income tax issues, such as personal property transactions or securities law matters.

If there is any change in the Internal Revenue Code, the regulations and published rulings issued thereunder, the current administrative rulings, the previous judicial interpretations, or in the current understanding and interpretation of accounting practices, the opinions expressed herein would necessarily have to be reevaluated in light of any such changes.

The opinions expressed herein reflect our assessment on the merits of the probable outcome of litigation and other adversarial proceedings based solely on an analysis of the existing tax authority relating to the issues. It is important, however, to note that litigation and other adversarial proceedings are frequently decided on the basis of such matters as negotiation and pragmatism. Furthermore, in recent years, courts of law have exhibited a willingness to interpret prior authorities, as well as to develop new theories, which will maximize tax revenues. We have not considered the effect of such negotiation, pragmatism and judicial willingness upon the outcome of such potential litigation or other adversarial proceedings.

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

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

Very truly yours,

ARTHUR ANDERSEN LLP

Arthur Andersen LLP

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FACTS AND ASSUMPTIONS AS PROVIDED BY MANAGEMENT

DESCRIPTION OF TRANSACTION

You have represented that Enron has potential deferred compensation obligations of approximately $67.7 million and potential postretirement medical, life insurance and executive death benefit (collectively "postretirement benefit") obligations of approximately $120.8 million as of December 1, 1995. These obligations arose over time as employees performed services for Enron and its various subsidiaries and deferred portions of their salaries and/or earned additional benefits under Enron's postretirement benefit plans.

Enron is the parent of a consolidated group of corporations which includes EGP Fuels Company, Enron Capital & Trade Resources Corp. and Enron Property & Services Corp. In addition, Enron owns an active subsidiary, Enron Service Corp. ("ESC"). ESC was formed in December 1992 to provide real estate, facility management and other administrative services to Enron Corp., and third parties. These functions have recently been transferred to Enron Property & Services Corp. (EPSC), a newly created subsidiary of Enron. As part of this transfer of functions, all of ESC's contracts and equipment leases have been transferred to EPSC. However, ESC will remain liable for the contracts because the transfer was in the form of an assignment rather than a novation. ESC retained all existing assets and liabilities other than liabilities arising under the contracts and leases described above. As of December 1, 1995, ESC had assets consisting of intercompany accounts receivable and Officer/Employee accounts receivable with a current book value of approximately $1.9 million and liabilities for taxes payable of approximately $20,000. ESC does not have a net operating loss carryover, built-in deduction or any other favorable tax attribute. ESC was previously incorporated and capitalized for the purposes described above and not for the purpose of managing deferred compensation and postretirement benefit obligations and administering other compensation and benefit plans.

Enron continually strives to control all costs, including the costs associated with administering and funding its obligations under various compensation and benefit plans. This is particularly true for its obligations under its deferred compensation plans and postretirement benefit plans. These cost containment efforts are consistent with other cost control efforts being implemented in all phases of Enron's business. For example, Enron has recently outsourced its internal audit function and its information system functions. As a variation on this strategy, Enron is considering offering management and employees who oversee the compensation and benefit functions of Enron an incentive to control these costs and to share in the cost savings. Enron hopes to utilize the skills and experience of these employees to review Enron's strategic direction and develop creative and innovative solutions to control costs. Such an arrangement is consistent with new methods of approaching employee compensation which is tied to performance in areas where the employees have direct control, and which is not at the mercy of the overall performance of the company.

To achieve this objective, Enron will use ESC to oversee the deferred compensation and postretirement benefit management function and to administer Enron's other compensation and benefit plans. It is envisioned that this subsidiary will employ current Enron employees in the compensation and benefits group, as well as engage outside advisers. The purpose of using the special purpose subsidiary was to segregate the compensation and benefits function to allow management to better control the costs associated with this function.

Enron enlarged ESC to manage its deferred compensation and postretirement benefit liabilities, administer Enron's other compensation and benefit plans, and better control the costs associated with these obligations. This subsidiary will employ current employees of Enron's compensation and benefits departments. Consistent with Enron's policy, these employees will transfer from Enron effective January 1, 1996. In addition it is contemplated that additional employees may be hired in the future. The subsidiary may institute its own incentive compensation plans.

The expansion of ESC to include the deferred compensation and postretirement benefit management function and administration of Enron's other compensation and benefit plans took the following form. Enron changed the name of ESC to Enron Management, Inc. ("EMI"). Next, Enron transferred a 20 year note receivable from EGP Fuels Company with a tax basis of $120.84 million and a 10 year note receivable from Enron Capital & Trade Resources Corp. with a tax basis of $67.7 million, subject to a contractual assumption of Enron's deferred compensation and postretirement benefit obligations. In addition, EMI has assumed responsibility for administering Enron's other compensation and benefit plans. EMI will charge an administrative fee to Enron for managing these plans. The contribution of these notes coupled with the assumption of the deferred compensation and postretirement benefit liabilities results in EMI having a net worth of approximately $1.94 million. (See Exhibit A, EMI Balance Sheet, attached.)

The note receivable from EGP Fuels Company was formalized from an existing intercompany account receivable. The note has a term of 20 years and accrues interest at a fixed rate of 7.77%. Interest accrues and is payable quarterly and the principal will be due on maturity of the note.

The note receivable from Enron Capital & Trade Resources Corp. was formalized from an existing intercompany account receivable. The note has a term of 10 years and accrues interest at a floating rate of interest (currently 13.35%). Interest of $1.5 million is payable quarterly. The excess accrued interest is added to principal. The note principal (plus unpaid accrued interest) is due at maturity. The floating rate of interest and the payment terms of this note were designed to approximate the expected interest accruals and payments under the deferred compensation plan obligations.

In exchange for the transfer, Enron received all of a newly created class of voting participating preferred stock in EMI which pays an annual 9 percent dividend and represents, in the aggregate, $40,000 of EMI's existing Net Equity of $1.94 million and 3 percent of any increase in EMI's Net Equity up to a maximum redemption value of $340,000. The holders of the voting participating preferred stock have the right to elect one of the six directors of EMI. The voting participating preferred shareholders have no other voting rights. Enron has represented that it did not receive any other property in the transaction. In addition the amended Certificate of Incorporation grants the holders of these shares the right to require EMI to redeem (i.e., "put") its shares anytime after five years from the date of initial issuance based on the formula described above calculated using a Redemption Value balance sheet. The Redemption Value balance sheet follows generally accepted accounting principles except that the liability for postretirement benefits under FAS 106 will be calculated using a discount rate of 7.5% instead of the rate which would normally be required under FAS 106. This modification to the GAAP basis financial statements is designed to remove the interest rate risk from EMI's economics and isolate the elements of the FAS 106 liability which management has the ability to control (i.e. the actual costs of benefits, etc.). The adjustment to the GAAP balance sheet will closely approximate the fair market value of EMI's Net Equity because a change in interest rates will effect the value of both the FAS 106 liability and the $120.8 million note receivable in a similar manner.

Similarly, EMI may call the voting participating preferred shares after six years from the date of initial issuance based on the same formula. However, the redemption value is capped at $340,000 so that the holders of these shares will not realize an "unbargained for" windfall in the value of its shares due to, amongst other things, an unexpected favorable change in healthcare legislation or significant technological breakthroughs.

The $340,000 redemption cap was determined by setting up various cash flow models based on potential favorable and unfavorable resolutions of the deferred compensation and postretirement benefit liabilities. For instance, under the scenario in which all deferred compensation and postretirement benefit obligations experience no significant change from the amounts currently projected based on information currently available the potential fair market value and Redemption Value of EMI remains unchanged. Thus, the holder of these shares would be able to recover their initial investment. In the scenario where actual costs exceed anticipated costs, the voting participating preferred shareholders would lose their initial investment. Under the most favorable foreseeable conditions (i.e. where actual future deferred compensation and postretirement liabilities are less than the amounts projected) the Redemption Value of EMI was computed to be approximately $11.94 million. Since the voting participating preferred shares represent $40,000 of the first $1.94 million of Redemption Value and 3 percent of the excess the voting participating preferred shareholders would be entitled to a $340,000 redemption price under the most favorable scenario.

The value of the notes is $40,000 greater than the current estimated value of the deferred compensation and postretirement benefit obligations contractually assumed by EMI. As a result, the value of the voting participating preferred is $40,000 at the time of the exchange. As stated above, the future redemption value of this stock is contingent on the success of the cost containment efforts in that the voting participating preferred stock will be entitled to 3 percent of the total cost savings generated by EMI as measured principally by the value of the notes receivable, less the liability under the revolving credit facility and the reserves for deferred compensation and postretirement benefits.

The management of EMI can reduce the postretirement benefit reserve by implementing plans which reduce the expected future costs of medical benefits and life insurance for retirees. One of the most significant factors used to determine these expected future costs is Enron's current experiences in paying medical costs for its current employees and retirees. If the current payment experience can be improved through implementing cost effective plans, the postretirement benefit obligation decreases. Additionally, the management of EMI can reduce the postretirement benefit obligation by improving the rate of return on assets held by the VEBA trust. The obligation for deferred compensation can be controlled and reduced to the extent the management of EMI can effectively influence negotiations with retiring employees for a voluntary termination designation in situations where it is appropriate.

Since the postretirement benefit obligation is so greatly affected by the payment experience under Enron's medical plan for current active employees, it is logical for EMI to have responsibility for administering and managing the active medical benefit plan as well as the postretirement benefit plan. Furthermore, the EMI employees who manage Enron's medical benefit plans also manage and administer other compensation and benefit plans. Therefore, in order to minimize administrative costs and avoid duplication of efforts, it is necessary for EMI to assume responsibility for managing all other compensation and benefit plans, including the assumption of Enron's obligations for deferred compensation. Additionally, managing all of these plans are a tremendous burden which Enron wants to shift to the management of EMI.

Enron plans to sell the voting participating preferred stock in EMI to management and certain employees in the compensation and benefits group to provide them with an incentive to control costs and share in the rewards of these cost containment efforts. At the time of Enron's receipt of the voting participating preferred stock in EMI, Enron had not identified these persons and had no firm commitment from any party to participate in this venture. In addition, they were not contractually bound to sell this stock. Furthermore, following the sale of the voting participating preferred stock, EMI will continue to be a part of Enron's affiliated group under the provisions of Section 1504 (All citations to Section or Treasury Regulation Section are in reference to the Internal Revenue Code (IRC) of 1986, as amended (Code), and the regulations thereunder).

Furthermore, by offering management and certain employees stock in a special purpose subsidiary, Enron would effectively increase the after-tax cash compensation payable without increasing its cash cost. Any cost savings achieved by EMI should increase the fair market value of its stock. A sale of this appreciated stock should enable these individuals to obtain capital gains treatment.

It is anticipated that the interest income on the notes receivable, along with an administrative charge to Enron, will provide the funds necessary to cover day-to-day payroll and operating expenses of EMI. Additionally, Enron has agreed to lend EMI up to $75 million through 2015 on a revolving basis at a rate equal to LIBOR. Furthermore, EMI has entered into several intercompany service agreements with Enron to provide and receive various services established at customary intercompany rates. For example, EMI has agreed to provide administrative services to Enron for managing Enron's obligations under certain compensation and benefit plans which have not been expressly assumed by EMI.

ENRON MANAGEMENT INC.
PROFORMA INITIAL BALANCE SHEET
as of December 1, 1995

Exhibit A

Assets	Accounts Receivable	1,886,379
	Notes Receivable	188,555,109
	Total Assets	190,441,488
Liabilities	Income Taxes Payable	21,738
	Accrued Taxes Payable	815
	Enron Corp. 1988 Deferral Plan	61,206,796
	HNG Deferral Income Program	6,508,313
	Other Post Retirement Employee Benefits	120,800,000
Total Liabilities		188,537,662
Equity	Common Stock	1,000
	Preferred Stock	40,000
	Retained Earnings	1,862,826
Total Equity		1,903,826
		190,441,488

Note: This balance sheet is based on prior EMI activity as of October 31, 1995.
This balance sheet will be updated for November 30, 1995 amounts when they are available.

TRANSFERS TO CONTROLLED CORPORATIONS—GENERAL RULES

Enron changed ESC into a special purpose subsidiary to oversee its deferred compensation and postretirement benefit management function by changing the name of ESC which is currently 100 percent owned by Enron, to EMI. Enron transferred to EMI a $120.84 million 20-year intercompany note receivable and a $67.7 million 10 year intercompany note receivable, subject to a contractual assumption of $188.5 million of Enron's deferred compensation and postretirement benefit obligations. In exchange, Enron received 100 percent of a second class of voting participating preferred stock in EMI. Based on the discussion below, this exchange should, more likely than not, qualify for nonrecognition of gain or loss under IRC Section 351.

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

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

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

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

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

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

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

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

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

It is important to note that in this transaction, Enron acquired voting participating preferred stock of EMI entitled to elect one of the six directors of EMI. Based on the rationale in Rev. Rul 69-126, 1969-1 C.B. 218 this class of stock possesses approximately 17% of the voting power of the corporation. More importantly, besides the existing common and new voting participating preferred stock classes, there are no other classes of stock in the corporation. Consequently, throughout the transactions contemplated Enron will possess a range of 83 to 100% of the total combined voting power of all classes of stock entitled to vote. Thus, Enron has continued to meet the control requirement of IRC Section 368(c) throughout the transaction. In the unlikely event the Service attempts to argue that the voting participating preferred stock possesses more than 20% of the combined voting power of all classes of stock of EMI, Enron should nonetheless meet the control requirement since it had not entered into any contracts or other legal commitments to sell or otherwise relinquish its legal ownership in the stock.

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

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

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

> A determination of "ownership," as that term is used in Section 368(c) and or purposes of control under Section 351, depends upon the obligations and freedom of action of the transferee with respect to the stock when he acquired

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

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

In American Bantam Car Co. v. Commissioner, 11 TC 397 (1948), *aff'd per curiam*, 177 F2d 513 (3d Cir. 1949), the owners of a manufacturing company transferred its assets to a new corporation ("Newco") in exchange for all its common stock. The shareholders had a general plan to issue Newco preferred stock to the public soon after the transfer of assets to Newco. Under the plan, the underwriters of the preferred stock were to receive common stock from the shareholders if a target amount of preferred stock was sold to the public. Five days after the contribution of assets to Newco, and receipt of 100 percent of Newco's stock by the shareholders, Newco, the shareholders and the underwriter entered into a binding agreement to sell the preferred stock. The agreement provided that the underwriter would be entitled to a maximum of 33 percent of the Newco common stock if its sales efforts were successful. This contract could be canceled by Newco. Eventually, 29 percent of Newco's common stock was transferred to the underwriter 16 months after the IRC Section 351 transaction. The Tax Court held that the requisite control existed immediately after the exchange, and that the loss of control that occurred 16 months later was not an integral part of the transaction. The language used by the court indicates that the mere existence of a plan to dispose of control is irrelevant. As the court stated:

> The understanding with the underwriters for disposing of the preferred stock, however, important, was not a sine quo non in the general plan, without which no other step would have been taken. While the incorporation and exchange of assets would have been purposeless one without the other, yet both would have been carried out even though the contemplated method of marketing the preferred stock might fail. The very fact that in the contracts of June 8, 1936, the associates retained the right to cancel the marketing order and, consequently, the underwriters' means to own common stock issued to the associates, refutes the proposition that the legal relations resulting from the steps of organizing the corporation and transferring assets to it would have been fruitless without the sale of the preferred stock in the manner contemplated. Id. at 406-407.

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

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

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

On December 7, 1995 the Clinton Administration announced its Seven-Year Balance Budget Proposal which included a provision which would treat certain preferred stock as "boot" in reorganization transactions under Section 368 or Section 351 transactions. Effective for transactions on or after December 7, 1995, the proposal would treat certain preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, including through a conversion privilege) as "boot" in such cases and tax its receipt currently. This new proposal, if enacted, should not apply to Enron's transaction since the EMI voting participating preferred stock was issued on December 1, 1995 prior to the proposed effective date of this provision, December 7, 1995. Additionally, even if this proposal were effective, EMI's voting participating preferred stock should not meet the definition of "preferred stock" in the proposal because its redemption feature provides for significant participation in corporate growth.

<u>Application of IRC Section 351 to the Proposed Transaction</u>

Enron transferred to EMI a $120.84 million 20-year note receivable and a $67.7 million 10 year note receivable subject to EMI's contractual assumption of $188.5 million of deferred compensation and postretirement benefit obligations. In exchange, Enron received 100 percent of the voting participating preferred shares of EMI. Additionally, Enron previously owned and continues to own 100 percent of the common stock of EMI. Thus, Enron controlled 100 percent of EMI immediately before and after the transfer. Furthermore, Enron has exchanged property (the notes receivable) solely for stock of EMI. Therefore, the contribution to EMI should qualify as an IRC Section 351 transaction, if the "control immediately afterward" requirement is met.

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

* * * * * * * * * * *

Based on the discussion above, Enron's contribution to EMI of the intercompany note, subject to the contractual assumption of the deferred compensation and postretirement benefit obligations in exchange for all of the voting participating preferred stock of EMI should, more likely than not, qualify for nonrecognition of gain or loss under IRC Section 351(a).

ENRON'S BASIS IN THE PREFERRED STOCK OF EMI

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

Enron has represented that its basis in the intercompany notes receivable transferred to EMI is $188.54 million. Enron has also represented that it did not receive any other property in the transaction. Thus, under the general rules, Enron's basis in the EMI voting participating preferred stock should be equal to its basis in the intercompany notes receivable of $188.5 million.

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

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

(1) In general–Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

(2) Exception–Paragraph (1) shall not apply to the amount of any liability excluded under Section 357(c)(3).

Thus, in certain situations, the assumption of a liability by the company issuing stock in a transaction in which IRC Section 351 applies may result in a decrease in the tax basis of the stock received in the transaction. This provision should, more likely than not, not apply to the transaction consummated by Enron because the deferred compensation and postretirement benefit obligations do not yet rise to the level to liabilities within the meaning of the Internal Revenue Code. Since the deferred compensation and postretirement benefit obligations are not liabilities under the Internal Revenue Code, they should not result in a basis adjustment in the EMI voting participating preferred stock received in the transaction. Even if, theoretically, the IRS were to assert on audit that the deferred compensation and postretirement benefit obligations rose to the level of liabilities, they should not result in a basis adjustment in the voting participating preferred stock. As described more fully below, the expenditures related to these deferred compensation and postretirement benefit obligations would have been deductible if paid by Enron or when paid by EMI. Consequently, these obligations are excludable for purposes of this basis adjustment rule. Although we are not rendering an opinion on the deductibility of these costs when paid by EMI, a discussion of the relevant law is included in support of this alternative position.

Enron and its subsidiaries have generated an obligation to pay deferred compensation and postretirement benefits in the course of their normal business operations. Although Enron can estimate the potential costs of these obligations, actual future outlays will depend on many factors including future interest rates and future health care costs. EMI has contractually assumed Enron's obligations for deferred compensation and postretirement benefits.

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

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

For plans deferring the receipt of compensation (deferred compensation plans) or welfare benefit funds, the economic performance requirement of Section 461(h) is satisfied to the extent that any amount is otherwise deductible under Section 404 or 419. Treasury Regulation Section 1.461-1(a)(2)(D).

With respect to Enron's deferred compensation plans, Sections 404(a) and (a)(5) provide that amounts paid under a deferred compensation plan shall be deductible under Section 404 in the taxable year in which an amount attributable to the contribution under the deferred compensation plan is includible in the gross income of employees participating in the plan. With respect to unfunded pension plans such as Enron's deferred compensation plans, where payments are made directly to former employees, such payments are includible in their gross income when paid, and accordingly , such amounts are deductible under Section 404(a)(5) when paid. Treasury Regulation Section 1.404(a)-12(b)(2).

With respect to Enron's unfunded postretirement benefit plans, Section 404(b)(2) provides that any plan providing for deferred benefits (other than compensation) for employees, their spouses or their dependents shall be treated as a deferred compensation plan. However, since many deferred benefits are not taxable, for this purpose Section 404(a)(5) is applied by ignoring the otherwise applicable exclusions from income. Treasury Regulation Section 1.404(b)-1T(A-1). Accordingly, amounts payable under this plan are deductible when paid in a manner similar to that described above for deferred compensation plans.

With respect to Enron's postretirement benefit plans funded through a VEBA pursuant to Section 501(c)(9), Section 419 governs the timing of the deduction. Section 419(a)(2) provides that contributions paid or accrued by an employer to a welfare benefit fund shall (subject to certain limitations) be deductible for the taxable year in which paid.

Enron has not made payments related to any of the obligations assumed by EMI. Therefore, "economic performance" should not have occurred with respect to these obligations at the time they were contractually assumed by EMI.

Since the contingent obligations should fail the "all events" and "economic performance" tests of IRC Section 461, these obligations should not be taken into account under IRC Section 358(d) because they have not yet risen to the level of "liabilities" for purposes of the Internal Revenue Code. Thus, the assumption of the deferred compensation and postretirement benefit obligations will not be treated as money received on the exchange and will not reduce Enron's basis in the EMI voting participating preferred stock.

The IRS has seemingly adopted this same reasoning in PLR 9343011 (July 16, 1993). In this ruling, the IRS has held (Holding number 11) that unspecified liabilities (the "Q" and "R" liabilities) assumed by the transferee corporation pursuant to a Section 351 incorporation "will be excluded in determining the amount of liabilities assumed or to which the property transferred is subject for purposes of Sections 357(c) and 358(d) of the Code (Sections 357(c)(3) and 358(d)(2))". Under the facts of PLR 9343011, an accrual basis member in a consolidated group of corporations transferred the assets of a division and stock in other members to a newly incorporated subsidiary in exchange for stock. As part of this transfer the subsidiary assumed the Q and R liabilities. None of the Q and R liabilities assumed by the transferee subsidiary had been previously taken into account for tax purposes by the transferor corporation. Furthermore, since Holding number 12 provides that the Q and R liabilities will be deductible by the transferee under Sections 162, 404(a)(5), 404(b) and 461(h), these liabilities presumably included deferred compensation obligations and deferred benefit obligations.

The Service has since formalized its position on this issue in Rev. Rul. 95-74, 1995-46 I.R.B.1 (October 27, 1995). In this ruling, the Service held that contingent environmental liabilities that have not been deducted or capitalized by the transferor and are assumed by the transferee corporation in a Section 351 incorporation are not liabilities for purposes of Sections 357(c) and 358(d). The Service also ruled that the liabilities assumed by the new subsidiary in the Section 351 exchange are deductible by it as business expenses under Section 162 or are capital expenditures under Section 263, as appropriate, under its method of accounting. Under the facts of the ruling, P, an accrual basis corporation, transferred the assets of a division to a newly incorporated subsidiary, S, in exchange for all of the stock of S and for S's assumption of the liabilities associated with the division, including environmental liabilities. P did not undertake any environmental remediation efforts before the transfer and did not deduct or capitalize any amount with respect to the contingent environmental liabilities. P had no plan or intention to dispose of (or have S issue) any S stock at the time of the transfer. In later years S undertook remediation efforts relating to property transferred in the Section 351 exchange.

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

The holdings of Rev. Rul 95-74 are subject Section 482 and other applicable sections of the Code and principles of law, including the limitations discussed in Rev. Rul 80-198, 1980-2 C.B. 113 (limiting the scope of the revenue ruling to transactions that do not have a tax avoidance purpose) and limitations on "stripping transactions" described in Notice 95-53, 1995-44 I.R.B. 1. These limitations on the applicability of Rev. Rul 95-74 should not apply to Enron for the following reasons: Enron entered into these transactions for valid business reasons and not for tax avoidance purposes and all transactions occurred at an arm's length fair market value.

Recently, the Service issued a Revenue Ruling in which it held that a short sale obligation transferred in a Section 351 transaction does give rise to a basis reduction in the underlying shares. In Revenue Ruling 95-45, I.R.B. 1995-26, (June 6, 1995) Corporation P entered into a short sale of XYZ securities. P's broker took XYZ securities on hand and sold them on P's behalf for $1000x. P left the cash proceeds with the broker and was thereafter obligated to deliver identical XYZ securities in the future to close out the short sale. Prior to the delivery of these securities P contributed its interest in the cash proceeds from the short sale to the capital of S corporation in a valid Section 351 transaction. S assumed the obligation of P to deliver the XYZ securities.

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

This ruling is distinguishable from the transaction at hand and should, more likely than not, not effect the basis that Enron had in the EMI voting participating preferred stock. First, the basis of the short sale asset was completely dependent on the short sale obligation. The tax basis created in the short sale asset was entirely a function of the creation of the concurrent liability to deliver the underlying securities. Here, the deferred compensation and postretirement benefit obligations do not give rise to any basis and are completely unrelated to the note receivable contributed to EMI. Enron has tax basis in the note receivable regardless of the existence of any deferred compensation and postretirement benefit liability.

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

As discussed above, since the contingent obligations should fail the "all events" and "economic performance" tests, these obligations should not reduce Enron's basis in the EMI voting participating preferred stock. However, even if in the unlikely event the IRS were to successfully assert on audit that the deferred compensation and postretirement benefit obligations rose to the level of "liabilities" under IRC Section 461, the obligations are the type specifically excluded from IRC Section 358(d). Thus, even if these obligations theoretically rose to the level of "liabilities," they should not result in a basis reduction in the voting participating preferred stock received in the exchange.

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

(3) Certain Liabilities Excluded –

(A) In General–If a taxpayer transfers, in an exchange to which Section 351 applies, a liability the payment of which either–

(i) would give rise to a deduction, or

(ii) would be described in Section 736(a),

then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject

(B) Exception–Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

Thus, even if Enron's deferred compensation and postretirement benefit obligations theoretically rise to the level of "liabilities" under IRC Section 461 for all tax purposes, these obligations should not cause a basis adjustment in the voting participating preferred stock if they would have been deductible when paid by Enron or will be deductible when paid by EMI. Additionally, Rev. Rul. 95-74 has expanded the Section 357(c)(3) exception to include not only liabilities that give rise to deductible items, but also to liabilities that give rise to capital expenditures as well.

Therefore, even if the IRS were to successfully assert that certain payments under Enron's deferred compensation plans or postretirement plans gave rise to a capital expenditure under Section 263 through an application of INDOPCO Corporation v. Comm., 112 S. Ct. 1039 (1992), the exception under Section 357(c)(3) remains applicable.

To summarize, these deferred compensation and postretirement benefit obligations fail the "all events" and "economic performance" tests of IRC Section 461. Therefore, they should not constitute "liabilities" and should not decrease Enron's basis in the voting participating preferred stock received in the transaction. Alternatively, in the unlikely event the deferred compensation and postretirement benefit obligations assumed by Subsidiary constituted "liabilities," they should not be liabilities that decrease Enron's basis in its EMI voting participating preferred stock since these obligations should be deductible (or capitalizable) when paid and, thus, are specifically excluded under IRC Section 358(d)(2) and IRC Section 357(c)(3)(A)(i) as interpreted by Rev. Rul. 95-74.

* * * * * * * * * * *

Based on the arguments discussed above, Enron's tax basis in the voting participating preferred stock of stock of EMI should, more likely than not, equal Enron's basis in the intercompany notes contributed to EMI not reduced by the amount of deferred compensation and postretirement benefit obligations assumed by EMI.

DUPLICATED LOSS

Enron transferred the intercompany notes subject to EMI's contractual assumption of Enron's deferred compensation and postretirement benefit obligations in exchange for EMI voting participating preferred stock. The value of the intercompany notes is approximately $188.54 million and the amount of Enron's deferred compensation and postretirement benefit obligations is $188.5 million. Therefore, Enron's participating preferred stock should have nominal fair market value of $40,000. Enron may later sell the voting participating preferred stock to management and certain employees associated with the benefits function to provide them with an incentive to control costs and to allow them to share in the rewards of these cost containment efforts. Since the fair market value of Enron's voting participating preferred stock is only $40,000 while Enron's basis in the voting participating preferred stock should be equal to its basis in the intercompany note of $188.54 million (see Appendix C for a detailed discussion), Enron should recognize a loss on the sale of the voting participating preferred stock. A loss on the sale of the voting participating preferred stock of EMI should, more likely than not, not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1)(iii).

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

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

(vi) Duplicated loss. "Duplicated loss" is determined immediately after a disposition or deconsolidation, and equals the excess (if any) of

(A) The sum of–

(1) The aggregate adjusted basis of the assets of the subsidiary other than any stock and securities that the subsidiary owns in another subsidiary, and

(2) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and

(3) Any deferred deductions (such as deductions deferred under Section 469) of the subsidiary, over

(B) The sum of–

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

(2) Any liabilities of the subsidiary, and

(3) Any other relevant items.

At the time of the disposition of the voting participating preferred stock, the only assets that EMI has are the intercompany account receivable and the Employee/Officer accounts receivable and the intercompany notes. The intercompany notes should be excluded from this computation since, by its terms, they should qualify as securities in another subsidiary.

The term "security" is not defined anywhere in the Treasury Regulation Section 1.1502-20 regulations and, in fact, is not defined anywhere else in the Internal Revenue Code or regulations. Rather, the definition of security has been developed by judicial decisions. The leading case on whether a debt obligation constitutes a security is Camp Wolters Enterprises Corporation v. Commissioner, 22 TC 737 (1954), *aff'd* 230 F2d 555 (5th Cir.), *cert. denied* 352 U.S. 826 (1956). In Camp Wolters, the court stated:

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

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

The intercompany notes should be securities because they give the holder of the note a significant degree of participation and continuing interest in the business as required by Camp Wolters. The notes have 10 year and 20 year terms with none of the principal payable until maturity. Clearly, the holder of the notes has a significant continuing interest in the issuers such that the notes should qualify as securities.

As discussed above, the intercompany notes should qualify as securities. Based on the facts and assumptions the only other assets held by EMI with any adjusted tax bases should be the intercompany accounts receivable and Officer/Employee accounts receivable possessing a tax basis of approximately $1.9 million. Thus, since both the issuers and EMI are subsidiaries of Enron and members of Enron's consolidated group, under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(1), the aggregate adjusted basis of the assets of EMI, other than the stock and securities that EMI owns in other subsidiaries (i.e., the intercompany notes), should be approximately $1.9 million.

Immediately after the disposition of the voting participating preferred stock of EMI by Enron, EMI should have no losses attributable to it that will be carried over to its next taxable year under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(2). Although EMI had been a going concern for many years it did not have any losses attributable to it that can be carried over to its next taxable year after the disposition of the voting participating preferred stock. However, if significant deferred compensation and postretirement benefit payment activities occur before the sale of any of the voting participating preferred stock, EMI must be reevaluated to determine if there is any loss to be carried over to its next taxable year. Currently, since EMI has interest income from the intercompany notes and, since it is anticipated that substantial deferred compensation and postretirement benefit costs will not be incurred for some time, EMI has no losses attributable to it that will be carried over to its taxable year under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(2).

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

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

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

Thus, the sum of the amounts under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(1), (2) and (3) should be $1.9 million.

Immediately after the disposition of the voting participating preferred stock of EMI by Enron, the value of that stock under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(1) should be approximately $40,000, the value of the intercompany notes contributed to EMI in exchange for the voting participating preferred stock of $188.54 million reduced by the amount of Enron's deferred compensation and postretirement benefit obligations assumed by EMI of $188.5 million. The value of the common stock retained by Enron should be $1.9 million, the net equity of EMI reduced by the amount of net equity attributable to the voting participating preferred stock.

Immediately after the disposition of the voting participating preferred stock of EMI by Enron, EMI has a liability for taxes payable of approximately $20,000. under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(2). Enron's deferred compensation and postretirement benefit obligations should not rise to the level of liabilities for federal income tax purposes. See Appendix C for a more detailed discussion of this issue.

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

Thus the sum of the amounts under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(1), (2) and (3) should be $1.94 million.

Since the amount of a duplicated loss is the excess (if any) of the sum of the items under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A) over the sum of the items listed under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B), the amount of duplicated loss on the disposition of the voting participating preferred stock of EMI should be zero ($1.9 million is less than $1.94 million).

Treasury Regulation Section 1.1502-20(e) provides that the loss disallowance rules must be applied in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of these rules, adjustments must be made as necessary to carry out their purposes. Similarly, the new deferred intercompany transaction rules (whose application to this transaction are unclear) are generally effective for Enron's taxable year beginning January 1, 1996, and thus inapplicable to these transactions occuring during 1995. Treasury Regulation Section 1.1502-13(l)(1). However, Treasury Regulation Section 1.1502-13(l)(2) provides an accelerated effective date for avoidance transactions engaged in after April 8, 1994 with a principal purpose to avoid the general effective date of the new deferred intercompany transaction rules. Since Enron has an overriding business purpose for entering into these transactions, these anti-avoidance rules should not apply.

* * * * * * * * * * *

Based on the arguments discussed above, a loss on the sale of the voting participating preferred stock of EMI by Enron should, more likely than not, not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1)(iii).

ACQUISITION MADE TO EVADE OR AVOID INCOME TAX

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

Enron will transfer a \$120.84 million, 20-year intercompany note receivable and a \$67.7 million, 10-year note receivable , subject to a contractual assumption of \$188.5 million of Enron's deferred compensation and postretirement benefit obligations. In exchange, Enron will receive 100 percent of the voting participating preferred stock in EMI.

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

IRC Section 269(a) states:

(a) In general--If--

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transfer corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all class of stock of the corporation.

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

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

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

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

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

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

Enron acquired control of EMI when it subscribed to all of the common stock of its predecessor, Enron Services Corp. It acquired Enron Services Corp./EMI for nontax purposes. Enron controlled Enron Services Corp./EMI at its formation and that control has continued unbroken at all times since. Most importantly, Enron Services Corp./EMI has continued to be an ongoing operating business since its inception in 1992. Therefore, it is clear that, under the rationale of The Challenger Corporation case that when Enron exchanged the intercompany notes, subject to the deferred compensation and postretirement benefit obligations, for all the voting participating preferred stock of EMI, it was not acquiring control of EMI under IRC Section 269(a)(1).

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

IRC Section 269 provides for the disallowance of deductions and other tax benefits when tax avoidance is the principal purpose for acquisition of control of a corporation or for certain transfers from one corporation to another. A corporation's principal purpose in acquiring another corporation's stock or assets is tax avoidance if it "exceeds the importance of any other purpose." Treasury Regulation Section 1.269-3(a).

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

- to consolidate all of Enron's compensation and benefit management activities in one subsidiary,

- to better control the administrative costs and actual healthcare and insurance costs associated with the deferred compensation and postretirement benefit obligations, and

- to offer management and certain employees associated with the deferred compensation and postretirement benefit management function an incentive to control these costs and to share in the cost savings.

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

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

* * * * * * * * * * *

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

II. TAX OPINION LETTERS RELATING TO PROJECT VALOR

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December 27, 1996

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Dear Deborah and Jordan:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Very truly yours,

ARTHUR ANDERSEN LLP

Arthur Andersen LLP

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APPENDIX A

FACTS AND ASSUMPTIONS AS PROVIDED BY MANAGEMENT

DESCRIPTION OF TRANSACTION

Background

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

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

Credit Reserve Management

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

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

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

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

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

   - assigning an internal counterparty risk grade (the "E" rating) that is synthetically calculated through a sophisticated proprietary credit model;

   - setting appropriate credit limits; and

   - negotiating additional third-party credit enhancement in order to mitigate potential losses.

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

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

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

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

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

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

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

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

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

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

<u>Fixed Price and Risk Management Contract Liabilities</u>

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

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

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

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

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

<u>Objective</u>

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

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

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

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

Structure of Transaction

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

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

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

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

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

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

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

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

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

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

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

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

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

Exhibit A

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

TRANSFERS TO CONTROLLED CORPORATIONS – GENERAL RULES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> The understanding with the underwriters for disposing of the preferred stock, however important, was not a sine quo non in the general plan, without which no other step would have been taken. While the incorporation and exchange of assets would have been purposeless one without the other, yet both would have been carried out even though the contemplated method of marketing the preferred stock might fail. The very fact that in the contracts of June 8, 1936, the associates retained the right to cancel the marketing order and, consequently, the underwriters' means to own common stock issued to the associates, refutes the proposition that the legal relations resulting from the steps of organizing the corporation and transferring assets to it would have been fruitless without the sale of the preferred stock in the manner contemplated. Id. at 406-407.

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

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

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

Application of IRC Section 351 to the Transaction

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

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

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

ECT'S BASIS IN THE PREFERRED STOCK OF ECTS

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

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

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

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

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

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

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

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

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

Credit Reserves

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

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

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

Fixed Price and Risk Management Contracts

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

* * * * * * * * * * *

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

CONSOLIDATED RETURN REGULATIONS

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

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

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

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

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(B) The sum of–

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

(2) Any liabilities of the subsidiary, and

(3) Any other relevant items.

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

Subsection (vi)(A)(1)

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

1. Another subsidiary; and
2. Security.

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

The second part of subsection (vi)(A)(1) requires ECTS to own a "security" in some consolidated group member (besides the common parent). The term "security" is not defined anywhere in Treasury Regulation Section 1.1502-20 and, in fact, is not defined anywhere else in the Internal Revenue Code or regulations. Rather, the definition of security has been developed by judicial decisions. The leading case on whether a debt obligation constitutes a security is Camp Wolters Enterprises Corporation v. Commissioner, 22 TC 737 (1954), *aff'd*, 230 F2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956). In Camp Wolters, the court stated:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Judicial Interpretation of the Consolidated Return Regulations

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

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

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

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

In holding for the taxpayer, the Tax Court found that the rules concerning the calculation of earnings and profits contained in IRC Section 312 did apply to the consolidated regulations in situations where those regulations expressly provide for adjustments based on an entity's earnings and profits. Moreover, the court reaffirmed its holding in Woods Investment Co. v. Comm'r, and stated that the Treasury must be held accountable for the construction it chooses for the consolidated regulations. The court reiterated that the Treasury was free to amend the consolidated regulations if it felt their application was inconsistent with other provisions in the code and regulations. (See also Transco Exploration Co. v. Comm'r, 95 T.C. 373 (1990); Walt Disnev Inc. v. Comm'r, 97 T.C. 221 (1991) ("When the authority to prescribe legislative regulations exists, this Court is not inclined to interfere if the regulations as written support the taxpayer's position.")). Finally, the court distinguished its holding from its prior decision in Wyman-Gordon Co. v. Comm'r, infra, a case factually similar to CSI, since the taxpayer there sought to base its position on a Code section enacted subsequent to the taxable years at issue.

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

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

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

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

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

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

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

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

Intercompany Transaction Regulations of Treasury Regulation Section 1.1502-13

Background and Basic Operating Rules

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

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

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

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

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

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

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

The Anti-Avoidance Rule

In General

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

The SRLY Example

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

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

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

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

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

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

The Transitory Intercompany Transaction Example

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

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

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

Corporate Mixing Bowl Example

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

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

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

Partnership Mixing Bowl Example

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

M1 owns a self-created intangible asset with a $0 basis and a fair market value of $100. M2 owns land with a basis of $100 and a fair market value of $100. In Year 1, with a principal purpose of creating basis in the intangible asset (which would be eligible for amortization under IRC Section 197), M1 and M2 form partnership PRS; M1 contributes the intangible asset and M2 contributes the land. X, an unrelated person, contributes cash to PRS in exchange for a substantial interest in the partnership. PRS uses the contributed assets in legitimate business activities. Five years and six months later, PRS liquidates, distributing the land to M1, the intangible to M2, and cash to X. The group reports no gain under IRC Sections 707(a)(2)(B) and 737(a) and claims that M2's basis in the intangible asset is $100 under IRC Section 732 and that the asset is eligible for amortization under IRC Section 197. The example concludes that a principal purpose of the formation and liquidation of PRS was to create additional amortization without an offsetting increase in consolidated taxable income by avoiding treatment as an intercompany transaction and, therefore, "appropriate adjustments must be made."

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

<u>Sale and Leaseback Example</u>

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

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

Application of Anti-Avoidance Rule to ECTS Transaction

Principles to be Derived From the Examples

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

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

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

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

Additional Reasons Support the Taxpayer's Conclusions

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

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

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

It is important to note several additional arguments that support the conclusion that the anti-avoidance rule does not apply to the ECTS transaction. First, as described above, the ECTS transaction is motivated by numerous substantial business purposes. ECTS is capitalized with notes used to fund the credit reserve and FPRM contract management activity assumed by it. The consideration issued is stock in ECTS in order to provide the holders with highly negotiated equity and voting terms so that the holders are true owners and participants in the activity as opposed to passive investors or mere employees. As a result, we would argue that a reduction or deferral of consolidated tax liability is not a principal purpose of the ECTS transaction. At this time, however, there is no guidance on the meaning of "a principal purpose." Therefore, it is unclear whether this argument would be successful.

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

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

A recent court decision is worthy of note. In RLC Industries v. Commissioner, 95-2 USTC ¶50,328 (9th Cir., 1995), the court declared invalid section 1.611-3(d)(5) of the regulations. This provision was promulgated pursuant to legislative regulatory power to provide rules for determining a reasonable allowance for the depletion of timber. In exercising this authority, the Service issued regulations that defined the units or blocks that were to be used to calculate depletion deductions. In addition, the Service provided in its regulations that: "For good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts." The court declared this regulation invalid because such regulation was inconsistent with the rulemaking authority granted the Service in IRC Section 611 in that the regulation attempted to vest in the Service the overriding power to decide the reasonableness of a particular taxpayer's timber depletion allowance and "eviscerate[d] the fundamental distinction that is deeply embedded in administrative law between quasi-legislative and quasi-judicial power." Because the court found the regulation to be an attempt to vest quasi-judicial power in the Service and the regulatory authority to vest only quasi-legislative power in the Service, the court found the regulation to go beyond the Service's authority as it was granted in IRC Section 611.

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

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

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

* * * * * * * * * * *

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

Summary

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

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ACQUISITION MADE TO EVADE OR AVOID INCOME TAX

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

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

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

IRC Section 269(a) states:

(a) In general – If–

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transfer corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

ECTS was "acquired" as that term is used in IRC Section 269(a)(1) when ECT subscribed to all of the common stock of its predecessor, EGGI. The principal purpose of acquiring EGGI/ECTS at that time was not tax avoidance. For IRC Section 269(a)(1) to apply, the principal purpose of the acquisition must be the evasion or avoidance of federal income tax by securing the benefit of a deduction, credit or allowance which the acquiring corporation would not otherwise enjoy. ECT's principal purpose in acquiring ECTS is determined at the time ECTS was formed and ECT received all of its common stock, not when ECT received the voting preferred stock. The voting preferred stock will represent less than 20 percent of the vote and value of ECTS. Therefore, ECT will not acquire control of ECTS within the meaning of IRC Section 269(a)(1) when it obtains the voting preferred stock, since ECT controlled ECTS from its inception and continued to control ECTS at all times thereafter.

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

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

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

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

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

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

IRC Section 269 provides for the disallowance of deductions and other tax benefits when tax avoidance is the principal purpose for acquisition of control of a corporation or for certain transfers from one corporation to another. A corporation's principal purpose in acquiring another corporation's stock or assets is tax avoidance if it "exceeds the importance of any other purpose." Treasury Regulation Section 1.269-3(a).

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

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

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

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

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

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

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

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III. TAX OPINION LETTERS RELATING TO PROJECT STEELE

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

AUSTIN
BRUSSELS
HOUSTON
LONDON
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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.

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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.

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[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*

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(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.

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

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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

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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.

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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]

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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*

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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.

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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

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.

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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.

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."

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[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.

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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.

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

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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

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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.

(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

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[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 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.

PRIVILEGED ATTORNEY
CLIENT COMMUNICATION

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.

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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.

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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

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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).

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]

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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:

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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.

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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

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IV. TAX OPINION LETTERS RELATING TO PROJECT COCHISE

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

March 21, 2001

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

Dear Dave:

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

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

I. <u>DOCUMENTS EXAMINED</u>

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

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

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

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

EC2 000033988

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Any capitalized terms not defined herein have the same meaning as in the appropriate documents from the list above. For purposes of this letter, the terms "phantom income" and "phantom deductions" refer, respectively, to items of taxable income or deduction with respect to a REMIC residual interest that are not matched by economic benefits or burdens associated with the ownership of such interest. Similarly, the terms "economic income" and "economic deductions" refer, respectively, to items of income or deduction with respect to a REMIC residual interest that are matched by economic benefits or detriments associated with the ownership of such interest.

II. STATEMENT OF FACTS

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

A. The Bankers Trust and the Enron Affiliated Groups

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

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

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

C. The Leased Equipment

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

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

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

D. Maliseet

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

E. The January 28, 1999, Transactions

1. The Maliseet Transactions

a. The Capitalization of Maliseet

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

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

i. The Series B Preferred Stock

(a) Dividends

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

(b) <u>Liquidating Distributions</u>

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

(c) <u>Voting Rights</u>

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

(d) Redemption Rights

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

ii. The Series A Preferred Stock

(a) Dividends

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

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

(b) Liquidating Distributions

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

(c) Voting Rights

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

(d) Redemption Rights

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

iii. The Common Stock

(a) Rights to Distributions

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

(b) Liquidation Rights

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

(c) Voting Rights

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

(d) Redemption Rights

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

b. The Shareholders Agreement

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

i. The Recapitalization Right

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

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

ii. REIT Status of Maliseet

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

iii. Consent Dividends

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

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

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

c. <u>The Put Agreements</u>

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

d. <u>The Put and Call Agreement</u>

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

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

2. The Leased Equipment Transactions

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

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

F. The Subsequent Transaction

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

III. REPRESENTATIONS AND ASSUMPTIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

You have consented to the following assumptions:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

IV. <u>OPINION</u>

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

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

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

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

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

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

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

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

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

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

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

V. LEGAL ANALYSIS

A. Section 351 Qualification of Transfers to Maliseet

1. Section 351

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

2. Transfers to an Investment Company and Diversification

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

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

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

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

3. Property

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

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

4. Stock

As described above, section 351 requires a transfer in exchange for "stock" of the transferee corporation. The determination of whether an instrument is debt or equity depends upon the facts and circumstances of each case. See Lundgren v. Commissioner, 376 F.2d 623, 626 (9th Cir. 1967). Because the line between debt and equity can be fine, the courts have used a multiple-factor analysis in classifying corporate instruments. No one factor is controlling; all

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factors must be taken into account. See John Kelley Co. v. Commissioner, 326 U.S. 521, 530 (1946); Hardman v. United States, 827 F.2d 1409, 1411-12 (9th Cir. 1987).

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

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

a. The Common Stock

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

b. The Series A Preferred Stock

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

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

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

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

i. The Recapitalization Right

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

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

ii. The Undistributed Preferred A Dividend Right

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

iii. Summary

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

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

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

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

5. Control

Section 351 permits nonrecognition of gain or loss upon the transfer of property to a corporation only when the transferors are in control of the transferee corporation immediately after the exchange. See I.R.C. § 351(a). The Service takes the position that control, for this purpose, means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each other class of stock of the corporation (the "Control Requirement"). See I.R.C. §§ 351(a), 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

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

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

6. Transfers of Liabilities

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

7. Substance of the Maliseet Transactions

a. Substantiality of Stock Received

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

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

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

b. Bifurcation

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

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

8. Conclusion

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

B. Basis of Residual Interests

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

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

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

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

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

1. Profit Motive

a. Pre-tax Motive Requirement

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

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

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

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

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

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

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

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

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

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

b. Treatment of Finance Costs

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

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

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

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

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

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

c. Consideration of Present Value Concepts

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

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

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

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

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

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

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

2. Investment in the Enron Shares and the Leased Equipment

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

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

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

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

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

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

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

1. Section 269 Generally

Section 269(a) provides that if

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Id. at 195.

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

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

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

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

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

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

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

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

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

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

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

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

4. The Relevant Tax Avoidance Purposes

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

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

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

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

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

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

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

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

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

Id. at 1312.

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

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

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

Id. at 399.

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

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

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

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

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

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

Id. at 320.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

5. Definition of Tax Avoidance or Evasion

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

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

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

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

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

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

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

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

a. Identification of Relevant Purposes and Benefits

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

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

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

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

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

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

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

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

b. <u>Whether the Carryover Basis Deductions Will Effect a Distortion of Income</u>

i. <u>The REMIC Provisions</u>

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

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

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

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

ii. Analysis

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

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

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

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

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

(b) Net Losses With Respect To Residual Interests

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

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

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

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

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

(c) Distortion With Respect to Other Taxable Income

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

7. Conclusion

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

E. Section 382

1. Background

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

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

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

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

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

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

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

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

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

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

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

See Treas. Reg. § 1.382-2(a)(1).

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

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

2. Application of Section 382 to the Phantom Deductions Generated by the Residual Interests

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

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

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

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

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

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

a. Result if Maliseet is not a Successor

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

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

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

ii. The DB Acquisition

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

b. Maliseet's Status as a Successor Corporation

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

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

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

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

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

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

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

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

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

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

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

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

i. Maliseet Treated as an Entity Separate from Bankers Trust

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(b) The DB Acquisition

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

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

ii. Maliseet as a Single Entity with Bankers Trust

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

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

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

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

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

(b) The DB Acquisition

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

F. Tax Shelter Registration

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

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

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

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

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

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

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

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

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

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

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

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

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

1. Maliseet's Investment in the Residual Interests

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

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

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

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

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2. Investment in Maliseet

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

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

3. Maliseet and the Leased Equipment

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

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

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

G. Penalty Provision

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

H. Consent Dividends

1. Generally

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

2. Requirements for Dividends Paid Deduction

a. Dividend Described in Section 316

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

b. Dividend Not Preferential

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

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

Treas. Reg. § 1.562-2(a).

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

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

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

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

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

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

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

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

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

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

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

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

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

3. <u>Consent Dividends</u>

a. <u>Consent Stock</u>

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

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

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

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

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

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

b. Required Filings

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

4. Analysis

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

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deduction for dividends paid, as defined in section 561, and be deductible by Maliseet under section 857(b)(2)(B).

CONCLUSION

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

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

Sincerely,

McKEE NELSON, ERNST & YOUNG LLP

By: ______________________
William S. McKee

By: ______________________
James D. Bridgeman

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DIRECT DIAL: DIRECT FAX:

May 14, 2001

Enron Corp.
Maliseet Properties, Inc.
1400 Smith Street
P.O. Box 1188
Houston, Texas 77251-1188

Ladies and Gentlemen:

You have requested our opinion as to the qualification of Maliseet Properties, Inc., a Delaware corporation ("Maliseet"), as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended (the "Code").

FACTS AND ASSUMPTIONS RELIED UPON

In rendering the opinion expressed herein, we have examined such documents as we have deemed appropriate, including (but not limited to) the following:

Amended and Restated Certificate of Incorporation of Maliseet Properties, Inc. as filed with the Delaware Office of Secretary of State on January 27, 1999.

Amended and Restated Bylaws of Maliseet Properties, Inc., adopted January 27, 1999.

Action of the Board of Directors Taken by Unanimous Written Consent in Lieu of a Meeting of Maliseet Properties, Inc., dated as of January 27, 1999.

Purchase and Sale Agreement, dated as of January 28, 1999, between BT Green, Inc. and Enron Corp.

Purchase and Sale Agreement, dated as of January 28, 1999, between BT Green, Inc. and Bankers Trust Company, acting through its branch office in London, England.

Subscription and Contribution Agreement, dated as of January 28, 1999, between Enron Corp. and Maliseet Properties, Inc.

EC2 000033980

Subscription and Contribution Agreement, dated as of January 28, 1999, between Bankers Trust Company, acting through its branch office in London, England and Maliseet Properties, Inc.

Promissory Note ,dated January 28, 1999, in the principal amount of $5,396,318 issued by Maliseet Properties, Inc. in favor of Bankers Trust Company.

Two Year Put Agreement, dated as of January 28, 1999, between Bankers Trust Company and Enron Corp.

78 Month Put Agreement, dated as of January 28, 1999, between Bankers Trust Company and Enron Corp.

Put and Call Agreement, dated as of January 28, 1999, between Bankers Trust Company and Enron Corp.

Guaranty of Obligations, dated as of January 28, 1999, by Enron Corp. in favor of Bankers Trust Company.

Shareholders Agreement, dated as of January 28, 1999, by and among Enron Corp., Bankers Trust Company, and Maliseet Properties, Inc.

Management Agreement, dated as of January 28, 1999, between Maliseet Properties, Inc. and Enron Corp.

The 1999 federal income tax return on Form 1120-REIT for Maliseet Properties, Inc., together with Forms 972 (Consent of Shareholder to Include Specific Amount in Gross Income) and 973 (Corporation Claim for Deduction for Consent Dividends) included with such return.

Income and asset test schedules prepared by Maliseet for 1999 and 2000 showing its compliance with the REIT income and asset tests under Section 856 of the Code.

Schedules prepared by Maliseet summarizing the information contained on the quarterly Schedule Qs (Form 1066) issued by each of the REMICs in which Maliseet held a residual interest during 1999 and 2000.

Schedules prepared by Maliseet summarizing the information provided to Maliseet by the REMICs in which Maliseet held a regular interest (in accordance with Treas. Reg. §1.6049-7(e)(2)) during 1999 and 2000.

Minutes of the Maliseet Board of Directors for all periods since Maliseet's formation in 1985.

In our examination of documents and in our reliance upon them in issuing this opinion, we have assumed, with your consent, that all documents submitted to us are authentic originals, or if submitted as photocopies or telecopies, that they faithfully reproduce the originals thereof, that all such documents have been or will be duly executed to the extent required in substantially the same form as they have been provided to us, that all representations and statements set forth in such documents are true and correct, and that all obligations imposed by any such documents on the parties thereto have been or will be performed or satisfied in accordance with their terms. We also have obtained such additional information and representations as we have deemed relevant and necessary through consultation with representatives of Maliseet and Enron, including representations from Maliseet in a letter to us of even date herewith (the "Officer's Certificate").

In addition, with your consent, in rendering our opinion herein, we have relied upon, and assumed the accuracy of, the opinion of McKee, Nelson, Ernst & Young, LLP, dated as of March 21, 2001, as to certain federal income tax consequences of the formation and operation of Maliseet. We have also relied on the opinion of Potter Anderson & Corroon LLP, dated January 28, 1999, regarding certain matters of Delaware law.

OPINION

Based upon and subject to the foregoing, it is our opinion that Maliseet should qualify for taxation as a REIT under the Code for its taxable year ended December 31, 1999 and that Maliseet's organization and proposed method of operation should enable it to continue to meet the requirements for qualification and taxation as a REIT under the Code for its taxable year ended December 31, 2000 and subsequent taxable years.

The opinion expressed herein is given as of the date hereof and is based upon the Code, the U.S. Treasury regulations promulgated thereunder, current administrative positions of the U.S. Internal Revenue Service, and existing judicial decisions, any of which could be changed at any time, possibly on a retroactive basis. Any such changes could adversely affect the opinion rendered herein and the tax consequences to Maliseet and its shareholders. In addition, as noted above, our opinion is based solely on the documents that we have examined, the additional information that we have obtained, and the representations that have been made to us, including those contained in the Officer's Certificate, and cannot be relied upon if any of the facts contained in such documents or in such additional information is, or later becomes, inaccurate or if any of the representations made to us is, or later becomes, inaccurate.

We hereby consent to the reliance by McKee, Nelson, Ernst & Young, LLP on our opinion in rendering the opinion that is referred to above. Except as stated in the preceding sentence, our opinion is rendered solely for your benefit and may not be relied upon by any other person without our prior written consent.

Finally, our opinion is limited to the qualification of Maliseet as a REIT under the Code, and we have not been asked to address, nor have we addressed, any other matters.

Very truly yours,

King & Spalding

V. TAX OPINION LETTERS

RELATING TO

PROJECT TERESA

KING & SPALDING

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

MEMORANDUM

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

FROM: William S. McKee
Susan Jewett

DATE: February 20, 1997

RE: Deferred Tax Liability Accounting Transaction

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

EC2 000033661

1. Assumed Facts

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

II. Tax Consequences Summary

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

A. Affiliation

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

B. Purchase

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

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

C. Formation of Holdco and Enron Sub III

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

D. Holdco Redemption

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

E. Enron Sub III Redemption

We believe that the payments by Enron Sub III in redemption of the Enron Sub III common and preferred stock should be treated as distributions subject to section 301 and as dividends under section 301(c)(1). We believe that the adjusted basis of the Enron Sub III preferred stock retained by Partnership should be increased by an amount equal to Partnership's adjusted basis in the Enron Sub III preferred stock redeemed by Enron Sub III and that the adjusted basis of SPVCo's interest in Partnership should be increased by its distributive share of the dividend attributable to the redemption of Enron Sub III preferred stock from Partnership. We believe that section 1059 should not be applicable to reduce Partnership's basis in the retained Enron Sub III preferred stock, to reduce SPVCo's basis in its interest in Partnership, or to trigger gain on the redemption. We believe that SPVCo should be treated, for purposes of section 243, as having received from Enron Sub III its distributive share of the dividend attributable to the redemption of preferred stock from Partnership and should be treated as having satisfied the holding period requirement of section 246(c). We believe that SPVCo's dividends received deduction with respect to any dividends on stock of Enron Sub III should not be subject to reduction under section 246A. We believe that the adjusted basis of the Enron Sub III common stock retained by SPVCo should be increased by an amount equal to SPVCo's adjusted basis in the Enron Sub III common stock redeemed by Enron Sub III and that section 1059 should not be applicable to reduce the basis of the Enron Sub III common stock in the hands of SPVCo or to trigger gain on the redemption. Legislation proposed by the President, if enacted, would deny any dividends received deduction with respect to dividends on the Enron Sub III preferred stock if such stock were issued more than 30 days after the date of enactment of the provision.

III. Analysis

A. Deconsolidated Status of SPVCo

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

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

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

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

The Service has also respected the use of heavy voting stock to break affiliation. In Private Letter Ruling 6710242620B (Oct. 24, 1967), the taxpayer wanted to deconsolidate a subsidiary using a class of common stock having the power to elect 1/3 of the board of directors of the corporation but representing less than 3.5 percent of the consideration paid for all of the corporation's outstanding stock. The letter ruling concludes, without mentioning the disproportionality between the voting power and value of the stock, that ownership of the entire class of stock outside the group would be sufficient to terminate affiliated status.[3]

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

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

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

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

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

Section 957(a) provides that a foreign corporation is a CFC if more than 50 percent of the total combined voting power of the corporation is owned by United States shareholders. (Section 957(a) was amended in 1986 to add, as an alternative basis for classification as a CFC, ownership of more than 50 percent of the total value of the stock of the corporation by United States shareholders.) The regulations under section 957 provide that, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person on whose behalf it is exercised, or, if not exercised, will be disregarded if the percentage of voting power of such class is substantially greater than its proportionate share of the corporate earnings, if the facts show that the shareholders of such class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification as a CFC. Treas. Reg. § 1.957-1(b)(2). Accordingly, disproportionality between vote and value or between vote and profit share does not appear to be a sufficient reason by itself to disregard the voting power of a class of stock. Rather, the facts and circumstances surrounding the manner in which the vote is exercised are critical to a determination to disregard such voting rights.

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

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

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

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

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

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

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

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

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

B. <u>Affiliation of Enron Sub III</u>

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

The term "includible corporation" means any corporation except (1) corporations exempt from tax under section 501, (2) insurance companies subject to taxation under section 801, (3) foreign corporations, (4) corporations with respect to which an election under section 936 is in effect for the taxable year, (5) regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1 of the Internal Revenue Code of 1986, and (6) a DISC (as defined in section 992(a)(1)). Section 1504(b). Enron Sub III is a for profit Delaware corporation that will not be an insurance company subject to taxation under section 801, a regulated investment company or a real estate investment trust subject to tax under subchapter M of chapter 1 of the Code, or a DISC (as defined in section 992(a)(1)). No election under section 936 will be made with respect to Enron Sub III. Accordingly, we believe Enron Sub III is an includible corporation.

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

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

The yield on the preferred stock of Enron Sub III does not vary with either the profitability of the issuing corporation or the appreciation of its assets. Terms that do not vary the return on the preferred stock with the profits of the issuing corporation may not be sufficient to establish an absence of participation in corporate growth, however, if the facts and circumstances indicate that the preferred stock in effect participates in corporate growth. See H.R. Rep. No. 98-861, at 817 (1984) ("preferred stock carrying a dividend rate materially in excess of a market rate when issued would not be ignored"). An argument might be made that the preferred stock nevertheless participates in corporate growth if the capitalization or operations of the corporation were such that corporate growth would be required in order for the issuing corporation to satisfy its obligations with respect to the preferred stock.[5]

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

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

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

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

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

C. <u>Purchase</u>

1. <u>Section 304</u>

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

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

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

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

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

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

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

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

2. Consequences of Dividend Treatment

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

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

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

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

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

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

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

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

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

3. Consolidated Return Regulations

a. Inapplicability of Section 304 Within a Consolidated Group

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

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

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

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

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

b. Intercompany Transaction Rules

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

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

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

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

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

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

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

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

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

c. Earnings and Profits Rules

The section 304 dividend from Enron Sub II should result in a reduction under section 312 in Enron Sub II's earnings and profits. H.R. Rep. No. 98-861, at 1223 (1984). Additional adjustments to the earnings and profits of members of the Enron consolidated group may be required in connection with the Purchase under Treasury Regulation § 1.1502-33, which contains rules (the "earnings and profits rules") for adjusting the earnings and profits of members of the group where one member owns stock of another member.[12]

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

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

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

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

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

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

d. Investment Adjustment Rules

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

As discussed above, the Service has consistently taken the position that basis adjustments attributable to the deemed distributions and contributions resulting from a section 304 transaction are made with respect to stock held directly by the taxpayer receiving the deemed distribution or making the deemed contribution, but not with respect to stock that is held constructively by such taxpayer. Rev. Rul. 71-563; Rev. Rul. 70-496. Based on this authority, we believe that distributions and contributions that are deemed to occur under section 304 with respect to stock that is constructively held by a taxpayer should not be treated as being made through the shareholder from whom ownership is attributed (the "direct" shareholder) for purposes of determining the federal tax effects of such deemed transactions on the direct shareholder. Accordingly, we believe Enron should not be treated as having either received a distribution from or made a contribution to Enron Sub II in connection with the Purchase for purposes of applying the investment adjustment rules (or other applicable basis rules of the Code).[13]

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

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

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

4. Dividends Received Deduction

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

a. Receipt of a Dividend from a Domestic Corporation

In determining its income tax, each partner must take into account separately, as part of the dividends received by it from domestic corporations, its distributive share of dividends received by the partnership with respect to which the partner is entitled to a deduction under part VIII of subchapter B (currently sections 241-250). Section 705(a)(2); Treas. Reg. § 1.701-1(a)(5). The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of section 701(a) is determined as if such item were realized directly from the source from which realized by the partnership. Section 702(b); Treas. Reg. § 1.702-1(b). Based on this authority we believe that each partner in a partnership should be treated, for purposes of section 243, as having received its distributive share of a partnership's dividend income directly from the source from which the partnership received the dividend.

Section 304 was amended in 1984 to clarify, among other things, the source of deemed distributions. Pursuant to those amendments, section 304(b)(2) provides that the determination of the amount which is a dividend and the source thereof is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. The effect of this amendment was described in the legislative history as follows:

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[14] The revenue proposals in the President's proposed fiscal year 1998 budget include a proposed amendment that would deny the dividends received deduction for dividends on "limited term preferred stock" of a corporation that is not an affiliate of the taxpayer. Limited term preferred stock is stock that is limited and preferred as to dividends, that does not participate (through a conversion privilege or otherwise) in corporate growth to any significant extent, and with respect to which (i) the holder has the right to put the stock to the issuer or a related person, (ii) the issuer or a related person is required to purchase the stock, (iii) it is more likely than not that the issuer or a related person will exercise a right to redeem or purchase the stock, or (iv) the dividend rate on the stock varies in whole or in part with reference to interest rates, commodity prices, or similar indices. See 1998 Revenue Proposals Explanation. This amendment would apply to dividends on stock issued more than 30 days after the date of enactment. If enacted, this proposal would deny the dividends received deduction with respect to dividends received by Partnership on any preferred stock of Enron Sub III that is issued more than 30 days after the date of enactment.

> [I]n all cases . . . the characterization of a distribution as a dividend, and the source of the dividend will be determined by treating the distribution as made by the acquiring corporation directly to the selling shareholder to the extent of the earnings and profits of the acquiring corporation and then as made by the issuing corporation directly to the selling shareholder to the extent of its earnings and profits. Thus, any dividend received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the corporation which is treated as having made the distribution.

H.R. Rep. No. 98-861, at 1223 (1984). The fiction of a dividend made directly to the seller by the acquiring corporation to the extent of the acquiring corporation's earnings and profits has been respected by the Service for purposes of section 243 where the seller has only constructive ownership of stock of the acquiring corporation. Priv. Ltr. Rul. 8609054 (Dec. 3, 1985), modified on another issue, Priv. Ltr. Rul. 8737027 (June 12, 1987) (dividends received deduction allowed to seller that had only constructive ownership of stock of acquiring corporation). Accordingly, we believe that, for purposes of section 243, Partnership should be treated as having received the Deemed Distribution directly from Enron Sub II and SPVCo should be treated as having received its distributive share of the Deemed Distribution directly from Enron Sub II.

b. Section 246(c)

No deduction is allowed in respect of any dividend on any share of stock which is held by the taxpayer for 45 days or less. Section 246(c)(1)(A). For purposes of determining the period for which the taxpayer has held any share of stock, any day which is more than 45 days after the date on which such share becomes ex-dividend is not taken into account. Section 246(c)(3)(B). The holding period is reduced for periods where the taxpayer's risk of loss is diminished. Section 246(c)(4).

Implicit in the provisions of section 702, which contemplate that a partner may be entitled to a dividends received deduction with respect to dividends received by a partnership, is that the holding period requirements of section 246(c) can be satisfied with respect to stock that a corporation owns indirectly through a partnership. Accordingly, we believe that a partner should be considered to have satisfied the holding period requirement of section 246(c) to the same extent that the partnership that receives the dividend would be considered to have satisfied the holding period requirement of section 246(c) if the partnership itself were otherwise entitled to the dividends received deduction.[15]

In order to determine whether Partnership could satisfy the holding period requirement of section 246(c), it is first necessary to identify the share of stock on which a dividend is paid. In the context of a section 304 transaction involving constructive ownership, the identity of the stock on which the dividend is paid is not clear. In the instant case, prior to any Purchase, Enron has a holding period in the common stock of Enron Sub III and Enron Sub II, SPVCo has a holding period in the common stock of Enron Sub III, and Partnership has a holding period in the preferred stock of Enron Sub III in excess of the 45 days required by section 246(c)(1). Accordingly, whether one looks to the holding period of the stock of the acquiring corporation (Enron Sub II) or to the holding period of the stock of the issuing corporation (Enron Sub III), and whether one considers directly held stock or constructively held stock, we believe the holding period requirement of section 246(c)(1) should be satisfied.

In the case of stock having a preference in dividends, the required holding period is extended to 90 days if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days. Section 246(c)(2). If the section 304 dividend were treated as paid on the Enron Sub III preferred stock, the Service might argue that the 90 day holding period is applicable if the earnings and profits that support the dividend were accrued over a period of more than 366 days. The Service might further argue that the disposition in the Purchase of some of the Enron Sub III preferred shares prevented those shares from satisfying the 90 day holding period requirement, triggering the application of section 246(c) to deny the dividends received deduction. Such an argument requires that the section 304 dividend be treated as paid on the transferred Enron Sub III preferred stock, which is inconsistent with the directive of section 304(b)(2) and its legislative history that the section 304 distribution be treated as made first by Enron Sub II to the extent of its earnings and profits. Moreover,

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15 If complete aggregate treatment of a partnership were applied for purposes of section 246(c), it might be argued that the holding period of the partner with respect to its interest in the partnership should be taken into account in applying section 246(c). Cf. Treas. Reg. § 1.856-3(g) (real estate investment trust deemed to own its proportionate share of assets of partnership in which it is a partner; holding period with respect to sale of property by partnership is shorter of partnership's holding period in asset or partner's holding period in partnership interest); Priv. Ltr. Rul. 9615004 (Apr. 12, 1996) (extending aggregate treatment prescribed by statute for purposes of section 851(b)(2) to determine satisfaction by regulated investment company of section 854 requirements relating to sections 243, 246, and 246A; holds regulated investment company will be deemed to hold its proportionate share of assets of a partnership for the period that the partnership held the assets or for the period the regulated investment company has held its interest in the partnership, whichever is shorter). Under the facts, each partner will have a holding period in its interest in Partnership that should satisfy the requirements of section 246(c)(1).

where the basis of the redeemed shares is added to the basis of the retained shares, and assuming the 90 day holding period will be satisfied with respect to the retained shares prior to any disposition of those shares, we believe the case for applying section 246(c)(2) to deny the dividends received deduction would be weak.

c. Section 246(b)

Section 246(b) imposes limits on the aggregate amount of section 243 deductions, based on the taxable income of the taxpayer, computed with certain adjustments. Section 246(b)(2). In essence, section 246(b) denies a taxpayer the benefit of the dividends received deduction to the extent the dividend is offset by other deductions. Partnership and each of its partners will have taxable income from nondividend sources that exceeds its deductible expenses. Accordingly, we believe section 246(b) should not apply.

d. Section 246A

Section 246A reduces the percentage used in computing the dividends received deduction "in the case of any dividend on debt-financed portfolio stock." Section 246A(a). Portfolio stock means any stock of a corporation unless, as of the beginning of the ex-dividend date, (A) the taxpayer owns stock of the corporation that represents 50 percent of the vote and 50 percent of the value of all stock of the corporation (the "50 percent test"), or (B) the taxpayer owns stock of the corporation that represents 20 percent of the vote and 20 percent of the value of all stock of the corporation (the "20 percent test") and five or fewer corporate shareholders own stock that satisfies the 50 percent test. Section 246A(c)(2). For purposes of satisfying the 50 percent test and the 20 percent test, stock described in section 1504(a)(4) is not taken into account. Section 246A(c)(4).

In order to determine whether a section 304 dividend is paid on portfolio stock, it is necessary to determine the identity of the corporation on whose stock the section 304 dividend is paid. Section 304(a)(1) treats the purchase by Enron Sub II as a distribution in redemption of stock of Enron Sub II and section 304(b)(2) determines the amount of the deemed distribution which is treated as a dividend (and the source thereof) as if the property were distributed by Enron Sub II. The Service has characterized a section 304 dividend as a dividend to the selling corporation from the acquiring corporation where the selling corporation had only constructive ownership of stock of the acquiring corporation. Priv. Ltr. Rul. 8609054 (Dec. 3, 1985). In addition, the Service has applied the ownership test of section 902(a), which applies to a domestic corporation that owns 10 percent or more of the voting stock of a foreign corporation from which it receives a dividend, by reference to the constructive ownership of the stock of the acquiring corporation in a section 304 transaction. Rev. Rul. 92-86, 1992-2 C.B. 199. Accordingly, we believe that the section 304 dividend should be treated as paid to Partnership by Enron Sub II.

While we have found no explicit authority on the identity of the stock on which a redemption dividend is paid, we believe that a dividend that is treated as paid by Enron Sub II should be treated as paid on stock of Enron Sub II. See H.R. Conf. Rep. No. 98-861, at 817 (1984) (statement in legislative history of section 1059 that a redemption dividend is treated as being made pro rata with respect to the stock of the shareholder which is not redeemed).[16]

Applying the requirements of section 246A at the partner level, stock of Enron Sub II will not be portfolio stock with respect to SPVCo if Partnership's constructive ownership of stock of Enron Sub II is taken into account. Section 246A does not specifically provide for the general application of constructive ownership rules. Nevertheless, in the context of a transaction which is subject to section 304 based on ownership of the stock of Enron Sub II that is constructive only, we believe that the constructive ownership of the stock of Enron Sub II should be taken into account in applying section 246A with respect to a section 304 dividend from Enron Sub II. See Rev. Rul. 92-86, 1992-2 C.B. 199. Accordingly, we believe that the stock of Enron Sub II should not be treated as portfolio stock with respect to SPVCo and that SPVCo's dividends received deduction with respect to its distributive share of the Deemed Distribution should not be subject to reduction under section 246A.

e. Percentage

Section 243(a)(1) provides for a deduction equal to 70 percent of the dividend amount, with certain exceptions that are not applicable to the instant case. Section 243(c) increases this percentage to 80 percent in the case of any dividend received from a 20-percent owned corporation. A 20-percent owned corporation is defined as any corporation if 20 percent or more of the stock of such corporation (by vote and value) is "owned" by the taxpayer. Section 243(c)(2). This definition raises the issues of whether a partner is treated as "owning" stock owned by a partnership and whether constructive ownership under section 304 is taken into account in determining "ownership."

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[16] The Service might argue that the dividend should be treated as paid on the only stock that Partnership owns directly (i.e., stock of Enron Sub III). If the section 304 dividend were treated as a dividend on the preferred stock of Enron Sub III retained by Partnership, we believe SPVCo's dividends received deduction with respect to the section 304 dividend should not be subject to reduction under section 246A because SPVCo owns 20 percent of the common stock of Enron Sub III.

With respect to the issue of whether a partner should be treated as owning stock owned by a partnership, the Service has taken the position that ownership through a partnership is ownership for purposes of the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation. See Rev. Rul. 71-141, 1971-1 C.B. 211 (allowing section 902 credit to partners who hold 20 percent interests, indirectly through a partnership, in foreign corporation). Based on this authority, we believe that it is more likely than not that, for purposes of section 243(c), SPVCo will be treated as owning 98 percent (its share of profits and capital) of any stock of Enron Sub II that Partnership is treated as owning.

With respect to the issue of whether constructively held stock will be taken into account in determining ownership of the payor corporation in a section 304 transaction, we again look to the statement in the legislative history of the 1984 amendment to section 304 that any dividends received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the acquiring corporation (to the extent of its earnings and profits). The Service has cited this legislative history in ruling that a section 304(a)(1) dividend qualifies for the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation, even though the transferor corporation did not own directly any stock in the acquiring corporation. Rev. Rul. 92-86, 1992-2 C.B. 199. Of particular importance is the fact that section 902, like section 243(c), does not invoke the constructive ownership provisions of section 318. See First Chicago Corp. v. Commissioner, 96 T.C. 421 (1991) (corporation not allowed to aggregate its ownership with that of its affiliates so as to meet the requisite ownership of section 902); Rev. Rul. 85-3, 1985-1 C.B. 222 (section 902 does not allow indirect ownership through subsidiaries to satisfy the section 902 ownership requirement). Nevertheless, Revenue Ruling 92-86, 1992-2 C.B. 199, explicitly holds that the transferor corporation's constructive ownership as determined under section 304(c) is counted for purposes of determining the existence and amount of direct ownership under section 902. Based on the legislative history of section 304 and the Service's position in Revenue Ruling 92-86, we believe that it is more likely than not that Partnership will be treated, for purposes of section 243(c)(2), as "owning" the stock of Enron Sub II that it constructively owns for purposes of section 304.

5. Section 1059

Section 1059 provides for the reduction (but not below zero) of a corporation's basis in stock by the amount of the dividends received deduction allowable with respect to certain "extraordinary" dividends received with respect to such stock. Extraordinary dividends that trigger the application of section 1059 include (i) a dividend received by a corporation with respect to a share of stock that equals or exceeds a threshold percentage of the corporation's adjusted basis in such share of stock, if the corporation has not held such share of stock for more than two years before the dividend announcement date or (ii) any amount treated as a dividend in the case of any redemption of stock which is non pro rata as to all shareholders. Sections 1059(a)(1), 1059(e)(1). The reduction occurs immediately before any sale or disposition of the stock. Section 1059(d)(1). Any excess of the dividends received deduction over the basis of the stock is treated as gain upon disposition of the stock. Section 1059(a)(2). The Service takes the position, and we assume for purposes of this discussion, that a partnership is treated as an aggregate for purposes of applying section 1059, with each partner treated as owning its share of the stock owned by the partnership. Treas. Reg. § 1.701-2(f) *Example 2*. The discussion refers to Partnership and the application of section 1059 to Partnership, with the understanding that the dividends received deduction that causes a portion of the dividend to be nontaxable is that of one or more partners of Partnership.

While Treasury has been given broad regulatory authority by section 1059(g), to date there have been no regulations or other administrative authorities addressing the application of section 1059 to a section 304 transaction.[17] The difficulties in determining how or whether section 1059 should be applied in the instant case arise from the fact that Partnership does not own directly any stock of Enron Sub II. Section 1059 assumes that the recipient of a dividend owns the stock with respect to which a dividend is paid and has a basis in such stock that could be reduced. Despite these uncertainties, we believe that the Purchase should not be treated as meeting the threshold requirements of section 1059 under current law.

a. Pro Rata Redemption

A threshold question in the case of a redemption of stock is whether the redemption is pro rata as to all shareholders. No guidance has been issued on the meaning of "pro rata" for these purposes. The application of section 304, and the resulting deemed redemption of stock of Enron Sub II from Partnership, is based on Partnership's constructive ownership of all of the stock of Enron Sub II. Where the only ownership by a taxpayer of stock of the redeeming corporation is

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17 The President's fiscal year 1998 revenue proposals include a proposed amendment that addresses the interaction of sections 1059 and 304. See Treasury Explanation of Clinton Administration's Fiscal Year 1998 Revenue Proposals (Feb. 6, 1997) ("1998 Revenue Proposals Explanation"). Under this amendment, section 1059 would be applicable to the Deemed Distribution without regard to either the holding period of any stock or the amount of the Deemed Distribution. The effective date of this amendment would be for transactions after the date of first committee action. If this amendment were enacted, we believe that section 1059 would be applicable to a Purchase that occurs after the effective date to reduce Partnership's basis attributable to the transferred shares of Enron Sub III preferred stock by the amount of the dividends received deduction allowable with respect to the Deemed Distribution.

constructive, we believe the "non pro rata" test of section 1059(e) should be applied by reference to this same constructive ownership. In other contexts, a redemption from a shareholder that owns 100 percent of the stock of a corporation by attribution is treated as being pro rata. See United States v. Davis, 397 U.S. 301 (1970) (application of attribution rules make 25 percent shareholder a 100 percent shareholder; treated as "sole shareholder" for purposes of section 302; Congress clearly mandated that pro rata distributions be treated under rules of section 301 rather than under section 302; redemption was essentially equivalent to a dividend); Rev. Rul. 81-289, 1981-2 C.B. 82 (describing the distribution in Davis as "precisely pro rata"). Since Partnership constructively owns 100 percent of all classes of stock of Enron Sub II, we believe Partnership should be viewed as the sole shareholder of Enron Sub II for purposes of testing whether a deemed redemption from Partnership of stock of Enron Sub II is "pro rata as to all shareholders." In the case of a redemption from a sole shareholder, we do not believe it is necessary to determine the class of stock that is deemed to have been redeemed in order to determine whether the redemption is pro rata as to all shareholders. Accordingly, we believe the deemed redemption of Enron Sub II stock from Partnership should be treated as pro rata as to all shareholders for purposes of section 1059(e).[18]

b. Two-Year Holding Period

Where a redemption is pro rata, a second threshold question for application of section 1059 is whether the stock with respect to which the dividend is received has been held by the corporation for more than two years. For this purpose, the holding period of stock is determined under rules similar to the rules of sections 246(c)(3) and 246(c)(4). Section 1059(d)(3). For the reasons discussed below, we believe it is the holding period in the Enron Sub II stock that should be relevant in applying section 1059. Accordingly, we believe that a two-year holding period with respect to the stock of Enron Sub II should preclude application of section 1059.

Enron Sub II is the corporation that is treated as redeeming its stock under section 304(a)(1) and as the payor of the section 304 dividend under section 304(b)(2)(A). The legislative history of section 1059 states that "if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to stock of the shareholder

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18 If the determination of whether a redemption is pro rata were made at the partner, rather than the partnership level, we believe the redemption should be treated as pro rata provided that each partner's distributive share of the dividend is proportional to each partner's proportionate share of stock held, directly, indirectly, or constructively, by the partnership. We believe this should be the result if allocations of substantially all Partnership items, and allocations of all items relating to any stock, are made in proportion to the capital contributions of each partner.

which is not redeemed." H.R. Conf. Rep. No. 98-861, at 817 (1984). Accordingly, we believe the stock with respect to which the Deemed Distribution is made should be stock of Enron Sub II that is owned by Partnership and that is not redeemed (i.e., that remains outstanding after the transaction). Where a taxpayer does not directly own any stock of the redeeming corporation, we believe that the holding period test of section 1059 should be applied by looking to the holding period of stock that is constructively held by the taxpayer.

We believe looking to the holding period of the Enron Sub II stock is consistent with the purpose of section 304 to ensure that Code provisions relating to dividend treatment of direct redemptions are not circumvented through the use of indirect redemptions. It is the common ownership by Enron of Enron Sub II and Enron Sub III that results in the application of section 304, and it is the earnings and profits of Enron Sub II that support the dividend characterization of the deemed redemption. Under these facts, we believe that the direct redemption, the tax consequences of which section 304 is intended to mimic, should be considered to be a redemption of Enron Sub II stock from Enron. If Enron Sub II had redeemed a portion of its stock directly from Enron, section 1059 would not have been applicable, given that Enron's holding period with respect to the Enron Sub II stock exceeds two years. Similarly, if Enron owned Enron Sub III preferred stock directly, then in a purchase by Enron Sub II of Enron Sub III preferred stock directly from Enron, we believe it would be the holding period in the stock of the redeeming company (i.e., Enron Sub II) that would be considered relevant for purposes of determining whether section 1059 would be applicable to such a transaction.

Section 1059 was enacted to address tax arbitrage opportunities presented by the effective rate of tax on dividend income as compared to the effective rate of tax on income that could be offset by a capital loss. H.R. Rep. No. 98-432, pt. 2, at 1186 (1984). Section 1059 is concerned with the creation of a noneconomic tax loss where a corporation purchases stock in anticipation of an extraordinary dividend, receives the dividend, and then sells the stock for a loss (resulting from the decline in value of the stock attributable to the payment of the dividend). See H.R. Rep. No. 98-432, pt. 2, at 1184 (1984); S. Prt. 98-169, vol. I, at 170 (1984). The Service may argue that, despite the technical satisfaction of the two-year holding period requirement with respect to the stock of Enron Sub II, application of section 1059 is necessary to effectuate the intent of Congress to prevent tax arbitrage because the recipient of the extraordinary dividend (Partnership) holds an asset (the retained Enron Sub III stock) with respect to which a potential noneconomic tax loss (i.e., an excess of basis over value) has been created in connection with the section 304 transaction. The Service might argue further that, to the extent Partnership has a holding period of less than two years in the Enron Sub III stock, the literal language of section 1059 should yield to the underlying purpose of the statute to prevent tax arbitrage and section 1059 should be applicable.

While this argument has some initial appeal, an examination of the facts indicates that the distortion between basis and economics in the instant case is created by the combined fictions of sections 304 and 318, which treat a sale of stock as if it were a dividend from, and a contribution to the capital of, a corporation in which the taxpayer has no direct ownership of stock, rather than by the effects of an extraordinary dividend addressed by section 1059. The excess of basis over value in the stock of Enron Sub III retained by Partnership is not attributable to a reduction in the value of Enron Sub III due to a dividend distribution, but rather to an increase in the basis of the retained Enron Sub III stock with respect to a deemed contribution to capital to another corporation (Enron Sub II). Moreover, where it is the earnings and profits of Enron Sub II that support the dividend characterization of the section 304 deemed redemption, we believe the holding period with respect to the Enron Sub III stock should be considered irrelevant in the context of the objectives of section 1059.

The lack of any distortion caused by the dividend portion of a section 304 transaction (as opposed to the basis adjustment relating to the deemed capital contribution) can be demonstrated by comparing the economic and tax consequences of a direct dividend, a direct redemption, and a section 304 transaction in which the stock of the acquiring corporation and the stock of the issuing corporation are held directly by a common parent. Assume the following facts:

> Initially X, a corporation unrelated to Parent, owns all 100 outstanding shares of Acquiring;
>
> At the beginning of Year 1, Parent purchases 75 shares of the stock of Acquiring from X for their fair market value of $75;[19]
>
> During Years 1 through 3, Acquiring accumulates $20 of earnings and profits and the fair market value of Parent's 75 shares of Acquiring's stock increases to $90;
>
> At the end of Year 3, Parent purchases 75 shares of the 100 outstanding shares of Issuing from an unrelated party for their fair market value of $75.
>
> At the beginning of Year 4, Acquiring does one of the following three things: (i) pays a dividend of $20 pro rata to Parent and X; (ii) redeems $20 worth of its stock pro rata from Parent and X; or (iii) purchases 15 shares of Issuing stock from Parent for their fair

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19 The example assumes 75 percent ownership because special rules alter the effects of sections 304 and 1059 in the case of transactions between affiliates. See sections 304(b)(4), 1059(e)(2).

market value of $15 (i.e., the value of the Issuing stock has not changed since the purchase by Parent).

Economically, each of the first two transactions (the direct dividend and the direct redemptions) would result in a $20 reduction in the overall value of Acquiring and no change in the relative ownership of Acquiring by Parent and X. The value and basis of Parent's stock in Acquiring is $75 after the distribution. The distribution does not create any potential tax loss for Parent, because the value of the earnings and profits on which the dividend characterization of those distributions is based is not reflected in Parent's basis before the distribution. Consistent with the absence of any potential for tax arbitrage at which section 1059 is directed, section 1059 is not applicable, based on Parent's two-year holding period in its 75 shares of Acquiring stock.

The economics of the third transaction above (the paradigm section 304 transaction) are different from those of the direct dividend and the direct redemptions. In the paradigm section 304 transaction, the overall value of Acquiring and the relative interests of Parent and X in Acquiring are unchanged. There is no net reduction in the value of Parent's 75 shares of Acquiring, but the basis of those shares is increased by the deemed capital contribution of the Issuing shares with a $15 basis. As a result, Parent holds 75 shares of Acquiring with a value and basis of $90. As with the direct dividend and the direct redemption transactions discussed above, the paradigm section 304 transaction does not create any potential tax loss for Parent where the value of the earnings and profits on which the dividend characterization of the section 304 deemed redemption is based is not reflected in Parent's basis before the transaction. Consistent with the absence of any potential for tax arbitrage at which section 1059 is directed, the threshold requirement of section 1059 of a holding period of two years or less would not be met based on Parent's two-year holding period in its 75 shares of Acquiring stock.[20]

Given that none of what might be considered economically equivalent transactions (a direct dividend distribution from Enron Sub II to Enron, a direct redemption of Enron Sub II stock from Enron, and the dividend portion of a section 304 transaction in which Enron Sub II purchases stock of Enron Sub III from Enron (with no affiliation among the parties)) would be subject to section 1059 based on a two year holding period of the Enron Sub II stock, and that none of those transactions appears to violate the spirit of section 1059, we believe a court should not consider the holding period of the retained Enron Sub III stock to be relevant to the application of section 1059 to the Purchase. Rather, we believe a court should recognize that the

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[20] Some redemption from X might be required to avoid section 1059(e)(1)(B), which overrides the two year threshold requirement in the case of non pro rata redemptions. It is unclear how one would determine whether a section 304 deemed redemption is pro rata where a shareholder directly owns some, but less than 100 percent, of the stock of the redeeming corporation.

distortions between basis and value created in the retained Enron Sub III stock are attributable to the fictions created by sections 304 and 318 in which there is a deemed capital contribution to a corporation in which the contributor has no direct ownership.

Congress viewed acquisitions of stock in anticipation of the payment of an extraordinary dividend as the acquisition of two assets: the right to distributions to be made with respect to the stock and the underlying stock itself. In such cases, Congress concluded that it was appropriate to reduce the basis of the underlying stock to reflect the value of the distribution that was not taxed to a corporate distributee. See H.R. Rep. No. 98-432, pt. 2, at 1186 (1984); S. Prt. No. 98-169, vol. I, at 172 (1984). Congress used objective rather than subjective criteria to identify transactions that were appropriately treated as "two asset" acquisitions (i.e., those acquisitions in which a portion of the basis of the shareholder is attributable to the value of an anticipated distribution). The statute provides a dual test for its application, requiring both a holding period of two years or less as of the dividend announcement date (presumably as an indication that the dividend might have been anticipated at the time of the acquisition and thus reflected as a separate asset in the acquisition transaction) and a dividend in excess of a specified percentage of the basis in the stock (presumably to exclude regular dividends, the tax arbitrage potential of which is addressed by section 246(c)). Subject to certain express statutory exceptions, the statute does not apply where the taxpayer's holding period exceeds the objective two year holding period standard, regardless of whether the shareholder in fact anticipated an extraordinary dividend or whether the value of an extraordinary dividend is in fact reflected in the shareholder's basis in the stock. In effect, there is an irrebuttable presumption that the distortion between basis and economics created by a dividend distribution and addressed by section 1059 is not present where a shareholder has a holding period in excess of two years as of the dividend announcement date. We believe the holding period threshold in section 1059 serves as an objective substitute for an inquiry into whether an extraordinary dividend distribution is made with respect to stock having a basis that reflects the value of the earnings and profits that fund the extraordinary dividend. We believe that it is consistent with the purposes of section 1059 to look to the holding period in the stock of the corporation having the earnings and profits that fund a dividend to determine whether the two-year threshold of section 1059 is satisfied. Accordingly, we believe that section 1059 should not be applicable to a Purchase that occurs at a time when the holding period of each share of stock of Enron Sub II is greater than two years.

c. <u>Threshold Percentage</u>

The Service might argue that the relevant holding period for Partnership is the shorter of the period for which it has constructively owned Enron Sub II stock and Enron's holding period in the Enron Sub II stock. We believe that the period of constructive ownership has no relevance to the purposes of section 304 and 1059. Accordingly, we believe such an argument should be rejected by a court. If such an argument were, nevertheless, accepted, then in the case of a Purchase that occurs within two years of the formation of Partnership, the characterization of a dividend as extraordinary would become significant.[21]

In general, the term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds 10 percent (5 percent in the case of stock which is preferred as to dividends) of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends received within an 85-day period, or exceeds 20 percent of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends having ex-dividend dates within an 365-day period. Section 1059(c).

Enron Sub II will not, during any 85 day period that begins within two years of the formation of Partnership, purchase Enron Sub III preferred stock in amounts such that, if the dividends resulting from all Purchases ("Section 304 Dividends") were treated as made pro rata with respect to all stock of Enron Sub II, the sum for any share of stock of Enron Sub II of all Section 304 Dividends that are treated as made with respect to such share of Enron Sub II stock during such 85 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 85 day period is greater than 10 percent of the shareholder's basis in such share. Enron Sub II will not, during any 365 day period that begins within two years of the formation of Partnership, purchase Enron Sub III preferred stock in amounts such that, if the Section 304 Dividends resulting from all Purchases were treated as made pro rata with respect to all stock of Enron Sub II, the sum for any share of stock of Enron Sub II of all Section 304 Dividends that are treated as made with respect to such share of Enron Sub II stock during such 365 day period plus all other dividends on such share that are received or that have an ex-dividend

[21] The two-year holding period requirement of section 1059 must be satisfied on the dividend announcement date. The term "dividend announcement date" means the date on which the corporation declares, announces, or agrees to the amount or payment of such dividend, whichever is the earliest. Section 1059(d)(5). The legislative history of this provision states that "[i]f there is a formal or informal agreement to pay the particular dividend prior to the declaration date, the date of such agreement shall be treated as the dividend announcement date for purposes of applying the two-year holding period requirement." H.R. Conf. Rep. No. 99-841, vol. II, at II-164 (1986). While it is anticipated that a substantial portion of the preferred stock of Enron Sub III may be sold over time, the timing and amount of Purchases will be contingent on a variety of factors, including the continued availability of the anticipated accounting treatment of such transactions and the financial position of Enron and its Affiliates that are included in its consolidated financial statements. With respect to any Purchase that may occur more than two years after the 304 Start Date, there is currently no fixed plan as to the date or amount of any such Purchase and there will be no announcement, action by Enron Sub II's board of directors, formal or informal agreement or fixed plan, commitment, or other action relating to the amount or the time of such Purchase within two years of the 304 Start Date. Based on these facts, we believe that, with respect to a Purchase that occurs after the date that is two years after the 304 Start Date, the dividend announcement date also should be considered to be more than two years after the 304 Start Date.

date during such 365 day period is greater than 20 percent of the shareholder's basis in such share. Based on these facts, we believe a dividend attributable to a Purchase and deemed made with respect to stock of Enron Sub II that has been constructively held by Partnership for less than two years should not be treated as exceeding the threshold percentage.[22]

D. Formation of Holdco and Enron Sub III

1. Application of Section 351

The transfer by Enron of X percent of the common stock of Regulated to Enron Sub III in exchange for 80 percent of the common stock of Enron Sub III is a transfer to a controlled corporation as described in section 351(a), whether viewed separately or in combination with the transfers of cash by Partnership and SPVCo to Enron Sub III. Accordingly, no gain or loss should be recognized by Enron on the exchange. Enron's basis in its Enron Sub III stock should be the same as its basis in the contributed Regulated stock. Section 358.

The transfer by Enron to Holdco of common stock of Regulated in exchange for all of the common stock of Holdco, and the transfer by Enron Sub III to Holdco of common stock of Regulated and cash in exchange for all of the preferred stock of Holdco, are transfers to a controlled corporation as described in section 351 (a), upon which no gain or loss should be recognized. See Treas. Reg. § 1.1502-34.

22 The Service might argue that the threshold tests of section 1059 should be applied by reference to the retained stock of the issuing corporation (Enron Sub III) where that is the only stock that the dividend recipient (Partnership) owns directly. In support of such a position, the Service might point to the fact that the determination of whether the redemption is a sale or exchange is made by reference to the ownership of stock of the issuing corporation, without regard to the identity of the corporation that is deemed to have made the redemption or to have paid the dividend, and that the basis attributable to the deemed capital contribution of the redeemed shares to the acquiring corporation attaches to the retained shares of the issuing corporation, in the absence of any direct ownership of stock of the acquiring corporation. As discussed in the text, we believe that the threshold test of section 1059 should be applied by reference to the stock of the acquiring corporation (Enron Sub II), where such corporation is treated as making the redemption under section 304(a)(1) and as having made the section 301 distribution under section 304(b)(2)(A). In the event that, contrary to our views, a court were to apply the threshold tests of section 1059 by reference to the stock of the issuing corporation (Enron Sub III), the application of section 1059 could be avoided if the amount of Purchases and Enron Sub III Redemptions satisfied the threshold percentage requirements described above, as applied to the Enron Sub III preferred stock held by Partnership. Under such circumstances, the percentage threshold tests would be 5 percent per 85 day period (instead of 10 percent) and 20 percent per 365 day period of the basis of Partnership in the Enron Sub III preferred stock.

Enron Sub III's basis in its Holdco preferred stock should equal the amount of cash contributed plus the basis of the Regulated stock at the time of the contribution. Section 362(a). Holdco's basis in its Regulated stock should be equal to the sum of Enron's and Enron Sub III's basis in the transferred stock immediately prior to its contribution to Holdco. Section 362(a).

2. Earnings and Profits Rules

The consolidated return regulations modify the determination of the earnings and profits of a member of a consolidated group ("P") by adjusting the earnings and profits of P to reflect a subsidiary's ("S") earnings and profits for the period that S is a member of the consolidated group. Treas. Reg. § 1.1502-33(a)(1). The purpose for these modifications (the "earnings and profits rules") is to treat P and S as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent. Id. Adjustments to the earnings and profits of P under these rules are in addition to adjustments under other rules of law (e.g., section 312), subject to the limitation that P's earnings and profits must not be adjusted in a manner that has the effect of duplicating an adjustment. Treas. Reg. § 1.1502-33(a)(2).

The general rule is that S's earnings and profits are "tiered up" to P. Under Treasury Regulation § 1.1502-33(b)(1), P's earnings and profits are adjusted to reflect changes in S's earnings and profits in accordance with the applicable principles of Treasury Regulation § 1.1502-32 (the investment adjustment rules), S's earnings and profits are allocated among S's shares under the principles of Treasury Regulation § 1.1502-32(c) of the investment adjustment rules, and the principles of the investment adjustment rules are modified in that P's earnings and profits adjustment is determined by reference to S's earnings and profits, rather than S's taxable and tax-exempt items.

The earnings and profits rules contain a provision that deals with a change in location of a subsidiary within the group. Treas. Reg. § 1.1502-33(f)(2). Under this rule, if the location of a member changes within a group, "appropriate adjustments" must be made to the earnings and profits of the members to prevent the earnings and profits from being eliminated. If P transfers all the stock of S to another member in a section 351 transaction, the transferee's earnings and profits are adjusted immediately after the transfer to reflect the earnings and profits of S immediately before the transfer. Accordingly, we believe the transfer by Enron of X percent of the common stock of Regulated to Enron Sub III should cause X percent of the earnings and profits of Holdco to "tier up" to Enron Sub III. Similarly, we believe the transfer by Enron and Enron Sub III of all of the stock of Regulated to Holdco should cause the earnings and profits of Regulated to "tier up" to Holdco. Given the clear "tier up" example in the regulations, we do not believe that the transfer by Enron Sub III of Regulated stock to Holdco should affect the "tier up" of X percent of Regulated's earnings and profits to Enron Sub III.

3. <u>Earnings and Profits Anti-avoidance Rule</u>

The earnings and profits rules contain an anti-avoidance rule that provides for adjustments as necessary to carry out the purposes of the rules if any person acts with a principal purpose contrary to the purpose of the rules, to avoid the effect of the rules, or to apply the rules to avoid the effect of any other provision of the consolidated return regulations. Treasury Regulation § 1.1502-33(g). The primary earnings and profits effects of the formation of Holdco and Enron Sub III on members of the Enron consolidated group are the duplication of all of Regulated's earnings and profits in Holdco and the duplication of X percent of the earnings and profits of Regulated in Enron Sub III. These earnings and profits effects will cause redemption distributions by Holdco to Enron Sub III and by Enron Sub III to Partnership to be treated as dividends.

The statement of the purpose of the earnings and profits rules (to treat a parent and a subsidiary as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent) is consistent with these effects. The rules cause the earnings and profits of Regulated to "tier up" to Holdco and Enron Sub III, which are higher-tier members in the Enron group. Reflecting the earnings and profits of Regulated in Holdco and Enron Sub III is consistent with treating the Enron consolidated group as a single entity. Accordingly, we do not believe that the earnings and profits anti-avoidance rule should be applicable to the formation of Holdco and Enron Sub III.

E. <u>Holdco Redemption</u>

1. <u>Dividend Treatment</u>

A distribution in redemption of stock from a corporate shareholder is treated as a sale or exchange of stock if the redemption is not essentially equivalent to a dividend, is substantially disproportionate with respect to the shareholder, or is in complete redemption of all of the stock of the corporation owned by the shareholder. Sections 302(a), 302(b). In general, the constructive ownership rules of section 318(a) apply for purposes of these tests. Section 302(c)(1). A redemption that is not treated as a sale or exchange under section 302(a) is treated as a distribution of property to which section 301 applies. Section 302(d).

Enron Sub III owns all of the preferred stock of Holdco. Under the constructive ownership rules of section 318, Enron Sub III owns all of the stock owned by Enron. Enron owns all of the common stock of Holdco. Applying the constructive ownership rules, Enron Sub III should be treated as owning all of the stock of Holdco both before and after a Holdco Redemption. In the absence of any change in Enron Sub III's ownership of Holdco as a result of a Holdco Redemption, the redemption would not be substantially disproportionate or a complete redemption of all stock of Holdco owned by Enron Sub III. Moreover, we believe such a redemption should not be treated as not essentially equivalent to a dividend. See United States v. Davis, 397 U.S. 301 (1970). Accordingly, we believe the redemption should not be treated as a sale or exchange under section 302(a) and should be treated as a distribution of property to which section 301 applies.

Under section 301(c)(1) and section 316, a distribution is treated as a dividend to the extent of the earnings and profits of the distributing corporation. Given current and accumulated earnings and profits of Holdco for the year in which Holdco Redemption occurs in excess of the aggregate amount of the redemption price plus all other actual or deemed section 301 distributions by Holdco for that year, the full amount of the redemption should be treated as a dividend from Holdco to Enron Sub III.

2. Section 312 Earnings and Profits and Section 302 Basis Effects

Under section 312, the earnings and profits of Enron Sub III should be increased by the amount of the dividend and the earnings and profits of Holdco should be decreased by the amount of the dividend. Under section 302, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Treas. Reg. § 1.302-2(c). The examples in Treasury Regulation § 1.302-2(c) suggest that the "proper adjustment" is to increase the basis of stock retained by the taxpayer by the amount of the taxpayer's basis in the redeemed stock, even where dividend treatment is based on constructive ownership of shares held by someone other than the taxpayer. See Treas. Reg. § 1.302-2(c) *Example (1)*, *Example (3)*. Accordingly, we believe the proper adjustment in the case of a Holdco Redemption of some, but not all, of Holdco preferred stock held by Enron Sub III should be to increase the basis of the remaining Holdco preferred stock held by Enron Sub III by the amount of the basis of Holdco preferred stock that is redeemed.

3. Consolidated Return Adjustments

In addition to the above effects under sections 312 and 302, the consolidated return regulations provide for earnings and profits adjustments and investment adjustments in connection with the dividend. Treas. Reg. §§ 1.1502-32, -33. Under the consolidated return regulations, the dividend should be excluded from Enron Sub III's income to the extent that Enron Sub III has a corresponding negative basis adjustment under the investment adjustment rules. Treas. Reg. §§ 1.1502-13(f)(2)(ii).

a. <u>Investment Adjustment Rules</u>

The consolidated return regulations provide for adjusting the basis of the stock of S owned by P to reflect S's distributions and S's items of income, gain, deduction, and loss taken into account for the period that S is a member of the consolidated group. Treas. Reg. § 1.1502-32(a)(1). The purpose of these adjustments (the "investment adjustment rules") is to treat P and S as a single entity so that consolidated taxable income reflects the group's income. <u>Id.</u> Adjustments to P's basis in S's stock under these rules are in addition to adjustments under other rules of law (e.g., section 1016), subject to the limitation that P's basis in S's stock must not be adjusted in a manner that has the effect of duplicating an adjustment. Treas. Reg. § 1.1502-32(a)(2). Adjustments are made as of the close of each consolidated return year, and as of any other time (an interim adjustment) if a determination at that time is necessary to determine a tax liability of any person. Treas. Reg. § 1.1502-32(b)(1).

The amount of the adjustment to P's basis in S's stock is the net amount of S's (i) taxable income or loss, (ii) tax-exempt income, (iii) noncapital, nondeductible expenses and (iv) distributions with respect to S's stock. Treas. Reg. § 1.1502-32(b)(2). Distributions, for these purposes, are distributions with respect to S's stock to which section 301 applies and all other distributions treated as dividends. Treas. Reg. § 1.1502-32(b)(3)(v).

The portion of an adjustment that is described in Treasury Regulation § 1.1502-32(b)(2)(iv) (the "negative distribution adjustment") is allocated to the shares of S's stock to which the distribution relates. Treas. Reg. § 1.1502-32(c)(1). The remainder of the net adjustment (the "net remainder adjustment") is allocated among the shares of S's stock according to a series of rules. If the net remainder adjustment is positive, it is allocated first to any preferred stock to the extent required (when aggregated with prior allocations) to reflect distributions described in section 301 (and all other distributions treated as dividends) to which the preferred stock becomes entitled, and arrearages arising, during the period that S is a member of the consolidated group. Treas. Reg. § 1.1502-32(c)(1), -32(c)(3). If the net remainder adjustment is negative, it is allocated only to common stock. Treas. Reg. § 1.1502-32(c)(1). If S has more than one class of common stock, the extent to which a net remainder adjustment is allocated to each class is determined by taking into account the terms of each class and all other facts relating to the overall economic arrangement. The allocation generally must reflect the manner in which the classes participate in the economic benefit or burden (if any) corresponding to the items of income, gain, deduction, or loss allocated. Treas. Reg. § 1.1502-32(c)(2)(ii). Within a single class of common stock, the net remainder adjustment is generally allocated equally to each share within the class. Treas. Reg. § 1.1502-32(c)(2)(i).

A member's basis in each share of S's preferred and common stock must be redetermined whenever necessary to determine the tax liability of any person. Treas. Reg. § 1.1502-32(c)(4)(i). The redetermination is made by reallocating S's net remainder adjustment for each consolidated return year (or other applicable period) of the group by taking into account all of the facts and circumstances affecting allocations as of the redetermination date. Id.

The redemption of Holdco preferred stock from Enron Sub III should be treated as a distribution subject to section 301 and as a dividend, creating a negative adjustment for the distribution which is allocated to the shares of Holdco stock to which the distribution relates.[23] Section 302(d) characterizes the redemption as a distribution to which section 301 applies, but does not identify the shares to which such distribution relates. The preamble to the proposed investment adjustment rules justifies the negative basis adjustment for all distributions based on the fact that a distribution always reduces the value of S's stock, and the basis adjustments reflect this decrease. Based on this explanation for the negative distribution adjustment and on the transfer of the basis of the redeemed shares to the Holdco shares retained by Enron Sub III, we believe the shares to which the Holdco Redemption distribution relates should be considered, for purposes of the investment adjustment rules, to be the Holdco shares retained by Enron Sub III. Accordingly, we believe the negative distribution adjustment attributable to the Holdco Redemption should be allocated to Enron Sub III.

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[23] Section 1059 adjustments, if any, are taken into account as noncapital, nondeductible expenses. Treas. Reg. § 1.1502-32(b)(3)(iii)(B). The legislative history of section 1059 indicates that basis reductions under section 1059 are not to be made if they would duplicate basis adjustments under the consolidated return rules with respect to distributions or deemed distributions. See S. Rep. 100-445, at 42, 43-44 (1988); H.R. Rep. No. 100-795, at 40, 42 (1988); H.R. Conf. Rep. No. 99-841, vol. II, at II-166 (1986); S. Rep. No. 99-313, at 250 (1985). Under the current investment adjustment regulations, a negative basis adjustment is required for all distributions between members of a consolidated group. Accordingly, any application of section 1059 to a dividend between members of a consolidated group would result in duplicate basis adjustments, contrary to the expressed intent of Congress. While the consolidated return regulations do not specifically state that section 1059 is not applicable within a consolidated group, they do prohibit duplicate basis adjustments. Treas. Reg. § 1.1502-32(a)(2). Furthermore, we believe the preamble to the proposed investment adjustment regulations implicitly recognizes that section 1059 is not applicable to transactions between members of a consolidated group. The preamble, in justifying the rule that all distributions result in negative investment adjustments, points out that providing exceptions to this rule would require special rules to implement section 1059(e)(2)(B) in certain cases. Based on the above authorities, we believe that section 1059 is not applicable to dividends between members of a consolidated group.

Treating the Holdco Redemption as a distribution with respect to the Holdco preferred stock retained by Enron Sub III, the allocation rules of Treasury Regulation § 1.1502-32(c)(1), -32(c)(3), and -32(c)(4) direct that positive net remainder adjustments be allocated, either from the current year or from prior years under a cumulative redetermination, to the Holdco preferred stock retained by Enron Sub III to the extent required (when aggregated with prior allocations to the Holdco preferred stock) to reflect the Holdco Redemption distribution plus all other distributions described in section 301 (and all other distributions treated as dividends) and arrearages with respect to the preferred stock. To the extent that positive investment adjustments with respect to Regulated common stock are reflected in the basis of the Holdco preferred stock, it might be argued that some portion of these adjustments already "reflect" the Holdco Redemption distribution in the basis of the Holdco preferred stock and no further positive investment adjustment is necessary. Similarly, if Holdco investment adjustments were allocated to the Holdco preferred stock in excess of the coupon on the Holdco preferred stock in order to reflect the liquidation preference of those shares in the unrealized appreciation of Regulated represented by the value of the Regulated common shares at the time of their contribution to Holdco by Enron Sub III, some portion of such investment adjustments might be viewed as "reflecting" the Holdco Redemption distribution. Under such a view, the positive adjustment required to reflect the Holdco Redemption distribution would equal the excess of the Holdco Redemption distribution over prior investment adjustments allocable to the Holdco preferred stock (including investment adjustments allocable to the Regulated common stock that Enron Sub III contributed to Holdco) that reflect the amount paid in the redemption. To the extent that the positive investment adjustment required to reflect the Holdco Redemption distribution is less than the full amount of the Holdco Redemption payment (i.e., the amount of the negative investment adjustment attributable to the distribution), the net investment adjustment with respect to the Holdco Redemption will be negative.[24]

b. <u>Earnings and Profits Rules</u>

The application of the earnings and profits rules to a Holdco Redemption is unclear, both because of difficulties in translating the principles of the investment adjustment rules to apply in the context of earnings and profits adjustments and because of the existence of special rules modifying the general rule in the earnings and profits rules. Looking first at the translation issue, under the investment adjustment rules, negative distribution adjustments are allocated to the

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24 To the extent that Holdco's current year positive net remainder adjustment is insufficient to match all previously unmatched section 301 distributions and other dividends with respect to its preferred stock, application of the cumulative redetermination rule as described above should result in a reduction of prior positive adjustments to the basis of Holdco common stock (or the predecessor shares of Regulated common stock) held by Enron. <u>See</u> Treas. Reg. § 1.1502-32(c)(5) *Example 3*.

shares of S stock to which the distribution relates and the net remainder adjustment is allocated among shares of S's stock in accordance with the rules set forth in Treasury Regulation § 1.1502-32(c). Since distributions are reflected in S's earnings and profits (which would be part of the net remainder adjustment) but not in S's taxable income, an issue arises whether the reduction in earnings and profits attributable to a distribution should be treated as a negative distribution adjustment or as an element of the net remainder adjustment. In the absence of any clear direction, we have considered the effects of both approaches.[25]

Treating the earnings and profits effects of a distribution as a separate item, and treating the Holdco Redemption/section 301 dividend as relating to the Holdco preferred stock retained by Enron Sub III, the reduction in Holdco's earnings and profits attributable to the Holdco Redemption/section 301 dividend should be allocated to Enron Sub III and positive net remainder adjustments, either from the current year or from prior years under a cumulative redetermination, should be allocated to the Holdco preferred stock retained by Enron Sub III in an aggregate amount equal to the excess of the amount of the Holdco Redemption/section 301 dividend over prior allocations of positive net remainder adjustments that are treated as reflecting the Holdco Redemption/section 301 dividend (e.g., positive net remainder adjustments with respect to Regulated common stock that are reflected in Enron Sub III's earnings and profits as a result of the contribution of the Regulated common stock to Enron Sub III). The net effect of these adjustments on Enron Sub III would be to reduce Enron Sub III's earnings and profits by the amount of any prior "tier up" of Regulated's or Holdco's earnings and profits that are treated as reflecting the redemption distribution, leaving Enron Sub III with earnings and profits, after the

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25 The one example in the earnings and profits rules that involves a distribution during a year in which a corporation has current earnings and profits contains language that suggests a netting approach. Treas. Reg. § 1.1502-33(b)(3)(ii) *Example 1*(c). In the example, S distributes $50 to P in a year during which S has $100 of current earnings and profits. The example concludes that "P's earnings and profits are increased by $100 (S's $50 of undistributed earnings and profits, plus P's receipt of the $50 distribution)." This statement suggests that the rules are applied by netting the $50 earnings and profits reduction from the distribution with the $100 of current earnings and profits, resulting in an adjustment equal to the net change in S's earnings and profits of $50. The language could be explained, however, as a summary of the net effects of application of the rules first to reduce P's earnings and profits by the $50 reduction in S's earnings and profits attributable to the distribution and then to increase P's earnings and profits by the $100 increase in S's earnings and profits attributable to other items. Accordingly, we do not believe this example is conclusive as to the manner in which the earnings and profits reduction attributable to a distribution is treated. But cf. Treas. Reg. § 1.1502-32(b)(5) *Example 5(a)* (describing investment adjustments for current distribution; "P increases its basis in S's stock . . . by a $110 net amount ($120 of taxable income, less a $10 distribution)").

section 312 increase for the dividend and the net earnings and profits adjustments, equal to the amount of the Holdco Redemption/section 301 dividend.[26]

Treating the earnings and profits effects of a distribution as an element of the net remainder adjustment, the excess of the Holdco Redemption/section 301 dividend over Holdco's current earnings and profits should result in a negative net remainder adjustment. Negative net remainder adjustments are allocated only to common stock. Accordingly, under this view there would be no adjustments to Enron Sub III's earnings and profits, leaving Enron Sub III with section 312 earnings and profits equal to the amount of the Holdco Redemption/section 301 dividend plus the amount of any prior "tier up" of earnings and profits. (Presumably a cumulative redetermination would not allocate positive net remainder adjustments to Enron Sub III in the amount of the Holdco Redemption/section 301 dividend because that distribution is already "reflected" by the inclusion of the earnings and profits effects of the distribution in the net remainder adjustment for the year of the distribution. Moreover, it would appear that future dividend distributions on the Holdco preferred should be treated as already "reflected" to the extent of the lesser of the negative remainder adjustment created by the Holdco Redemption and any prior "tier up" of earnings and profits that is treated as reflecting the Holdco Redemption /section 301 dividend.)

4. <u>Anti-avoidance Rules</u>

The investment adjustment rules contain an anti-avoidance rule which calls for adjustments to be made to carry out the purpose of the investment adjustment rules if a person acts "with a principal purpose which is contrary to the purpose of [the investment adjustment rules], to avoid the effect of [the investment adjustment rules], or to apply [the investment adjustment rules] to avoid the effect of any other provision of the consolidated return regulations." Treas. Reg. § 1.1502-32(e)(1). The purpose of the investment adjustment rules is to treat the shareholder/member and the subsidiary as a single entity so that consolidated taxable income reflects the group's income. Treas. Reg. § 1.1502-32(a)(1).

The examples under the investment adjustment anti-avoidance rule suggest that it is applicable where stock ownership or affiliated status is manipulated in order either to obtain the benefits of positive investment adjustments without bearing the burden of corresponding negative investment adjustments (Examples 1, 4, 5) or to shift basis among group members or among

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26 This assumes that any prior tier up of earnings and profits that reflect the redemption distribution has been retained by Enron Sub III. This should be the case where there have been no Enron Sub III Redemptions prior to a Holdco Redemption and Enron Sub III has current earnings and profits in each year in excess of all distributions (other the Enron Sub III Redemptions) made on its stock.

classes of stock, thereby reducing gain recognition on an anticipated sale (Examples 2, 3). Treas. Reg. § 1.1502-32(e)(2) *Examples 1-5*. A Holdco Redemption will not have any direct or indirect federal income tax effect on members of the Enron consolidated group other than the section 312 transfer of earnings and profits from Holdco to Enron Sub III and any investment and earnings and profits adjustments attributable to a Holdco Redemption. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a Holdco Redemption. There is no current plan or intention, and there will be no plan or intention at the time of any Holdco Redemption, that any member of the Enron consolidated group dispose of any stock of Holdco or Enron Sub III except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to a Holdco Redemption. Based on these facts, we believe that neither Enron nor any of its Affiliates should be considered to have a principal purpose which is contrary to the purposes of the investment adjustment rules, to avoid the effect of the investment adjustment rules, or to apply the investment adjustment rules to avoid the effect of any other provision of the consolidated return regulations.

The earnings and profits rules contain an anti-avoidance rule that provides for adjustments as necessary to carry out the purposes of the rules if any person acts with a principal purpose contrary to the purpose of the rules, to avoid the effect of the rules, or to apply the rules to avoid the effect of any other provision of the consolidated return regulations. Treasury Regulation § 1.1502-33(g). The primary earnings and profits effect of Holdco Redemption on members of the Enron consolidated group is the transfer of earnings and profits of a Holdco to Enron Sub III. This earnings and profits effect will cause a distribution by Enron Sub III to Partnership in redemption of Enron Sub III preferred stock to be treated as a dividend.

The statement of the purpose of the earnings and profits rules (to treat a parent and a subsidiary as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent) provides little real guidance against which to measure the effect of a mechanical application of the rules to a Holdco Redemption. The allocation rules reflect the earnings and profits of Holdco in Enron Sub III, which appears to be a higher-tier member in that it owns stock of Holdco. Moreover, reflecting the earnings and profits of Holdco in Enron Sub III seems to be consistent with treating the Enron consolidated group as a single entity.

The attempt to deduce a more detailed purpose for the earnings and profits adjustments as applied to redemptions by looking at the detailed rules is equally disappointing, since the detailed rules appear to provide diametrically opposed results in the case of a redemption depending on whether the redemption dividend relates to preferred or common stock. A redemption dividend that relates to common stock would appear to require a corresponding allocation of earnings and profits pro rata to each share of common stock or, in the case of more than one class of common stock, to the various classes of common stock based on the manner in which each class shares in the economic benefits or burdens associated with the earnings and profits. In contrast, a redemption dividend that relates to preferred stock appears to require a corresponding allocation of earnings and profits to the preferred stock, without regard to the manner in which various classes of stock share in the economic benefits or burdens associated with the earnings and profits.

Given a clearly stated mechanical rule with respect to the manner in which earnings and profits are allocated to preferred stock with respect a distribution to which that stock is entitled, it is difficult to see how the statement of purpose in the earnings and profits rules would justify a conclusion that a redemption transaction produces a result that is contrary to the purposes of the rules. The Service might argue, however, that the purposes of the rules are not limited to treating the group as a single entity. In support of its position, the Service could point to the fact that the purpose is implemented by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent (i.e., tiering profits upstream through the ownership chain only). If single entity treatment were the sole purpose of the regulations, earnings and profits should be tiered downstream through a chain as well as upstream. Moreover, the change in location provision indicates that the earnings and profits rules are concerned with the location of earnings and profits within a group as well as with the consolidation of earnings and profits in the ultimate parent of the group.

The Service might also point to the preamble to the regulations, which describes the earnings and profits system as "fundamentally concerned with measuring dividend paying capacity. . . ." T.D. 8560, 1994-2 C.B. 200, 201. The Service might argue that the earnings and profits rules are designed to "tier up" earnings and profits to reflect the economic interest in earnings and profits of shareholders that are "upstream" in the corporate chain from those earnings and profits, thereby reflecting the dividend paying capacity of such higher-tier members. Based on this theory, the Service might argue that, economically, Enron Sub III has no dividend paying capacity in excess of that attributable to the coupon it receives on Holdco preferred stock. While the Enron consolidated group has dividend paying capacity attributable to Holdco's accumulated earnings and profits, the economics supporting that dividend paying capacity remain with the Holdco common stock. Given that the dividend characterization of a Holdco Redemption is inconsistent with the economics of the transaction vis-a-vis Enron Sub III (i.e., without regard to Enron Sub III's constructive ownership of Holdco common stock held by

Enron), the Service might argue that such a dividend should not carry earnings and profits with it in a consolidated group.

This argument fails to explain the reasons for the disparate treatment by the earnings and profits rules of redemption dividends relating to preferred stock and redemption dividends relating to common stock. While the common stock allocation rules key off of economics, the preferred stock allocation rules look exclusively to the entitlement to distributions, without reference to economics. Given the conflict between the view of the earnings and profits regulations as reflecting economic dividend paying capacity and the clearly stated mechanical rule relating to allocations to preferred stock, we believe the purposes of the earnings and profits rules as applied to redemption dividends that relate to preferred stock are so vague as to make application of the anti-avoidance rule difficult. Nevertheless, where a transaction is specifically structured to put a taxpayer in the position of utilizing a mechanical rule to its own advantage, we believe there is a risk that a court would sustain an application of the earnings and profits anti-avoidance rule.

There is no current plan or intention, and there will be no plan or intention at the time of any Holdco Redemption, that any member of the Enron consolidated group dispose of any stock of Holdco or Enron Sub III except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to a Holdco Redemption. Under these circumstances, we believe that neither the investment adjustment anti-avoidance rule nor the intercompany transaction anti-avoidance rule should be applicable to a Holdco Redemption.

F. <u>Enron Sub III Redemption</u>

1. <u>Dividend Treatment</u>

A distribution in redemption of stock from a corporate shareholder is treated as a sale or exchange of stock if the redemption is not essentially equivalent to a dividend, is substantially disproportionate with respect to the shareholder, or is in complete redemption of all of the stock of the corporation owned by the shareholder. Sections 302(a), 302(b). A pro rata redemption from all shareholders cannot satisfy any of these conditions. Accordingly, we believe an Enron Sub III Redemption should be treated as a distribution of property to which section 301 applies. Section 302(d).

Under section 301(c)(1) and section 316, a distribution is treated as a dividend to the extent of the earnings and profits of the distributing corporation. Given current and accumulated earnings and profits of Enron Sub III, determined without regard to any Holdco Redemptions and without regard to any Enron Sub III Redemptions, for the taxable year in which the Enron Sub III Redemption occurs in excess of the aggregate amount of any distributions, other than an Enron Sub III Redemption, made or deemed made by Enron Sub III to its shareholders during such year, the full amount of the redemption should be treated as a dividend from Enron Sub III to each redeemed shareholder.

2. Section 312 Earnings and Profits and Section 302 Basis Effects

Under section 312, the earnings and profits of each redeemed shareholder should be increased by the amount of the dividend and the earnings and profits of Enron Sub III should be decreased by the amount of the dividend. Under section 302, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Treas. Reg. § 1.302-2(c). The examples in Treasury Regulation § 1.302-2(c) suggest that the "proper adjustment" is to increase the basis of stock retained by the taxpayer by the amount of the taxpayer's basis in the redeemed stock, even where dividend treatment is based on constructive ownership of shares held by someone other than the taxpayer. See Treas. Reg. § 1.302-2(c) *Example (1)*, *Example (3)*. Accordingly, we believe the proper adjustment in the case of an Enron Sub III Redemption of some, but not all, of the Enron Sub III stock held by a shareholder should be to increase the basis of the remaining Enron Sub III stock held by the shareholder by the amount of the basis of the Enron Sub III stock that is redeemed.

We believe that each partner's distributive share of Partnership's dividend income from an Enron Sub III Redemption should increase the basis of the partner's interest in Partnership and that there should not be any reduction in such basis for any dividends received deduction that may be allowable to the partner. Section 705(a)(1)(A) and (B); Treas. Reg. § 1.705-1(a)(2)(ii) (a partner's basis is increased by tax-exempt receipts of the partnership).

3. Consolidated Return Adjustments

In addition to the above effects under sections 312 and 302, the consolidated return regulations provide for earnings and profits adjustments and investment adjustments in connection with the dividend. Treas. Reg. §§ 1.1502-32, -33. The earnings and profits adjustments and the investment adjustments attributable to an Enron Sub III Redemption relate primarily to the allocation between Enron Sub III's common and preferred stock of Enron Sub III's earnings and profits and investment adjustments.

The investment adjustment rules contain an anti-avoidance rule which calls for adjustments to be made to carry out the purpose of the investment adjustment rules if a person acts "with a principal purpose which is contrary to the purpose of [the investment adjustment rules], to avoid the effect of [the investment adjustment rules], or to apply [the investment adjustment rules] to avoid the effect of any other provision of the consolidated return regulations." Treas. Reg. § 1.1502-32(e)(1). The purpose of the investment adjustment rules is to treat the shareholder/member and the subsidiary as a single entity so that consolidated taxable income reflects the group's income. Treas. Reg. § 1.1502-32(a)(1). The examples under the investment adjustment anti-avoidance rule suggest that it is applicable where stock ownership or affiliated status is manipulated in order either to obtain the benefits of positive investment adjustments without bearing the burden of corresponding negative investment adjustments (Examples 1, 4, 5) or to shift basis among group members or among classes of stock, thereby reducing gain recognition on an anticipated sale (Examples 2, 3). Treas. Reg. § 1.1502-32(e)(2) *Examples 1-5*.

The earnings and profits rules contain an anti-avoidance rule that provides for adjustments as necessary to carry out the purposes of the rules if any person acts with a principal purpose contrary to the purpose of the rules, to avoid the effect of the rules, or to apply the rules to avoid the effect of any other provision of the consolidated return regulations. Treasury Regulation § 1.1502-33(g). The primary earnings and profits effect of the Enron Sub III Redemption on members of the Enron consolidated group is the reduction under section 312 of the earnings and profits of Enron Sub III.

A Enron Sub III Redemption will not have any direct or indirect federal income tax effect on members of the Enron consolidated group other than the section 312 earnings and profits effects and any investment and earnings and profits adjustments attributable to the Enron Sub III Redemption. A Enron Sub III Redemption will not (i) alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Enron Sub III Redemption) by members of the Enron consolidated group to nonmembers that are treated as made out of earnings and profits or (ii) result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Enron Sub III Redemption on the earnings and profits of members of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to an Enron Sub III Redemption. There is no current plan or intention, and there will be no plan or intention at the time of any Enron Sub III Redemption, that any member of the Enron consolidated group dispose of any stock of Holdco, Enron Sub II, or Enron Sub III except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to an Enron Sub III Redemption. Based on these facts, we believe that neither Enron nor any of its Affiliates should be considered to have a principal purpose which is contrary to the purposes of the investment adjustment rules, to avoid the effect of the investment adjustment rules, or to apply the investment adjustment rules to avoid the effect of any other provision of the consolidated return regulations. Under these circumstances, we believe that neither the investment adjustment anti-avoidance rule nor the intercompany transaction anti-avoidance rule should be applicable to an Enron Sub III Redemption.[27]

4. Intercompany Transaction Rules

Based on the same analysis as set forth above relating to a Purchase, we believe that the intercompany transaction anti-avoidance rule should not be applicable to an Enron Sub III Redemption.

5. Dividends Received Deduction

a. Section 243

SPVCo directly owns 20 percent of the common stock of Enron Sub III. Accordingly, we believe the applicable percentage for determining SPVCo's dividends received deduction should be 80 percent.[28]

b. Section 246

Each shareholder of Enron Sub III stock will have a holding period of at least 45 days in such stock at the time of an Enron Sub III Redemption. Accordingly, we believe the holding period requirement of section 246(c)(1) should be satisfied.

In the case of stock having a preference in dividends, the required holding period is extended to 90 days if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days. Section 246(c)(2). The Service might argue that the 90 day holding period is applicable if the earnings and profits that support the dividend character of an Enron Sub III Redemption were accrued over a period of more than 366 days. The Service might further argue that the disposition in the Enron Sub III

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27 We have not analyzed the specific earnings and profits and investment adjustments that would be required under the consolidated return regulations with respect to a Enron Sub III Redemption. The specifics of those adjustments are not critical to our analysis of the application of the anti-avoidance rules, given the facts set forth in the text above.

28 As discussed above, one of the revenue proposals int he President's fiscal year 1998 proposed budget would deny the dividends received deduction with respect to dividends on certain preferred stock, including preferred stock of Enron Sub III if it were issued more than 30 days after the date of enactment of the proposal.

Redemption of some of the Enron Sub III preferred shares prevented those shares from satisfying the 90 day holding period requirement, triggering the application of section 246(c) to deny the dividends received deduction. Such an argument requires that the Enron Sub III Redemption dividend be treated as paid on the redeemed Enron Sub III preferred stock. We believe a redemption dividend is more appropriately treated as paid on stock retained by the shareholder. See H.R. Conf. Rep. No. 98-861, at 817 (1984) ("if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to stock of the shareholder which is not redeemed"). Moreover, where the basis of the redeemed shares is added to the basis of the retained shares, and assuming the 90 day holding period will be satisfied with respect to the retained shares prior to any disposition of those shares, we believe the case for applying section 246(c)(2) to deny the dividends received deduction would be weak. Accordingly, we believe that the holding period requirement of section 246(c)(2), if applicable, should be satisfied.

c. Section 246(b)

The discussion above with respect to the potential application of section 246(b) to SPVCo's distributive share of a section 304 dividend is equally applicable to its distributive share of an Enron Sub III Redemption dividend.

d. Section 246A

As discussed above, section 246A reduces the percentage used in computing the dividends received deduction "in the case of any dividend on debt-financed portfolio stock." SPVCo owns 20 percent of the common stock of Enron Sub III and Enron owns the remaining 80 percent of the common stock of Enron Sub III. Thus, SPVCo owns stock of Enron Sub III that satisfies the 20 percent ownership test and one corporation (Enron) owns stock of Enron Sub III that satisfies the 50 percent test with respect to Enron Sub III. Accordingly, we believe that section 246A should not be applicable to reduce the dividends received deduction of SPVCo with respect to any dividend income on Enron Sub III stock.

6. Section 1059

a. Pro Rata Redemption

An Enron Sub III Redemption is a redemption of identical percentages of Enron Sub III common and preferred stock. Such a redemption has no effect on the relative holdings of any shareholder. We believe an Enron Sub III Redemption should be considered pro rata for purposes of section 1059(e).

b. Two-Year Holding Period

Where a redemption is pro rata, a second threshold question for application of section 1059 is whether the stock with respect to which the dividend is received has been held by the corporation for more than two years before the dividend announcement date. Partnership's holding period in Enron Sub III's preferred stock would not exceed this threshold two-year period in the case of an Enron Sub III Redemption occurring within two years of Partnership's acquisition of the Enron Sub III preferred stock. Accordingly, we believe an Enron Sub III Redemption that has an announcement date within two years of Partnership's acquisition of Enron Sub III's preferred stock will be subject to section 1059 unless the resulting dividend is not an extraordinary dividend. (See the discussion of the threshold percentage test for extraordinary dividends, below.)

The term "dividend announcement date" means the date on which the corporation declares, announces, or agrees to the amount or payment of such dividend, whichever is the earliest. Section 1059(d)(5). The legislative history of this provision states that "[i]f there is a formal or informal agreement to pay the particular dividend prior to the declaration date, the date of such agreement shall be treated as the dividend announcement date for purposes of applying the two-year holding period requirement." H.R. Conf. Rep. No. 99-841, vol. II, at II-164 (1986). While it is anticipated that a substantial portion of the preferred stock of Enron Sub III may be redeemed over time, the timing and amount of Enron Sub III Redemptions will be contingent on a variety of factors, including the continued availability of the anticipated accounting treatment of such transactions and the financial position of Enron and its Affiliates that are included in its consolidated financial statements. With respect to any Enron Sub III Redemption that may occur more than two years after the 302 Start Date, there is currently no fixed plan as to the date or amount of any such Enron Sub III Redemption and there will be no announcement, action by Enron Sub III's board of directors, formal or informal agreement or fixed plan, commitment, or other action relating to the amount or the time of such Enron Sub III Redemption within two years of the 302 Start Date. Based on these facts, we believe that, with respect to an Enron Sub III Redemption that occurs after the date that is two years after the 302 Start Date, the dividend announcement date also should be more than two years after the 302 Start Date.

c. Threshold Percentage

In the case of an Enron Sub III Redemption that occurs within two years of Partnership's acquisition of the Enron Sub III preferred stock, the characterization of a dividend as extraordinary will be significant. In general, the term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds 10 percent (5 percent in the case of stock which is preferred as to dividends) of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends received within an 85-day period, or exceeds 20 percent of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends having ex-dividend dates within an 365-day period. Section 1059(c).

Enron Sub III will not, during any 85 day period that begins within two years of Partnership's acquisition of Enron Sub III preferred stock, redeem from Partnership Enron Sub III preferred stock having, in the aggregate, a value greater than the excess of 5 percent of Partnership's basis in its Enron Sub III preferred stock over the sum of all dividends on such stock that are received by Partnership or have an ex-dividend date during such 85 day period. Enron Sub III will not, during any 365 day period that begins within two years of Partnership's acquisition of Enron Sub III preferred stock, redeem from Partnership Enron Sub III preferred stock having, in the aggregate, a value greater than the excess of 20 percent of Partnership's basis in its Enron Sub III preferred stock over the sum of all dividends on such stock that are received by Partnership or have an ex-dividend date during such 365 day period. Based on these facts, we believe a dividend attributable to an Enron Sub III Redemption that occurs within two years of Partnership's acquisition of Enron Sub III's stock should not be treated as exceeding the threshold percentage.[29]

d. Disqualified Preferred Stock

Any dividend with respect to disqualified preferred stock is treated as an extraordinary dividend subject to section 1059(a) without regard to the period the taxpayer held the stock. Section 1059(f)(1). Disqualified preferred stock means any stock which is preferred as to dividends if:

(A) when issued, such stock has a dividend rate which declines (or can reasonably be expected to decline) in the future,

(B) the issue price of such stock exceeds its liquidation rights or its stated redemption price, or

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[29] As discussed above, we believe that section 1059 should be applied with respect to the section 304 dividend attributable to a Purchase by reference to the stock of Enron Sub II. Accordingly, we believe that, for purposes of applying section 1059 to an Enron Sub III Redemption, no portion of a section 304 dividend attributable to a Purchase should be treated as a dividend with respect to the Enron Sub III preferred stock retained by Partnership. If, contrary to our view, a court were to treat section 304 dividends as dividends with respect to Enron Sub III stock, such dividends would have to be taken into account in applying the threshold percentage test of section 1059 to an Enron Sub III Redemption.

(C) such stock is otherwise structured --

(i) to avoid the other provisions of [section 1059], and

(ii) to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of stock.

Section 1059(f)(2).

The Enron Sub III preferred stock is preferred as to dividends. The dividend rate on the Enron Sub III preferred stock is a floating rate based on LIBOR. The spread over LIBOR is fixed and does not decline over time. The legislative history of section 1059(f) states that the provision is not intended to apply to dividends on floating rate or auction rate preferred stock whose dividend rate declines solely in response to changes in prevailing market conditions. Committee on Finance, 101st Cong., 1st Sess., Revenue Reconciliation Act of 1989, Explanation of Provisions Approved by the Committee on October 3, 1989, 64 (Comm. Print 1989). Accordingly, we believe the Enron Sub III preferred stock should not be treated as described in section 1059(f)(2)(A).[30] The issue price of the Enron Sub III preferred stock does not exceed its liquidation rights or its stated redemption price. Accordingly, we believe the Enron Sub III preferred stock should not be treated as described in section 1059(f)(2)(B). Finally, neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the partners of Partnership (in the aggregate), to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable,

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[30] If the dividends resulting from Purchases and/or Enron Sub III Redemptions were taken into account, it might be argued that the dividend rate on the Enron Sub III preferred stock can reasonably be expected to be higher during the period when Purchases and/or Enron Sub III Redemptions occur and lower in later years. The legislative history of section 1059(f) identifies the provision as requiring basis reduction for the nontaxed portion of dividends on self-liquidating stock and states the reason for change as follows: "Corporate stockholders may receive dividends eligible for the dividends received deduction in circumstances where the dividends more appropriately should be characterized as a return of capital. . . . The committee believes that basis reduction in such cases is appropriate to accurately reflect the true economic effect of these types of transactions." H.R. Rep. No. 101-247, at 63 (1989). We do not believe section 1059(f)(2)(A), which is premised on a true economic effect of a transaction being a return of capital, should be applied to require a basis reduction for a transaction (a redemption) that is in form a capital transaction but that has been recharacterized by section 302 as being economically equivalent to a dividend.

directly or indirectly, to a Purchase or an Enron Sub III Redemption. Accordingly, we believe the Enron Sub III preferred stock should not be treated as described in section 1059(f)(2)(C).[31]

G. Partnership Anti-abuse Rule

Under the partnership anti-abuse rule:

> [I]f a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of Subchapter K.

Treas. Reg. § 1.701-2(b). In the absence of any purpose to reduce the present value of the aggregate federal tax liability of the partners of Partnership, the partnership anti-abuse rule should not be applicable.

In order to apply this threshold test, it is necessary to determine a baseline aggregate federal tax liability of the partners in order to determine whether a transaction reduces the present value of the partners' aggregate federal tax liability. In determining the tax reduction purpose of a transaction, it seems logical to look at the tax position the taxpayer would have been in if it had not done the transaction. In order to do this, one must determine the scope of a "transaction" in order to determine the tax effects of not doing the transaction.

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31 Section 1503(f) applies to a subsidiary of a consolidated group that pays dividends on section 1504(a)(4) stock held by a nonmember. The provision denies the use of certain tax attributes of any other member of the group against a portion of the subsidiary's separate taxable income for the year equal to the amount of the dividend distribution. Section 1503(f)(4) states that the Secretary "shall" prescribe such regulations as may be necessary or appropriate to carry out the provisions of section 1503(f), including regulations to provide rules for cases in which the subsidiary owns (directly or indirectly) stock in another member. The legislative history of section 1503(f) states that, except as the Treasury Department may otherwise provide, it is expected that regulations will provide that the separately computed taxable income of any distributing corporation shall include an allocable portion of the separately computed taxable income of any other member of the group whose stock the distributing corporation holds directly or indirectly, as necessary to prevent avoidance of the provisions. H.R. Rep. No. 101-386, at 549-50 (1989). These regulations are expected to be effective as of the effective date of the provision. Id. at 550. Retroactive regulations under section 1503(f)(4) (or a determination that section 1503(f)(4) is self-executing in the absence of regulations) might deny the use of current or carryover net operating losses or credits of the group against the separately computed income of Enron Sub III or the tax liability thereon.

The maximum scope of a transaction for these purposes would include a particular step that produces a tax benefit (the "goal step") and all other steps ("related steps") that would not have been done if the goal step were not done. In the instant case, the goal step would be creating the potential for deductions with respect to tax basis in excess of the book value of assets ("excess basis"). The related steps would be all elements of the proposal, including the formation and capitalization of SPVCo, Enron GP, Enron Sub III, Holdco, and Partnership. Under this view of what constitutes the transaction, two of the partners of Partnership (SPVCo and Enron GP) would not exist if the transaction were not done. It seems reasonable to believe that the tax liability of a partner that does not exist in the absence of the transaction would be determined by looking to the tax liability of the persons that own the assets that would have been transferred to the partner. Under this view, the baseline would be the present value of the aggregate tax liability of the Enron consolidated group, and BT Sub if no steps are taken to execute the transactions described in the facts above.

Given a baseline that includes the tax liability of the Enron consolidated group, it would seem that any comparison of (i) the aggregate tax liability of the partners to (ii) the baseline tax liability should include the effects of the transaction on the tax liabilities that are included in the baseline, including the tax liability of the Enron consolidated group. Thus, the effects on the Enron consolidated group tax liability of transferring assets (and related income) from the Enron consolidated group to the SPVCo structure and of transactions between the Enron consolidated group and the SPVCo structure (e.g., the interest payments from Enron to Partnership on Partnership investments in Enron securities) would have to be taken into account along with the net tax liability of SPVCo and changes in the tax liability of BT Sub attributable to the transaction.

A more limited view of what constitutes a "transaction" would include the goal step and those other steps ("enabling steps") that are required in order to make the goal step possible. In the instant case, the enabling steps would be the steps required to create the excess basis (e.g., a Purchase or an Enron Sub III Redemption) and any steps taken to utilize that basis (e.g., section 732(c) distributions). Under this view, the baseline would be the tax liability of the partners if all steps of the proposal are executed except the Purchase or the Enron Sub III Redemption. The effects of the formation and capitalization of, and investments by, SPVCo and Partnership on the Enron consolidated group would be the same in the baseline as in the actual transaction, and accordingly would be irrelevant under this view. The change in tax liabilities as compared to the baseline would be attributable to the transaction increasing the income of the partners by the amount of the dividend income in excess of the dividends received deduction and decreasing the income of the partners by the amount of the deductions attributable to excess basis. The timing of these effects would be affected by the time at which the partners trigger deductions attributable to the excess basis.

A minimum view of what constitutes a "transaction" would treat each separate step as a transaction. In the instant case, under this view, each step of the proposal (e.g., the formation, a Purchase, an Enron Sub III Redemption, a section 732(c) distribution, or a triggering of deductions attributable to excess basis) would be a transaction. The baseline could be the tax liability of the partners determined as if any one step was not done. Under this view, reductions in the aggregate tax liability of the partners could be caused by transactions that invoke specific provisions of subchapter K to create a tax benefit (e.g., a section 732(c) distribution that converts basis in one asset into basis in another asset that has a greater tax benefit to the partners), or by the triggering of a deduction of excess basis.

In the absence of any authority indicating which of these approaches is most appropriate, we have considered the potential application of the partnership anti-abuse rule under each approach. There will be no present value tax benefit to the partners in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron when both dividend income and deductions attributable to a Purchase or an Enron Sub III Redemption are taken into account. There will be no present value tax benefit to the Enron consolidated group, SPVCo, Enron GP, BT Sub, and their Affiliates, in the aggregate, taking into account all of the transactions described above. Accordingly, we believe that under either the maximum or a limited view of the meaning of the term "transaction" in the partnership anti-abuse regulation, the regulation should not be applicable.

Under a minimum view of what constitutes a transaction, certain transactions (e.g., the triggering of a deduction, a liquidating distribution subject to section 732(c)), when viewed in isolation, may reduce the tax liability of the partners. Once it has been determined that a transaction reduces the present value of the partners' aggregate tax liability, it is necessary to determine whether that effect is inconsistent with the intent of subchapter K.

The tax reduction effects of a transaction that triggers a deduction attributable to an earlier Purchase or Enron Sub III Redemption could be duplicated without the use of a partnership (although the accounting benefits of the transaction could not be duplicated without a partnership). We believe that tax results that could be achieved without the use of a partnership should not be considered to be inconsistent with the intent of subchapter K.

The analysis of transactions that invoke specific provisions of subchapter K (e.g., section 732(c)) to create a tax benefit that would not be available in the absence of Partnership is more difficult. The anti-abuse rule includes a list of factors that may be indicative of the proscribed effect. The first negative factor is that the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. Treas. Reg. § 1.701-2(c)(1). This factor is apparently applied as if all transactions occur. See Treas. Reg. § 1.701-2(d) *Example 6*, *Example 7*, *Example 8*. Assuming transactions that result in a reduction of the partners' aggregate federal tax liability as compared to direct ownership of the assets (e.g., transactions that invoke section 732(c) to convert a capital deduction into a more beneficial ordinary deduction), we believe there is a risk that the Service would argue that the transaction produces results that are inconsistent with the intent of subchapter K.

The partnership anti-abuse rule provides little guidance on when the application of a provision of subchapter K in accordance with its terms should be viewed as producing results that are inconsistent with the intent of subchapter K. While the text of the abuse-of-subchapter K rule is illustrated by a series of eleven examples, these examples confuse as much as elucidate the interpretation of the abuse-of-subchapter K rule. All three of the "bad" examples (i.e., examples that permit the Commissioner to recast the transactions) involve a partnership that was formed with a view to achieving a particular tax result, a partner who became a partner with a view to achieving such a result, and/or property that is introduced into the transaction to achieve the desired result, suggesting that these factors cause a literal application of the rules of subchapter K to produce results that are inconsistent with the intent of subchapter K. Several of the "good" examples (i.e., examples where the abuse-of-subchapter K rule is not violated), however, also involve partnerships that were formed with a view to achieving a favorable (sometimes very favorable) tax result. The conclusory statements in the examples provide no substantive analysis distinguishing the "good" tax planning examples from the "bad" tax planning examples. In the absence of a transaction that is virtually identical to an example in the regulations, we believe the anti-abuse rule should not be interpreted to alter the application of a mechanical rule of subchapter K.

The Service might argue that the mechanical rules of subchapter K should not be applied literally based on general factors rather than particular examples, and in particular based on a substantial tax avoidance purpose at the time the partnership is formed, or on the magnitude of the tax benefits created by its application. Absent clearly expressed legislative intent to the contrary, the unambiguous language of a statute is controlling under all but rare and exceptional circumstances. Crooks v. Harrelson, 282 U.S. 55, 60 (1930). If the intent of Congress in drafting a rule (e.g., to allocate basis in proportion to the relative bases of the distributed property under section 732(c)) is clear, the regulation cannot change that rule. If the statute is silent or ambiguous, then the regulation may fill the gap with a reasonable interpretation. Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-43 (1984); see also National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 476-77 (1979). We believe the intent of Congress to have the mechanical rules of subchapter K apply without regard to tax motivations is clear. In view of this Congressional intent, we believe a regulatory interpretation of a mechanical rule that alters its application based on the presence or absence of tax motivation or the magnitude of tax benefits should not be considered a reasonable interpretation.

The overriding purpose of the drafters of subchapter K in 1954 was to eliminate confusion. The "vital need" was "clarification." S. Rep. No. 83-1622, at 89 (1954). Beyond the need for clarification, the drafters cited the principles of "simplicity, flexibility and equity as between the partners." Id. Conditioning the application of the literal language of provisions of subchapter K on the presence or absence of a tax avoidance motive would operate to defeat these stated legislative purposes. Moreover, the contemporary legal context in 1954 indicates that tax avoidance motives were not relevant, unless specifically made so by statute. Prior to 1954, the Supreme Court had clearly stated that the tax motivation of taxpayers does not alter what would otherwise be the result of the application of the tax law to a transaction. Gregory v. Helvering, 293 U.S. 465, 469 (1935); Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-96 (1930). The Supreme Court had also implicitly extended this principle to partnerships. Commissioner v. Culbertson, 337 U.S. 733 (1940); see also Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935) (cert. denied). The issue of the effect of a tax avoidance motivation on the validity of partnerships had been clearly presented to and considered by Congress prior to 1954 in the context of family partnerships. The Congressional response was to disregard tax motivation. See sections 191 and 3797(a)(2) of the Internal Revenue Code of 1939. Congress clearly knew how to address the issue of tax avoidance in general, and in the context of partnerships, when it wanted to. See section 129 of the Internal Revenue Code of 1939; section 704(b)(2) as enacted in 1954. Moreover, despite repeated examples of tax motivated uses of partnerships since 1954, Congress has failed to enact a broad, general, subjective intent based limitation on the literal application of the provisions of subchapter K. Instead, Congress has repeatedly addressed tax avoidance transactions involving partnerships by enacting specific rules which generally are applied based on objective factors. See, e.g., sections 704(c)(1)(B), 707(a)(2), 737.

The examples in the abuse-of-subchapter K rule suggest that the rule is also intended to expand upon judicial doctrines, primarily by requiring that the tax motivation for a transaction be taken into account in applying those doctrines. Generally, the courts have not taken tax motivation into account in determining whether a transaction is a sham, a transaction has a substantial business purpose, the step transaction is applicable, or the substance of a transaction matches its form. See, e.g., Knetsch v. United States, 364 U.S. 361, 365 (1960); Gregory v. Helvering, 293 U.S. 465, 469 (1935). But cf. Sheldon v. Commissioner, 94 T.C. 738 (1990). In contrast to the virtual unanimity in the courts with respect to the role of tax avoidance motivation under these doctrines, some controversy has arisen in recent years with respect to the issue of the role of tax motives in the determination of whether the profit motive requirement of various Code provisions (e.g., sections 162, 165(c)(2), 183, and 212) has been satisfied. While the test is often described as requiring a primary purpose of realizing a profit, the cases generally have considered the relative weight of profit motive only in comparison to personal motives. See Portland Golf Club v. Commissioner, 497 U.S. 154 n.16 (1990); Snyder v. Commissioner, 674 F.2d 1359 (10th Cir. 1982). In commercial transactions, where personal motives are not at issue, in some cases the courts have analyzed the facts of the transaction to determine whether a profit motive existed. In general, the finding of a profit motive has been sufficient for the courts to hold in favor of the taxpayer without further analysis. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Levy v. Commissioner, 91 T.C. 838 (1988). There have, however, been some tax shelter cases in which the courts have expanded their inquiry to consider the primacy of the profit motive as compared to the tax motive. See, e.g., Estate of Baron v. Commissioner, 83 T.C. 542 (1984), aff'd, 798 F.2d 65 (2d Cir. 1986); Fox v. Commissioner, 82 T.C. 1001 (1984). It remains to be seen whether tax motivation will play a significant role in the determination of whether a profit motive requirement within a particular Code provision is satisfied.

It has long been settled case law that tax motivation does not affect the qualification of an organization as a partnership. Culbertson. Furthermore, to date there has been no decision applying a "primarily for profit" requirement to the definition of partnerships or to any provision of subchapter K. But see Brannen v. Commissioner, 78 T.C. 471 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984) (dissent by J. Whitaker, suggesting that profit motive identical to that required under section 162 would be required for a partnership to be recognized for tax purposes). Accordingly, we believe, based on sixty years of case law that consistently denies any relevance of a tax avoidance motivation in applying the business purpose and substance over form doctrines, case law and legislation denying the relevance of a tax avoidance motivation in determining whether an organization is a partnership for tax purposes, and repeated reenactments of the entire Code in the context of that case law, that the regulation should not be considered a reasonable interpretation of the statute to the extent that it requires that judicial doctrines be modified to take into account tax motivation when applying those doctrines to partnership transactions.

We believe that a court should not interpret the partnership anti-abuse rule as overriding specific mechanical rules provided in subchapter K in the absence of an example that cannot reasonably be distinguished from the transaction on its facts. In the event that the partnership anti-abuse rule were nevertheless interpreted as being applicable to a particular transaction, we believe that a court should find the regulation to be invalid to the extent that it alters the clear rules of subchapter K based on the presence of a tax motivation.

H. Substance Over Form Doctrine

The tax consequences of a transaction are generally based on the substance of the transaction. Where the form reflects the substance, the tax consequences of the form are generally recognized. Where the form of a transaction does not reflect its substance, however, a variety of judicial approaches have been used to determine the tax consequences of the transaction. These approaches include refusing to recognize a participant in a transaction as a separate taxable entity and disregarding a transaction as a sham.

1. Separate Taxable Entity

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the Supreme Court established the test for determining whether a corporation will be recognized as a separate taxable entity, stating that "so long as [the purpose for forming the corporation] is the equivalent of a business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Id. at 438-39. The level of activity necessary to constitute the "carrying on of business" within the meaning of the Moline Properties test appears to be quite minimal.[32] In practice, it seems to require little more than the observance of bookkeeping formalities, maintenance of separate bank accounts, having employees, executing contracts where appropriate, and representing the corporation to third parties as an independent organization. The separate entity tests set forth in Moline Properties have been applied to partnerships. Campbell County State Bank, Inc. v. Commissioner, 37 T.C. 430, 441-42 (1961), reversed on another issue, 311 F.2d 374 (8th Cir. 1963).

Each of Enron, Holdco, Enron Sub II, SPVCo, Enron GP and Enron Sub III represents itself to third parties as a separate entity in all transactions, observes all corporate and bookkeeping formalities, maintains separate bank accounts, has employees and/or pays fees for services that would otherwise be rendered by employees, and executes contracts in a manner consistent with its status as a separate entity. Partnership represents itself to third parties as a separate entity in all transactions, observes all partnership and bookkeeping formalities, maintains separate bank accounts, has employees and/or pays fees for services that would otherwise be rendered by employees, and executes contracts in a manner consistent with its status as a separate entity. Each of the entities listed in the preceding two sentences holds significant assets. In addition, each of Enron, Regulated, and Enron Sub II has been in existence for a substantial period of time and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons. SPVCo and Enron GP entered into a substantial joint venture (Partnership) with an unrelated person (BT Sub). Partnership has entered into financial transactions with respect to the Building with unrelated parties. Enron Sub III will engage in financial or business transactions with unrelated persons in each of its taxable years.

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32 Britt v. United States, 431 F.2d 227, 235 (5th Cir. 1970); Hospital Corp. of America v. Commissioner, 81 T.C. 520, 579 (1983) (nonacq. in part); Strong v. Commissioner, 66 T.C. 12, 24 (1976), aff'd without published opinion, 553 F.2d 94 (2d Cir. 1977); see also, B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 2.07[2] (6th ed. 1994).

Transactions with third parties are generally considered sufficient business activity to satisfy the Moline Properties test. For example, obtaining a loan from third parties has been found to be sufficient business activity to prevent taxpayers from disavowing the separate status of a corporation that admittedly served no business purpose. See Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945). Based on the above facts, we believe that each corporation described above and Partnership should be respected as a separate entity for federal income tax purposes.

2. Sham

The sham transaction doctrine is a judicially created theory under which a transaction can be ignored for tax purposes if, in effect, the transaction affects nothing but tax consequences to the parties. The most recent Supreme Court discussion of the sham transaction doctrine is the case of Frank Lyon Co. v. United States, 435 U.S. 561 (1978), in which the Court upheld the sale and leaseback of a building against the government's argument that the transaction was really a financing. Modern sham transaction theory originated in the Court's frequently quoted defense of a "genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . ." Frank Lyon Co., 435 U.S. at 583-84.

A two-pronged test for sham transactions emerged from that quotation. In order to find a sham, a court must determine both that the taxpayer was motivated by no business purposes other than obtaining tax benefits and that the transaction had no economic substance, independent of its tax consequences. Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985).[33] The business purpose test is a subjective analysis of the taxpayer's state of mind, while the economic substance test is objective, based upon the particular facts and circumstances.

Transactions between parent and subsidiary corporations and among other related persons are subject to a heightened level of scrutiny by the Service and are often the focus of sham transaction attacks. While transactions among related corporations often are suspect, they are not *per se* subject to recharacterization under the sham transaction doctrine. Indeed, the consolidated return regulations promulgated under section 1502 set forth myriad rules prescribing the treatment to be accorded transactions among members of a consolidated group. Such

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33 The text describes a "sham in substance." A second category of sham, sham in fact, occurs when a court finds that the purported transaction did not actually occur. We assume, for purposes of this memorandum, that all transactions described in the assumed facts actually occur, so that there is no question of the transactions being a sham in fact.

transactions may result in items of income, deduction, gain, or loss being eliminated, deferred, or disallowed, but such items are not disregarded on the basis that they arise from sham transactions.

In order to fail the business purpose portion of the sham test in Rice's Toyota World, a taxpayer can have no motive other than tax purposes. The predominant purpose for the transactions considered in this memorandum is to generate income for financial accounting purposes. Additional purposes include shifting risk on the Building to BT Sub and raising minority equity capital. These effects of the transactions provide Enron and its Affiliates with significant and material benefits independent of federal income tax considerations. The transactions were structured to achieve the above purposes without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements.

Improving a company's balance sheet has been recognized as a valid business purpose. See Frank Lyon Co., 435 U.S. at 577-78 (effect of debt on company's balance sheet has "distinct element of economic reality"); Newman v. Commissioner, 902 F.2d 159, 163 (2d. Cir. 1990) (business purposes in entering into operating agreement rather than lease for balance sheet purposes); Priv. Ltr. Rul. 9017061 (Jan. 31, 1990) (improvement of balance sheet for company's lenders is business purpose for section 355); Tech. Adv. Mem. 8803001 (Sept. 29, 1987), (movement of assets from non-member to member corporation of affiliated group to improve consolidated balance sheet is business purpose for section 368(a)(1)(C)), revoked by Tech. Adv. Mem. 8941004 (July 11, 1989) (based on insufficiency of facts submitted at time of examination). We believe that the presence of the nontax business purposes described above should be sufficient to satisfy the business purpose portion of the sham test in Rice's Toyota World.

The economic substance test depends upon all of the facts and circumstances. In the transactions at issue, Enron and BT Sub share in the combined net operating income, gains, and losses generated by all of the assets of Partnership. The terms of the various instruments issued in the transactions (including the interest and dividend rates, as the case may be) are consistent with commercial practices generally prevailing at the time of issue and are terms that could reasonably be expected to be agreed upon in negotiations between unrelated parties having adverse interests. Economic risk on the Building is shifted to BT Sub. We believe that these facts should be sufficient to satisfy the economic substance portion of the test.

Transactions involving the transfer, distribution, or exchange of the debt and equity securities of a corporate issuer to or by a related corporation or unincorporated entity are respected notwithstanding the circular ownership resulting from such transactions. In Peter Pan Seafoods, Inc. v. United States, 417 F.2d 670 (9th Cir. 1969), it was held that cancellation of indebtedness income did not arise when a newly formed corporation, 85 percent of whose stock was held by shareholders of the corporate obligor, purchased debt of the corporate obligor at a discount. The acquiring corporation was formed for the purpose of acquiring the debt and in order to avoid the adverse cancellation of indebtedness income consequences that would result from the corporate obligor's acquisition of its own debt. The Commissioner argued that the notes were in substance acquired by the obligor.

The Court refused to recharacterize the transaction in the manner argued for by the Commissioner. The court first noted that the corporate obligor and the acquiring corporation were separate legal entities and, more specifically, that the acquiring corporation was not a shell as was the corporation in Gregory. Id. at 672-673. While the relatedness of the two corporations and the formation of the acquiring corporation to avoid the adverse tax consequences associated with a direct acquisition by the obligor of its own debt justified close scrutiny of the acquiring corporation's activities, it did not *per se* justify ignoring the separateness of the acquiring corporation or the form of the transaction. Id. at 673. So long as the transaction had economic substance and was economically realistic, it was entitled to be recognized in accordance with its form for tax purposes. Id.

In finding economic substance, the court noted that the acquiring corporation raised its own funds from some of the obligor's shareholders, from some who were not shareholders of the obligor, and from a bank that had no other connection with the transaction. Id. In addition, by purchasing the notes at a discount, the acquiring corporation acquired the possibility of ultimately making a substantial profit if it turned out that the obligor could pay them off. Id. at 672. To that end, there was no evidence that the acquiring corporation would refrain from enforcing the notes, or would contribute them to the capital of the obligor,[34] or that there was any other understanding whereby the obligor would acquire the notes at a discount.

Peter Pan Seafoods supports treating the transactions addressed herein in accordance with their form for federal income tax purposes. BT Sub, an entity unrelated to Enron and its Affiliates, will contribute almost $32 million of capital to SPVCo and Partnership, acquiring an economic interest in the assets and liabilities of SPVCo and Partnership. Those assets and liabilities include preferred stock of Enron Sub III. It is anticipated that the structure created by these transactions will remain in place for at least seven years. While some stock of Enron Sub III may be sold or redeemed over time, it is anticipated that a substantial portion of the stock of

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[34] While the acquiring corporation did in fact contribute the notes to the obligor's capital two years after their acquisition when it became the sole shareholder of the obligor, there was no evidence that this was the purpose, or a part of the deal, at the time the acquiring corporation was founded and purchased the notes.

Enron Sub III will be retained by Partnership for at least two years. The presence of outside capital and the absence of any plan or obligation to unwind the transactions at issue immediately after they are entered into, with all of the funds being returned to each of the entities participating therein, distinguishes Peter Pan Seafoods and the instant transactions from various cases discussed below in which transactions were held to be shams.[35]

In contrast to the instant case, in which the economic rights of various parties, including BT Sub, are affected by the transactions, transactions among related entities that have been successfully challenged by the Service under the sham transaction doctrine generally involve circular financing schemes in which the transactions have no economic effect. Erhard v. Commissioner, 46 F.3d 1470 (9th Cir. 1995), aff'g 62 T.C.M. (CCH) 1 (1991), involved a series of circulating transactions throughout a "system" designed by the taxpayer's tax attorney (Margolis) pursuant to which Werner Erhard purported to cause the assets held by est, a.e.c. ("est"), a corporate entity, to be acquired by Werner Erhard and Associates ("WEA"), a sole proprietorship. The acquisition was structured as a purchase of assets by WEA from est, which purchase was funded by loans from ICF, a non-system entity. The ICF loans, however, were funded by system entities and, in fact, the transactions consisted of WEA receiving $15 million from system entities in the form of loans and returning $12 million to system entities in the form of purchase price for assets (the $3 million of retained funds were to be used for operating expenses). WEA paid interest to ICF on the loan and properly withheld ICF's federal income tax from its payments to ICF and transmitted these amounts to the Service.

The Tax Court found the transactions engaged in by WEA to be without economic substance, being merely circular money movements that "began and ended with system entities, with no change in the economic position of the system viewed as a whole." Erhard, 62 T.C.M. at 26. More importantly, the Tax Court concluded that the est organizational structure was simply a means of shielding "the true ownership of assets that in reality belong to the Werner Erhard operation." Id. at 28. Moreover, the series of transactions involving WEA was held to represent the "clean-up" phase in which the structure initially created for Erhard via est was to be shed in

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[35] See also, United States v. General Geophysical Co., 296 F.2d 86 (5th Cir. 1961) (contention of the taxpayer-corporation that it was entitled to a stepped-up basis for certain property by virtue of a transfer of the property to its major shareholders and a simultaneous repurchase from them by the corporation at an enhanced valuation was rejected, in part, on the basis that the distribution and repurchase occurred on the same day and without interruption in the corporation's control and use of the property); Priv. Ltr. Rul. 9447024 (Aug. 23, 1994) (temporal element was among factors mentioned in ruling by the Service that a $10 million cash contribution on January 21, 1991 by a corporation to one of its subsidiaries that was a PFIC, which funds were invested in an interest bearing account at a wholly owned foreign commercial banking affiliate of the two entities and then distributed back to the contributing corporation on April 29, 1991, had no economic substance and could be disregarded as a sham).

favor of the new WEA structure. Id. at 27. In connection with this restructuring, the appeals court noted that "Erhard needed to balance accounts with the system and to remove the assets which, *in reality were his, but which had been acquired in the name of various system entities.*" Erhard, 46 F.3d at 1477 (emphasis added). Indeed, the $3 million WEA retained to cover operating expenses were found to constitute est's "excess cash balances in the system that needed to be transferred to Erhard in order to square the accounts." Id. at 1478.

The court also rejected Erhard's contention that he had a clear business purpose for engaging in the transactions because he wished to terminate his relationship with Margolis, stating as follows:

> [E]ven if Erhard had a legitimate business purpose for terminating his relationship with Margolis, that did not give him a business purpose for engaging in the specific transactions at issue here. The fact that he may have a good business reason for separating from Margolis does not necessarily justify resorting to circular money movements (that just happened to create tax benefits) to effectuate that separation.

Id. Notwithstanding this broad language which seems to allow the Service to strike down the manner in which a transaction supported by sufficient business purpose is effected, the holding of the case appears to be based on the much narrower conclusion that the true ownership of the assets WEA purported to acquire from est in fact already resided in Erhard. Accordingly, the court refused to accord tax recognition to such an "acquisition" irrespective of where the funds used to "acquire" the assets originated. The transaction was a separation of Erhard from the Margolis system and not a loan followed by an asset acquisition. As in the other cases involving Margolis systems, the transaction purported to have been effected was not, in fact, actually entered into and the court, once again, refused to allow a fiction to determine the tax consequences. See also United States v. Clardy, 612 F.2d 1139 (9th Cir. 1980) (purported loans struck down as shams where check swapping used to generate circulation of funds that created self-canceling transactions of artificial loans and interest payments; taxpayers had no intent to complete transactions entered into); Goldberg v. United States, 789 F.2d 1341 (9th Cir. 1986) (deductions generated by transactions involving circulation of funds among system entities struck down; transactions wholly lacking in the indicia of arms length transaction; record devoid of any indication that taxpayers incurred any actual economic liabilities of any substance); United States v. Schulman, 817 F.2d 1355 (9th Cir. 1987) (series of loans generated by circulation of funds among system entities held to be a sham that lacked substance because of absence of economic risk associated with loans); Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543 (9th Cir. 1987) (taxpayer used fictitious transfers of money to borrow money from one entity and pay principal and interest back with loans from related entity; no evidence that loans could have benefited the taxpayer economically).[36]

Although there is a circulation of funds among various members of the Enron consolidated group and their Affiliates, we believe the transactions in which these entities are participating are not of the type that have been struck down using the sham transaction doctrine. In the first instance, the various Enron entities will not be in the same position as they were immediately prior to the execution of the transactions. The equity and debt instruments created in the transactions provide the holders thereof with specific rights and obligations. The terms of these instruments provide the potential for economic profit or loss to the various parties, including BT Sub. Moreover, these transactions will shift economic risk with respect to the Building to BT Sub and will raise minority equity for Enron. It is anticipated that the structure created by these transactions will remain in place for at least seven years. While some stock of Enron Sub III may be sold or redeemed over time, it is anticipated that a substantial portion of the stock of Enron Sub III will be retained by Partnership for at least two years.

In sum, we believe the transactions addressed herein should be recognized as creating legal rights and obligations such that the form of the transactions should be considered to be consistent with their substance.

I. Section 269

Section 269 applies to the acquisition of control of a corporation when the principal purpose of such acquisition is the "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which . . . would not otherwise [be] enjoy[ed]." For this purpose, control is defined as 50 percent of vote or value. The following acquisitions of control occurred as a result of the transactions described above:

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36 Goldberg, Schulman, Bail Bonds by Marvin Nelson, and Erhard all addressed transactions designed by Margolis, which transactions were described as "characterized by convoluted transfers of overvalued property rights, circular money movements among foreign trusts, delayed drafting, signing and backdating of documents, and client oblivion to the financial realities of their investments. . . . The contrived nature of his schemes has been succinctly described as a 'labyrinthian design of tax avoidance . . . and a concomitant hopelessness from the beginning of any economic benefit or effect, other than tax reduction. . . . Margolis transactions constitute financial gymnastics, devoid of economic substance. Margolis clients typically purchase highly inflated investments and tax shelters, oblivious of the economics of the investment. Indeed, proclaimed ignorance of the fact is a hallmark of Margolis clients. Even so, their ignorance is explained by the fact that there is no economic risk, since the transactions often are not legally binding, but shams." Goldberg, 789 F.2d at 1342-43.

Enron acquired control of SPVCo;

Enron acquired control of Forco;

Enron acquired control of Enron GP;

Partnership, Enron, and SPVCo acquired control of Enron Sub III;

Enron Sub III and Holdco acquired control of Regulated; and

Enron and Enron Sub III acquired control of Holdco.

In order to apply section 269, it is necessary first to identify a deduction, credit, or other allowance that benefits the acquired corporation or the acquiring persons and that stems from, and could not have been obtained in the absence of, the acquisition of control. See Zanesville Investment Co., v. Commissioner, 335 F.2d 507, 512 (6th Cir. 1964); Cromwell Corp. v. Commissioner, 43 T.C. 313, 320 (1964) (acq.); Commodores Point Terminal Corp. v. Commissioner, 11 T.C. 411, 417 (1948); Tech. Adv. Mem. 9134003 (May 6, 1991); Gen. Couns. Mem. 39472 (Aug. 2, 1985). We question whether any such deduction, credit, or other allowance is made available by any of the acquisitions of control listed above.

It might be argued that the acquisition of control of Enron Sub III allows Enron to receive, through SPVCo, the benefit of SPVCo's dividends received deduction and losses with respect to the basis in excess of value created by an Enron Sub III Redemption. The tax-free tiering up of earnings and profits from Regulated to Enron Sub III on the contribution of Regulated to Enron Sub III or on a Holdco Redemption occurs only if Enron Sub III is a member of the Enron consolidated group. Therefore, Enron must acquire control of Enron Sub III in order for the tax-free transfer of earnings and profits of Regulated to Enron Sub III.[37]

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[37] In the absence of an old and cold subsidiary to which stock of Regulated could be transferred, it is questionable whether the transfer of Regulated's earnings and profits to another corporation could be achieved other than through the acquisition of control of such corporation by Enron. While transfer of the earnings and profits of Regulated to a corporation that is not controlled by Enron is theoretically possible, through the issuance of stock of Regulated and the payment of dividends on such stock, such an approach is not a realistic possibility because of the economic consequences of such a transaction. Moreover, such a transaction would generate substantial federal income tax on the dividends paid to the noncontrolled corporation. It might be possible to structure the ownership of a noncontrolled (for purposes of section 269) corporation such that either redemptions of stock of Regulated held by the noncontrolled corporation would be treated as a dividend, or purchases of such stock would be section 304 dividends, in each case based on constructive ownership that is not relevant for purposes of section 269. While such a transaction may be feasible as an economic matter,

Earnings and profits are required in Enron Sub III in order for an Enron Sub III Redemption to produce the desired dividend treatment. The same tax benefits could be obtained by using an old and cold subsidiary of Enron (assuming such a subsidiary exists) as Enron Sub III. Similarly, the same tax benefits could be obtained by using Regulated in place of Enron Sub III (i.e., if Regulated issued its own preferred stock directly to Partnership and made pro rata redemptions of all of its stock at a later date). We believe that the availability of these alternative approaches suggests that the benefits are "otherwise available" to Enron, even if business reasons or regulatory restrictions make the use of a newly created subsidiary more desirable.

Even if the required deduction, credit, or other allowance could be identified, it is necessary to show that obtaining that benefit was the principal purpose for an acquisition of control. The predominant purpose for these transactions is to generate income for financial accounting purposes. Additional purposes include risk shifting and raising minority equity capital. The transactions, including the formation of SPVCo, Enron GP, Holdco, and Enron Sub III were structured to achieve these purposes without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements. We believe that these facts present a strong case for refuting any claim that the principal purpose of any of these transactions was the evasion or avoidance of tax. Accordingly, we believe that section 269 should not be applicable to any of these acquisitions.

J. Application of Section 482

Section 482 grants broad authority to the Secretary to allocate gross income, as necessary to clearly reflect income, among two or more entities that are controlled by the same interests. We assume, for purposes of discussion, that Enron and Partnership are under common control by virtue of Enron's control over Partnership's managing partner, Enron GP.

The threshold requirement for application of section 482 is that a transaction does not reflect arm's-length dealing between the parties. See Simon J. Murphy Co. v. Commissioner, 231 F.2d 639, 644-45 (6th Cir. 1956) (describing limits of predecessor of section 482, court stated that allocation not permitted where related parties deal with each other at arm's length; in case before court, failure of return to clearly reflect income was inherent in accrual method, not due to

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substantial federal income tax would be incurred on the dividend income of the noncontrolled corporation. Unless the loss to the noncontrolled corporation on the retained stock of Regulated were to offset this tax burden, the Service might argue that a tax benefit that is available without the acquisition of control only at a significant tax cost is not "otherwise available" (within the meaning of section 269) without the acquisition of control.

control over related parties); Haag v. Commissioner, 88 T.C. 604, 615 (1987), aff'd, 855 F.2d 855 (8th Cir. 1988) (to determine whether a reallocation is necessary to clearly reflect income or to prevent the evasion of taxes, court must decide whether the agreement reflected arm's-length dealing); Van Dale Corp. v. Commissioner, 59 T.C. 390, 398 (1972) (unless the tax benefit stems from less than arm's-length dealings, the threshold point for applying section 482 is simply not reached); Seminole Flavor Co. v. Commissioner, 4 T.C. 1215, 1229-31 (1945) (nonacq.) (court rejected government's argument that contract was for purpose of evading tax based on finding that terms of contract were arm's length); Treas. Reg. § 1.482-1(b)(1) (purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer; standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer); Tech. Adv. Mem. 7927009 (March 22, 1979) (conditioning application of section 482 on finding that control relationship was utilized to effect the transaction at bargain sale price). Given BT Sub's interest in Partnership, and terms of the purchase agreement that are, at the time the transaction is entered into, commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree, we believe that section 482 should not be applicable to reallocate among the entities the section 304 dividend or the basis adjustments resulting from a Purchase.

(202) 626-2908

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<~~DRAFT~~> May <~~6~~> **14**, 1997

R. Davis Maxey, **Esquire**
Senior Director, Tax Research
Corporate Tax
Enron Corp.
1400 Smith Street
Houston, TX 77002-7361

Re: Enron Leasing Partners, L.P.

Dear Dave:

You have requested our opinion with respect to certain federal income tax consequences of the formation of Enron Leasing Partners, L.P. ("Partnership").

This document is subject to the attorney-client privilege and the work-product doctrine. It contains the legal opinions, thoughts, impressions and conclusions of King & Spalding with respect to certain federal income tax matters. King & Spalding, as special tax counsel for Enron Corp. ("Enron"), has prepared this document at the request of Enron for its sole use. It has been prepared to aid Enron, among other things, in anticipation of possible future litigation regarding the federal income tax matters referenced above and covered herein. In that regard, this document has been prepared to help define, and as part of, the litigation strategy of Enron in the event of any challenge to the federal income tax treatment claimed with respect to the transactions that it addresses.

I. STATEMENT OF FACTS

Prior to the transactions considered in this letter, Enron directly owned all of the common stock, which was all of the outstanding stock, of each of Enron Liquids Holding Corp. ("Liquids"), Enron Operations Corp. ("Operations"), Organizational Partner, Inc. ("OPI"), and Houston Pipe Line Company ("Houston Pipe"). <~~[Add description of commercial history and assets of each corporation.]~~> As of March 20, 1997, there was outstanding an intercompany indebtedness from Houston Pipe to Enron in an amount in excess of $1.1 billion. This indebtedness was incurred for

<~~[$____] of~~> dividends declared but unpaid by Houston Pipe and <~~[$____] of~~> obligations of Houston Pipe to third parties, satisfied on behalf of Houston Pipe by Enron prior to March 20, 1997.

Enron's principal offices are located in the building at 1400 Smith Street, Houston, Texas (the "Building"). <~~[Add prior history of Building - acquisition, ownership, financing.]~~> Prior to the transactions considered in this letter, the Building was subject to a <~~synthetic~~> lease (the "Old Lease") that provided Enron with the <~~accounting~~> benefits of **ownership for federal income tax purposes and** off-balance sheet financing **for financial accounting purposes**. Under the Old Lease, Enron was prohibited from transferring its interest in the Building. Prior to the transactions considered in this letter, Enron had entered into negotiations to refinance the Building, replacing the Old Lease with a new <~~synthetic~~> lease. <~~[Describe reasons for refinancing.]~~> After Enron decided to contribute the Building to the structure created by the transactions considered in this letter, the negotiations with respect to the new <~~synthetic~~> lease were conducted with the understanding that <~~OPI~~> **a subsidiary of Enron** would be the lessee under the new <~~synthetic~~> lease and that <~~OPI~~> **the subsidiary** would be permitted to contribute its interest in the Building to a partnership. Pursuant to these negotiations, on April 14, 1997, the Old Lease was terminated and OPI entered into the Land and Facilities Lease Agreement (the "Lease Agreement") with Brazos Office Holdings, L.P. ("Brazos").

During the first week of March 1997, officers of Enron, based primarily on evaluations of the potential accounting benefits available through the structure created by the transactions considered in this letter, decided to enter into negotiations with Bankers Trust Company to set up such a structure and reached a preliminary understanding with Bankers Trust Company on the fees that would be paid to Bankers Trust Company if the negotiations were concluded successfully.

Negotiations relating to an acceptable recapitalization of OPI and Liquids were completed on March 21, 1997, and documents relating to the steps of the recapitalization that involved only members of the Enron consolidated group were executed on that date. The transactions covered by these documents included the reflection of a portion of the intercompany debt of Houston Pipe in a note (the "Note"), the amendment of the Certificate of Incorporation of OPI, the contribution by Enron of the Note <~~of Houston Pipe~~> and the Building to OPI, the amendment of the Certificate of Incorporation of Liquids, the contribution by OPI of the <~~note of Houston Pipe~~> **Note** to Liquids in exchange for common and preferred stock of Liquids, and the contribution by Enron of the stock of Operations to Liquids.

Negotiations relating to the formation of <~~Enron Leasing Partners, L.P. ("~~>Partnership <~~"~~)> were completed on March 27, 1997, and documents involving the participation of EN-BT Delaware, Inc. ("EN-BT") and Potomac Capital Investment Corporation ("PCI") in the structure were executed on that date. The transactions covered by these documents included the contributions by PCI and EN-BT of cash to OPI in exchange for preferred stock of OPI, the formation of Partnership, the

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contribution by OPI of the preferred stock of Liquids and the Building to Partnership in exchange for a 98 percent interest as a limited partner, the contribution by EN-BT of cash to Partnership in exchange for a <~~1~~> **one** percent interest as a limited partner, and the contribution by Enron Property Management Corp. ("Enron GP") of U.S. treasuries and cash to Partnership in exchange for a <~~1~~> **one** percent interest as a general partner. Enron GP was a newly formed wholly-owned subsidiary of Enron Cayman Leasing, Ltd. which was a newly formed wholly-owned subsidiary of Enron.

II. DOCUMENTS EXAMINED

In rendering this opinion, we have examined and relied upon the following documents:

Certificate of Incorporation of Organizational Partner, Inc., filed January 25, 1994.

Certificate of Amendment of Certificate of Incorporation of Organizational Partner, Inc., filed March 21, 1997.

Certificate of Incorporation of Enron Liquid Fuels Company, filed April 9, 1990.

Certificate of Amendment of Certificate of Incorporation of Enron Liquid Fuels Company, filed December 23, 1992, changing the name of the corporation to Enron Liquids Holding Corp.

Certificate of Amendment of Certificate of Incorporation of Enron Liquids Holding Corp., filed March 21, 1997.

Promissory Note of Houston Pipe Line Company, dated March 21, 1997, in the amount of $1,097,489,750.

Guaranty of Obligations, dated as of March 21, 1997, by Enron in favor of OPI, relating to the Note.

Contribution Agreement, dated as of March 21, 1997, by and between Enron and OPI ("Enron/OPI Contribution Agreement").

Written consent of the sole stockholder of OPI in lieu of a meeting, executed as of March 21, 1997.

Written consent of all members of the Board of Directors of OPI in lieu of a meeting, executed as of March 21, 1997.

Contribution Agreement, dated as of March 21, 1997, by and between Enron and Liquids ("Enron/Liquids Contribution Agreement").

Subscription and Contribution Agreement, dated as of March 21, 1997, by and between OPI and Liquids ("OPI/Liquids Contribution Agreement").

Assignment of Note and Guaranty Agreement, dated March 21, 1997, by and among OPI, Liquids, and Enron.

Indemnification Agreement, dated March 21, 1997, by and between Enron and Liquids, relating to liabilities for past activities of Liquids and liabilities for past and future activities of subsidiaries of Liquids.

Letter, dated March 21, 1997, to Enron from EN-BT and PCI, relating to intention to invest in OPI ("Intent Letter").

Indemnification Agreement, dated March 27, 1997, by and between Enron and OPI, relating to liabilities for past activities of OPI.

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between PCI and OPI ("PCI Subscription Agreement").

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between EN-BT and OPI ("EN-BT Subscription Agreement").

Limited Partnership Agreement of Enron Leasing Partners, L.P. ~~<("Partnership Agreement")>~~, effective as of March 27, 1997, by and among Enron GP, OPI, and EN-BT **<u>("Partnership Agreement")</u>**.

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between Enron GP and Partnership.

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between OPI and Partnership ("OPI/Partnership Contribution Agreement").

Guaranty and Indemnification Agreement, effective as of March 27, 1997, made by Enron in favor of EN-BT and PCI, relating to Enron GP's performance of its obligations under the Partnership Agreement.

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Letter, dated March 27, 1997, from PCI to Enron, relating to representations by PCI and liquidity of OPI.

Letter, dated March 27, 1997, from EN-BT to Enron, relating to representations by EN-BT and liquidity of OPI.

Letter, dated March 27, 1997, from Enron to EN-BT, relating to representations by Enron.

Three letters, dated March 27, 1997, from Thomas Finley to Richard A. Causey, relating to the engagement by Enron of Bankers Trust to provide certain services.

<[~~Guaranty, dated as of April 14, 1997, by Enron for and in favor of Brazos, relating to lessee's obligations under the Lease Agreement ("Parent Guaranty").~~]

[Indemnification ~~Agreement, effective as of April 14, 1997, by OPI for and in favor of Enron, relating to obligations under the Parent Guaranty.~~]

[OPI ~~Indemnity, effective as of April 14, 1997, by OPI for and infavor of the general partners of~~ Partnership~~, relating to lessee's obligations under the Lease Agreement.~~]>

In our examination of documents and in our reliance upon them in issuing this opinion, we have assumed, with your consent, that all documents submitted to us as photocopies faithfully reproduce the originals, that the originals are authentic, that all documents submitted to us have been duly executed and validly signed to the extent required in substantially the same form as they have been provided to us, that each executed document constitutes the legal, valid, binding and enforceable agreement of the signatory parties, that all representations and statements set forth in the documents are true and correct, and that all obligations, covenants, conditions or terms imposed on the parties by any of the documents have been or will be performed or satisfied in accordance with their terms. We have further assumed that, for our examination in connection with this opinion, you have disclosed to us all of the documents that are relevant to the transactions that are the subject of this opinion and that there are no undocumented agreements related to these transactions that modify or alter the effect of any documents listed above or that create any additional obligations or rights among the parties to those documents. We are not aware of any documents related to these transactions that would alter our opinions as set forth below.

Any capitalized terms not defined herein have the same meaning as in the appropriate documents from the list above.

III. REPRESENTATIONS AND ASSUMPTIONS

In rendering this opinion, we have relied upon the facts as set forth in the Statement of Facts in Section I above, which you have represented to us are true to the best of your knowledge and belief, and we have relied upon the following, which you have represented to us are true to the best of your knowledge and belief:

1. Enron and its Affiliates[1] will at all times act in accordance with the form of the transactions as reflected in the documents listed above.

2. The predominant purpose of Enron and its Affiliates for participating in the transactions considered in this letter was to generate income for financial accounting purposes. Additional purposes were to shift risk on contributed assets, to raise minority equity capital, and to obtain access to Bankers Trust Company's expertise in leasing transactions. These purposes provide Enron and its Affiliates with significant and material benefits. Enron and its Affiliates did not engage in the transactions considered in this letter with, and do not anticipate availing themselves of <~~Enron Leasing Partners, L.P. ("~~>Partnership <~~")~~> in connection with any transaction having, a purpose to reduce substantially the present value (determined using a discount rate that is less than or equal to the weighted average cost of capital of the Enron consolidated group during the relevant period) of the aggregate federal income tax liability of the partners of Partnership or increasing or decreasing, on a present value basis (determined using a discount rate that is less than or equal to the weighted average cost of capital of the Enron consolidated group during the relevant period), the aggregate federal income tax liability of the Enron consolidated group or those Affiliates of Enron that are included on Enron's consolidated financial statements.

3. <~~No tax benefit was anticipated from~~> **There was a bona fide business purpose, and no tax avoidance purpose, for** the assumption of liabilities by and the transfer of liabilities to OPI in conjunction with the contributions to OPI by Enron.

4. The aggregate adjusted tax basis of the Note and the Building in the hands of Enron exceeded the sum of the aggregate amount of liabilities of Enron assumed by OPI pursuant to the Enron/OPI Contribution Agreement and the aggregate amount of liabilities to which assets transferred to OPI pursuant to the Enron/OPI Contribution Agreement were subject.

5. There were no intercompany obligations between OPI and any member of the Enron consolidated group on March 27, 1997.

6. The Partnership will not elect to be classified as an association.

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1 For purposes of this <~~memorandum~~> **letter**, the "Affiliates" of a person are those persons directly or indirectly controlling, controlled by, or under common control with such person.

7. On the date the Liquids preferred stock was issued, (i) the annual dividend rate for the stock was no less than the rate that would be required by an investor that owned no common stock of Liquids and that was unrelated to Liquids, (ii) the annual dividend rate for the stock was not materially in excess of the then prevailing market rate for preferred stock having similar terms and issued by a corporation having a credit rating similar to that which Liquids would have had on the date of issuance if it were rated, (iii) all terms of the stock were consistent with commercial practices generally prevailing at that time and were terms that could reasonably be expected to be agreed upon in negotiations between unrelated parties having adverse interests, and (iv) the stock had a fair market value, to an investor that owned no common stock of Liquids and that was unrelated to Liquids, equal to its issue price.

8. The issue price of the Liquids preferred stock was not greater than its redemption price and its liquidation value and was not less than its redemption price and its liquidation value (except for a reasonable redemption or liquidation premium).

9. The fair market value of the assets of Liquids will at all times exceed the face amount of all outstanding debt plus any accrued but unpaid interest plus the liquidation value (including accrued but unpaid dividends) of its preferred stock. All dividends on the Liquids preferred stock will be paid currently. The aggregate current earnings and profits and net cash flow of Liquids for each year will each exceed the annual dividend on the preferred stock.

10. Brazos ~~<Office Holdings, L.P.>~~ is unrelated to Partnership.

11. The amount of the liability represented by the Lease Agreement does not exceed the fair market value of the Building.

In addition, you have consented to our reliance, in rendering this opinion, on the following assumptions:

1. Prior to the transactions considered in this letter, Enron was the owner of the Building for federal income tax purposes **<u>and the obligations created by the Old Lease were liabilities</u> of Enron secured by the Building**. For federal income tax purposes, the lessee under the Lease Agreement is ~~<treated as>~~ the owner of the Building and the obligations created by the Lease Agreement are ~~<treated as a liability>~~ **liabilities** of the lessee secured by the Building. The liability represented by the Lease Agreement is allocable under the rules of Treasury

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Regulation § 1.163-8T[2] to capital expenditures with respect to the Building. The sublease to Enron is a true lease for federal income tax purposes.

2. Enron will at all times exercise its voting rights in OPI independently of EN-BT and PCI, and will not exercise any control or influence over EN-BT and PCI in the exercise of their voting rights in OPI.

3. Prior to March 31, 1999, no transfers will be made from Partnership to any partner other than distributions made pursuant to the terms of the Partnership Agreement of amounts that do not exceed Partnership's net cash flow from operations within the meaning of Treasury Regulation § 1.707-4(b)(2).

4. The aggregate fair market value of distributions from Partnership to OPI made prior to March 31, 2002 will not exceed OPI's tax basis in its interest in Partnership.

5. Neither the Building nor any interest therein will be distributed by Partnership to any partner other than OPI within five years of March 31, 1997.

6. None of the interests in Partnership are traded on an established securities market. All of the existing interests in Partnership were offered and sold within the United States and were issued in transactions that were not required to be registered under the Securities Act of 1933. Any future interests in Partnership will be offered and sold within the United States and will be issued in transactions that are not required to be registered under the Securities Act of 1933. At all times, less than 100 persons will own, directly or indirectly through partnerships, grantor trusts, or S corporations, an interest in Partnership.

7. The terms of the Partnership Agreement are commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree.

8. The terms of any transactions, including any loan, lease, license, or fee for services, between any of OPI, Enron GP, Partnership and members of the Enron consolidated group will be commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree.

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2 All references to sections or to the Code are to the Internal Revenue Code of 1986, as amended and in effect as of the date of this letter, unless otherwise noted. All references to regulations are to Treasury Regulations thereunder, as most recently adopted, amended, or proposed, as the case may be, unless otherwise noted.

**PRIVILEGED AND CONFIDENTIAL
SUBJECT TO ATTORNEY-CLIENT PRIVILEGE
AND WORK PRODUCT DOCTRINE**

9. Enron will at all times exercise its voting rights in Liquids for the benefit of itself and the Enron consolidated group, and not on behalf of or for the benefit of OPI, Enron GP, Partnership, EN-BT and its Affiliates, or PCI and its Affiliates.

10. The Liquids preferred stock will at all times be treated by all parties as stock for tax, financial accounting, regulatory, and all other purposes.

11. Each of Enron, Houston Pipe, Liquids, OPI, and Enron GP will at all times represent itself to third parties as a separate entity in all transactions, observe all corporate and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Partnership will at all ~~<time>~~ **times** represent itself to third parties as a separate entity in all transactions, observe all partnership and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. **Each of the entities listed in the preceding two sentences holds significant assets. In addition, each of Enron, Houston Pipe, Liquids, and OPI has been in existence for a substantial period of time and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons.**

12. The transactions reflected in the documents listed above provide the potential for economic profit or loss to the various parties, including EN-BT and PCI. It is anticipated that the structure created by these transactions will remain in place for at least five years.

For purposes of rendering this opinion, you have also consented to our reliance on the additional information that we have obtained through consultation with officers, employees or legal representatives of OPI, Enron GP, Partnership, and members of the Enron consolidated group, as specifically set out in this letter.

IV. OPINIONS

Based upon our analysis of the pertinent authorities as they apply to the information relied upon, it is our opinion that, for federal income tax purposes:

1. OPI should have ceased to be a member of the affiliated group, within the meaning of section 1504(a)(1), of which Enron is the parent at the end of the day on March 27, 1997.

2. The preferred stock of Liquids should be described in section 1504(a)(4).

3. Partnership should be classified as a partnership and should not be a publicly traded partnership.

4. No gain or loss should be recognized on the contributions (i) made by Enron to OPI pursuant to the Enron/OPI Contribution Agreement, (ii) made by Enron to Liquids pursuant to the Enron/Liquids Contribution Agreement, (iii) made by OPI to Liquids pursuant to the OPI/Liquids Contribution Agreement, or (iv) made by OPI to Partnership pursuant to the OPI/Partnership Contribution Agreement.

5. Enron's adjusted basis in the common stock of OPI should be increased by **the excess of** Enron's **aggregate** adjusted ~~<basis>~~ **bases** in the Note **and the Building** immediately before Enron's contribution of ~~<the Note to OPI.>~~ **those assets to OPI over the amount of the liabilities represented by the Lease Agreement.**

6. Liquids' adjusted basis in the stock of Operations immediately after the contribution of such stock to Liquids should equal Enron's adjusted basis in the stock of Operations immediately before Enron's contribution of such stock to Liquids.

7. OPI's adjusted basis in the stock of Liquids immediately after the contribution of the Note to Liquids should equal Enron's adjusted basis in the Note immediately before Enron's contribution of the Note to OPI and should be allocated between the common stock and the preferred stock of Liquids in proportion to the fair market value of the stock of each class received by OPI.

8. The contribution of the common stock of Operations to Liquids should increase ~~<Liquids>~~ **Liquids'** accumulated earnings and profits by an amount equal to the accumulated earnings and profits of Operations at the time of the contribution.

9. Partnership's adjusted basis in the preferred stock of Liquids and in the Building should in each case equal ~~<Enron's>~~ **OPI's** adjusted basis **in** such asset immediately before ~~<Enron's>~~ **OPI's** contribution of the asset to OPI.

For purposes of providing you with information that may be relevant in connection with sections 6662 and 6664, we specifically state, without modifying the strength of any of the opinions set forth above, that in reaching the opinions set forth above we concluded, based on our analysis of the pertinent facts and authorities in the manner described in Treasury Regulation § 1.6662-4(d)(3)(ii), that there is substantial authority (within the meaning of Treasury Regulation § 1.6662-4(d)) for the tax treatment of the items as set forth above and there is a greater than 50 percent likelihood that the tax treatment of the items as set forth above will be upheld in litigation if challenged by the Internal Revenue Service (the "IRS").

V. LEGAL ANALYSIS

A. Deconsolidated Status of OPI

In order for OPI to be an affiliate of Enron under section 1504 of the consolidated return rules, members of the Enron affiliated group (within the meaning of section 1504) must own stock possessing at least 80 percent of the total voting power and 80 percent of the total value of the stock of OPI. Section 1504(a). Enron owns approximately 98 percent of the value, but only 75 percent of the voting power, of the OPI shares. PCI owns approximately 0.9 percent of the value and approximately 23.8 percent of the voting power of the OPI shares. EN-BT owns approximately 1.1 percent of the value and approximately 1.2 percent of the voting power of the OPI shares. Accordingly, if PCI's ownership of 23.8 percent of the voting power of OPI is respected, OPI will not be an affiliate of Enron.

We do not believe **that** the disproportionality between the voting rights and the value of the shares held by PCI should prevent the voting power of such shares from being taken into account in determining whether OPI is an affiliate of Enron. Prior to 1984, section 1504 required that a corporation own 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock of another corporation in order to file a consolidated return with such corporation. Concern about the potential for abuse of the consolidated return privilege by creating an affiliated group using stock that had disproportionately high voting rights as compared to value led to amendments of section 1504 in 1984. See H.R. Rep. No. 98-432, pt. 2, at 1205-06 (1984). The 1984 amendments changed the test for consolidation to require ownership of 80 percent of the voting power and 80 percent of the total value of the stock of a corporation and gave Treasury the authority to prescribe regulations which disregard changes in voting power to the extent such changes are disproportionate to related changes in value. Sections 1504(a)(2), 1504(a)(5)(F). To date, this regulatory authority has not been exercised.

Pre-1984 authority indicates that the IRS did not consider disproportionality between the voting rights and the value of shares of stock, by itself, to be a reason to disregard the voting power of such shares in determining affiliated status. The IRS has repeatedly respected the use of ~~<heavy voting-shares>~~ **stock with disproportionately high voting power as compared to value ("disproportionately high vote" stock)** to create affiliated status. In Technical Advice Memorandum 8030007 (Apr. 14, 1980), the taxpayer wanted to create affiliated status through its ownership of a class of common stock that initially represented approximately 80 percent of the number of, 73.5 percent of the consideration paid for, and 96 percent of the vote of all outstanding shares of the corporation, and later represented approximately 40 percent of the number of, approximately 20 percent of the consideration paid for, and slightly in excess of 80 percent of the voting power of all outstanding shares of the corporation. Finding that the voting power accorded the stock existed for a substantial period of time and, during such period, actually reflected the relative rights of the shareholders, the Technical Advice Memorandum concludes that the disproportionate allocation of voting rights was not a sham and that ownership of the stock was sufficient to establish affiliation, despite the facts that the disproportionate voting rights were given to the stock for the purpose of establishing affiliation and were intended to be eliminated after ~~<6>~~ **six** years. <u>See also</u> Priv. Ltr. Rul. 8139089 (June 30, 1981) (affiliated status respected based on ownership of common stock representing 100 percent of the voting power and 60 percent of the equity value of a corporation); Priv. Ltr. Rul. 7401231710B (Jan. 23, 1974)[3] (affiliated status respected based on ownership of common stock representing 80 percent of the voting power and 50 percent of the value of a corporation).

In contrast to the above rulings, in Private Letter Ruling 8022017 (Feb. 22, 1980), the IRS refused to permit consolidation based on the ownership of preferred stock representing 80 percent of the voting power of, and 50 percent of the capital contributions to, a corporation. The basis for refusing to allow consolidation was not the disproportionate voting rights, however, but the inconsistency between a literal application of the then applicable investment adjustment rules (which potentially allowed a double deduction of losses where the consolidated group owned only preferred stock) and the Congressional intent that consolidated returns clearly reflect the income tax liability of the affiliated group and prevent the avoidance of such liability. <u>See also</u> Priv. Ltr. Rul. 8339020 (June 28, 1983) (revoking Private Letter Ruling 8146071 (Aug. 21, 1981), in which affiliation was recognized based on ownership of ~~<heavy voting>~~ **disproportionately high vote** preferred stock, because on reconsideration it was concluded that the basis on which the earlier letter ruling was issued was not compatible with the requirements for determining affiliation).

The IRS has also respected the use of ~~<heavy voting>~~ **disproportionately high vote** stock to break affiliation. In Private Letter Ruling 9714002 (Dec. 6, 1996), the IRS ruled that a subsidiary could not be included in the parent's consolidated return for the period during which, by reason of a change in the voting rights of the outstanding preferred stock, the preferred stock of the subsidiary had 26 percent of the total number of votes of all stock of the corporation, despite the fact that the value of common stock held by the parent represented at least 80 percent of the value of the subsidiary's stock at all times. The IRS specifically rejected any application of section 1504(a)(5)(F) based on the fact that no regulations have been issued under that section and that it is not self-executing. In Private Letter Ruling 6710242620B (Oct. 24, 1967),[4] the taxpayer wanted to deconsolidate a subsidiary using a class of common stock having the power to elect ~~<1/3>~~ <u>**one-third**</u> of the board of directors of the corporation but representing less than 3.5 percent of the consideration paid for all of the corporation's outstanding stock. The letter ruling concludes, without mentioning

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[3] <u>**Reprinted in Fred W. Peel, Jr., Consolidated Tax Returns (3d ed. 1977).**</u>

[4] <u>**Reprinted in Fred W. Peel, Jr., Consolidated Tax Returns (3d ed. 1977).**</u>

the disproportionality between the voting power and value of the stock, that ownership of the entire class of stock outside the group would be sufficient to terminate affiliated status.[5]

Similarly, the Tax Court does not appear to consider a disproportionality between overall capital contributions and voting power to be significant in determining affiliated status. In Merlite Industries, Inc. v. Commissioner, 34 T.C.M. 1361 (1975), the common stock of a corporation was issued 100 shares to Merlite in exchange for $1,000 and 100 shares to an individual who apparently never paid in the $1,000 par value of his shares. Merlite and a subsidiary also made advances in the form of loans to the corporation totaling, over time, in excess of $200,000, of which in excess of $150,000 remained outstanding during the years at issue. The court held that these advances clearly constituted additional contributions to capital. Id. at 1365. In order to obtain a deduction for the substantial losses of the corporation, either under section 165(g)(3)(A) or through consolidation, Merlite argued that the individual's stock ownership should be disregarded because he never paid for his stock. While acknowledging that Merlite's contributions to capital far exceeded those of the individual, the court pointed out that the individual considered himself to be a stockholder (acting as chairman of the board, president and subsequently vice president), the books of the corporation reflected his stock ownership, the corporate income tax returns listed him as having 50 percent of the stock, he signed the stockholders' election of dissolution as a stockholder, no action was ever taken to void his shares, and he was treated as a stockholder from the creation to the dissolution of the corporation. Accordingly, the court concluded there was no basis for finding that he was not a shareholder, and therefore Merlite was not the 80 percent owner of, and was not entitled to file a consolidated return with, the corporation. Id. at 1366.

Consistent with the above authorities, we believe that the determination of whether the purported ownership of voting shares of a corporation should be respected for purposes of establishing or preventing affiliation should be based on an analysis of all facts and circumstances as they bear on the reality of the ownership and voting power of each shareholder. We believe that

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[5] Private Letter Ruling 6710242620B refers to an earlier ruling letter to the same taxpayer which held that the ownership by a nonmember of stock representing 21 <%> **percent** of the nonvoting stock of the corporation and 0.62 <%> **percent** of the total consideration paid for all of the issued and outstanding stock of the corporation should be disregarded. Accordingly, the technical lack of ownership by the group of 80 <%> **percent** of the nonvoting class of stock, as required by the statute at that time, did not prevent the corporation from being included as a member of the affiliated group. There is no indication in Private Letter Ruling 6710242620B whether it was the addition of voting rights to the stock held by nonmembers, the increase in the value of the stock held by nonmembers, or a combination of these factors that caused the stock held by nonmembers to be respected for disaffiliation purposes. Cf. Priv. Ltr. Rul. 8331015 (Apr. 26, 1983) (corporation issued 100 <%> **percent** of nonvoting class of common stock to individuals for valid business purpose; assuming the individuals did not hold the nonvoting stock as nominees of the owner of the voting stock and that the nonvoting stock had "sufficient substance" to be recognized for purposes of section 1504, the letter ruling concluded that the issuance of the stock would break affiliation with the owner of the voting stock).

neither a disproportionality between voting power and value, nor a purpose to avoid affiliation, should prevent the actual (as opposed to sham) ownership outside the group of more than 20 percent of the effective voting power of a corporation from breaking affiliation. See Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956) (court held sales and gifts by parent corporation of shares of a subsidiary to friendly buyers for the purpose of reducing ownership of the subsidiary to below 80 percent, allowing parent to take loss on liquidation of subsidiary, were effective; the court concluded that the substance of the transfers matched the form, noting the absence of any evidence of an understanding by the parties that any interest in the transferred stock was retained by the parent). Rather, we believe the analysis should focus on whether the purported ownership and voting rights are real or illusory. While disproportionality between vote and value and a purpose to deconsolidate may suggest that the substance of the transaction (i.e., the reality of the ownership and voting rights) deserves careful scrutiny, we believe that these factors by themselves should not cause stock to be disregarded for purposes of determining whether two corporations are affiliates. Cf. Higgins v. Smith, 308 U.S. 473 (1940) (related party transactions subject to greater scrutiny than transactions between unrelated parties because they may not be on arm's-length terms); Sun Properties, Inc. v. United States, 220 F.2d 171, 174 (5th Cir. 1955) (transaction not disregarded simply because not at arm's length).

Authorities dealing with the voting power test contained in the definition of a controlled foreign corporation ("CFC") provide some indication of the factors that the IRS and the courts might consider relevant in determining the reality of a shareholder's purported ownership and voting power. While the purposes of the CFC rules and the consolidation rules are quite different, we believe the CFC authorities can be useful in analyzing fact situations in which the taxpayer is attempting to avoid consolidation. The antiabuse considerations underlying enactment of the CFC rules are quite different from the considerations underlying enactment of the consolidated return rules, which are generally considered to create a taxpayer-favorable privilege. Consistent with these differing purposes, the authorities tend to interpret the voting control requirement in the CFC rules in favor of finding control, thereby imposing the limitations of CFC status on the tax avoidance opportunities available to a taxpayer, but tend to interpret the voting control requirement in the consolidated return rules against finding control, thereby denying the privilege of filing a consolidated return. Accordingly, we believe that voting rights that would be recognized as sufficient to avoid control for purposes of determining CFC status should be sufficient to avoid control for purposes of determining affiliation. See Priv. Ltr. Rul. 9714002 (affiliation status is much more neutral than ~~<controlled foreign corporation>~~ **CFC** status).

Section 957(a) provides that a foreign corporation is a CFC if more than 50 percent of the total combined voting power of the corporation is owned by United States shareholders. (Section 957(a) was amended in 1986 to add, as an alternative basis for classification as a CFC, ownership of more than 50 percent of the total value of the stock of the corporation by United States shareholders.) The regulations under section 957 provide that, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person on whose behalf it is exercised, or, if not exercised, will be disregarded if the percentage of voting power of such class is substantially greater than its proportionate share of the corporate earnings, if the facts show that the shareholders of such class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification as a CFC. Treas. Reg. § 1.957-1(b)(2). Accordingly, disproportionality between vote and value or between vote and profit share does not appear to be a sufficient reason by itself to disregard the voting power of a class of stock. Rather, the facts and circumstances surrounding the manner in which the vote is exercised are critical to a determination to disregard such voting rights.

Application of this regulation by the courts confirms that a disproportionately high vote compared to value or profit share does not, by itself, prevent the purported voting power of shares from being respected. See CCA, Inc. v. Commissioner, 64 T.C. 137 (1975) (nonacq.); Koehring Co. v. United States, 583 F.2d 313 (7th Cir. 1978); Kraus v. Commissioner, 490 F.2d 898 ~~<(2nd>~~**(2d** Cir. 1974); Garlock, Inc. v. Commissioner, 489 F.2d 197 ~~<(2nd>~~**(2d** Cir. 1973); Estate of Weiskopf v. Commissioner, 64 T.C. 78 (1975), aff'd, 538 F.2d 317 ~~<(2nd>~~**(2d** Cir. 1976).

In CCA, the court found that a Swiss corporation was not a CFC where preferred stock carrying 50 percent of the voting rights in the corporation was sold to foreign persons. The fact that the preferred shareholders paid less for their stock than 50 percent of the net worth of the corporation[6] was not considered by the court to be sufficient, in light of other factors present in the case, to disregard the voting power of the preferred stock. **CCA,** 64 T.C. at 153. The other factors considered by the court were that there were no substantial restrictions placed on the preferred stock other than a requirement for approval of transfers that was equally applicable to the common stock, no provision was made for the U.S. ~~<shareholders>~~ **shareholder** to acquire the preferred stock, the board of directors was equally divided between representatives of the common ~~<shareholders>~~ **shareholder** and the preferred shareholders, there were no provisions for breaking deadlocks, the board of directors had significant powers, any two members of the board of directors could act jointly to represent the corporation vis-a-vis the outside world, the preferred shareholders were not related to the U.S. ~~<shareholders>~~ **shareholder**, representatives of the preferred shareholders took an active part in shareholder and director meetings, and the U.S. shareholder retained no "significant strings" which could have been used to require the preferred shareholders to vote with it. The court found the facts in CCA to be in sharp contrast to those in Kraus, Garlock, and Weiskopf in which U.S. shareholders were found to have retained dominion and control, despite the ownership by foreign persons of shares representing 50 percent of the voting power of the corporation.

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6 Based on the facts set forth in the case, it appears that the preferred stock was purchased for an amount equal to not more than 12 percent of the net worth of the corporation.

In Kraus, a foreign corporation owned by U.S. persons was recapitalized, just before the CFC rules became effective, by the issuance of preferred stock representing 50 percent of the voting power in the corporation to foreign persons in exchange for a capital contribution that constituted less than 10 percent of the net worth of the corporation. The court disregarded the foreign shareholders' voting power, stating that it "defies credulity" that the owners of a corporation with a net worth in excess of $250,000 and annual profits in excess of $225,000 would surrender 50 percent of the control of their corporation to new shareholders who were making a capital contribution of less than $25,000. Kraus, 490 F.2d at 902. The court went on, however, to review other factors. The court noted that a foreign shareholder was present in person at only one meeting, that the foreign shareholders, while represented at all meetings, had never shown any dissent or disapproval, that the U.S. ~~<shareholder>~~ **shareholders** had sought out foreign shareholders who were related to, close personal friends of, or business associates of the U.S. ~~<shareholder>~~ **shareholders**, that the stock issued to the foreign shareholders was registered, could be transferred only upon approval of the board of directors and could be redeemed at any time, and that when the U.S. shareholders decided to sell their shares, they agreed to and did in fact cause the preferred shareholders to sell their stock to certain parties at a specified price. Based on the totality of the facts, and not on any one factor, the court concluded that the corporation was a CFC. Id. at 903.

Garlock is similar to Kraus in that preferred stock possessing 50 percent of the voting power of a foreign corporation was issued to a foreign person **(with a portion sold by the original investor to another foreign person)** just before the effective date of the CFC rules. The preferred stock received a maximum of 16 percent of corporate profits in the years at issue. The court sustained the IRS's application of the regulation under section 957, finding that the preferred ~~<shareholders>~~ **shareholders'** voting power was illusory. Garlock, 489 F.2d at 202. The court identified as significant the facts that the U.S. shareholder sought out parties who understood both its motives and its situation, that the terms of the arrangement were such that the preferred shareholders would have no interest in disturbing the U.S. shareholder's continued control, the stock was made attractive by paying a rate in excess of market, the stake of the preferred shareholders was limited since they could put their stock to the corporation after one year or if the working capital of the corporation fell below 200 percent of the aggregate par value of the preferred, and the arbitration provision for resolving disputes was unrealistic. Id. at 201-02.

In Weiskopf, a newly formed UK corporation (Ininco) issued preferred ordinary shares in exchange for £25,000 to another UK corporation (Romney), and issued to a U.S. corporation deferred ordinary shares in exchange for £2,500 and second preferred shares in exchange for £17,500. The preferred ordinary shares elected 50 percent of the board of directors and received a dividend of 12.5 percent per year. The deferred ordinary shares elected the remaining 50 percent of the board of directors and shared the profits of the corporation, after the payment of the dividend on the preferred ordinary shares, with the second preferred shares. While the facts are not entirely clear, it appears that the UK tax exemption of Ininco resulted in Ininco having very substantial net earnings, with the result that the 12.5 percent return on the preferred ordinary shares represented much less than 50 percent of the annual earnings of Ininco. Weiskopf, 64 T.C. at 96. Two and one-half years after its formation, the preferred ordinary shares of Ininco were sold for par value (£25,000) and the remaining shares were sold for approximately £810,000. Again, the opinion focuses on a factual analysis to determine the reality of the control exercised by Romney. The court concluded that, as in Garlock, the arrangement was such that the preferred shareholder would have no interest in disturbing the U.S. <~~shareholders'~~>**shareholder's** control and that the U.S. <~~shareholders~~> **shareholder** retained complete dominion and control of Ininco. The factors mentioned by the court in reaching its conclusion were the above market rate of return being paid on the preferred shares, the limitation of the preferred shareholder to a return of its investment upon disposing of its stock, the dependence of Ininco on the U.S. shareholder as its source of supply for Ininco's product line, the unrealistic provision for resolving a deadlock, the disproportionality between vote and profit share, and the control the U.S. shareholder demonstrated at the time of the sale of the stock of Ininco.

In Koehring, preferred stock entitled to 55 percent of the vote and less than 10 percent of the annual earnings of a Panamanian corporation was issued to a UK corporation that had a longstanding business relationship with the U.S. shareholder of the Panamanian corporation, followed shortly by a cross-investment of the identical amount of cash by the U.S. shareholder of the Panamanian corporation in the UK corporation. The opinion turns on the factual issue of whether the foreign preferred shareholder exercised its 55 percent voting rights independently, with the court focusing on the cross-investment, the dependence of the preferred shareholder on the U.S. shareholder under a license agreement, the actual actions taken by the preferred shareholder's directors and the understanding that the UK corporation could withdraw its investment after a year. The factual statement in the opinion also refers to the preferred directors not being authorized to draw checks on behalf of the corporation and a reference in the minutes of a board of directors meeting of the UK corporation to its control over the Panamanian corporation being "nominal." The court affirmed the district court's decision to disregard the voting power of the UK corporation, distinguishing CCA (without conceding that CCA was correctly decided) based on the tax court's finding of the absence of an agreement in CCA regarding the voting of the foreign shareholders' shares. Koehring, 583 F.2d at 324.

We believe that PCI's voting power in OPI should be respected because we believe the relevant facts and circumstances indicate that PCI's ownership of its shares and its voting rights under the documents should be considered to be real. First and foremost are the facts that Enron will not exercise any control or influence over PCI in the exercise of its voting rights in OPI and PCI will exercise its voting rights in OPI for the benefit of itself and its Affiliates, and not on behalf of or for the benefit of Enron and its Affiliates. In addition, the two classes of preferred stock of OPI, in the aggregate, have an economic interest in <~~2~~> **two** percent of the profits of OPI above the base return provided to the shareholders. It appears reasonable to believe that PCI would want to protect its approximately 45 percent interest in this <~~2~~> **two** percent <~~upside~~> **profit share** through the exercise of its voting rights. Furthermore, PCI and Enron are not related, and no fee paid by Enron in connection with the transactions described herein is contingent upon the manner in which PCI exercises its voting rights in OPI.[7] Finally, all classes of shares in OPI are freely transferable. While OPI has a right to redeem the shares held by PCI, and PCI has a right to require redemption of its shares, these rights do not arise for more than five years after the issuance of the OPI preferred stock. We believe these redemption rights should not affect the reality of PCI's voting power prior to the first date on which one or more of these rights can be exercised. Accordingly, we believe the voting power held by PCI should be respected prior to such date and that OPI should have ceased to be an affiliate of Enron under section 1504 at the end of the day on March 27, 1997. Treas. Reg. § 1.1502-76(b)(1)(ii)(A).

B. <~~Preffered~~> **Preferred** Stock of Liquids

The term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if the common parent owns directly stock meeting the 80 <~~-~~>percent voting and value test in at least one of the other includible corporations and stock meeting the 80 <~~-~~>percent voting and value test in each of the includible corporations (other than the common parent) is owned directly by one or more of the other includible corporations. Section 1504(a)(1). The 80 <~~-~~>percent voting and value test requires ownership of stock of a corporation that possesses at least 80 percent of the total voting power of the stock of such corporation and that has a value equal to at least 80 percent of the total value of the stock of such corporation. Section 1504(a)(2).

<~~For purposes of section 1504(a),~~> **Section 1504(a)(4) provides that** the term "stock" does not include stock that (A) is not entitled to vote; (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; (C) has redemption and liquidation rights which do not exceed the issue price (except for a reasonable redemption or liquidation premium); and (D) is not convertible into another class of stock. <~~Section 1504(a)(4).~~> The Liquids preferred stock is, by its terms, not entitled to vote, limited and preferred as to dividends, and not convertible into any other class of stock. Moreover, we believe that the facts do not indicate that the preferred stock

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7 We understand that PCI and EN-BT may have entered into a shareholder agreement and that EN-BT may have paid a fee to PCI in connection with PCI's investment in OPI. Even if these arrangements were to give EN-BT some influence over PCI's exercise of its voting rights in OPI, we believe that such arrangements should not be considered relevant in determining whether the voting rights of the preferred stock should be respected for purposes of determining whether OPI is a member of the Enron consolidated group. Rather, we believe that it would be only the relationship, if any, of Enron to the holders of the preferred stock, and Enron's influence, if any, over the exercise of the preferred stock voting rights, that should be considered relevant. Enron is unrelated to EN-BT and EN-BT will exercise its voting rights in OPI on behalf of itself and its Affiliates, and not for the benefit of Enron. Accordingly, even if EN-BT were in a position to influence PCI's exercise of its voting rights, we believe Enron should not be considered to be in a position to influence EN-BT's direct exercise of its voting rights in OPI or EN-BT's indirect exercise of voting rights through its influence over PCI.

of Liquids has any beneficial interest in or control over the voting power of the common stock of Liquids. The issue price of Liquids preferred stock is not less than its redemption price and its liquidation value (except for a reasonable redemption or liquidation premium).

The last requirement of section 1504(a)(4) is that the stock not participate in corporate growth to any significant extent. No regulatory guidance exists as to the meaning of this section 1504(a)(4) "participation" test. A similar test is contained in the regulations under section 382. An ownership interest that would not otherwise be treated as "stock" for purposes of section 382 is treated as stock if such interest "offers a potential significant participation in the growth of the corporation" and certain other facts are present. Treas. Reg. § 1.382-2T(f)(18)(iii)(A). Section 1504(a)(4) stock is not stock for purposes of section 382 unless the provisions of Treasury Regulation § 1.382-2T(f)(18)(iii) apply. Treas. Reg. § 1.382-2T(f)(18)(i). It appears that stock that satisfies the section 1504(a)(4)(B) requirement that it "not participate in corporate growth to any significant extent" could nevertheless be found to offer a "potential significant participation in the growth of the corporation." Cf. Priv. Ltr. Rul. 8945055 (Aug. 16, 1989). Thus, the participation standard in the section 382 regulation appears to be stricter than that in section 1504(a)(4)(B), and stock that does not offer a "potential significant participation in the growth of the corporation" for purposes of Treasury Regulation § 1.382-2T(f)(18)(iii) should not be considered to "participate in corporate growth to any significant extent" for purposes of section 1504(a)(4)(B).

The yield on the preferred stock of Liquids does not vary with either the profitability of the issuing corporation or the appreciation of its assets. Terms that do not vary the return on the preferred stock with the profits of the issuing corporation may not be sufficient to establish an absence of participation in corporate growth, however, if the facts and circumstances indicate that the preferred stock in effect participates in corporate growth. See H.R. Rep. No. 98-861, at 817 (1984) ("preferred stock carrying a dividend rate materially in excess of a market rate when issued would not be ignored"). An argument might be made that the preferred stock nevertheless participates in corporate growth if the capitalization or operations of the corporation were such that corporate growth would be required in order for the issuing corporation to satisfy its obligations with respect to the preferred stock.[8]

In the section 382 context, the IRS has ruled that preferred stock does not offer a potential significant participation in the growth of a corporation solely because of its dividend rate where the current earnings of the corporation are sufficient to permit the corporation to pay dividends at the highest rate with respect to the stock. **See** Priv. Ltr. Rul. 8945055 (Aug. 16, 1989). The IRS has

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8 See Michael L. Schler, Money Market Preferred Stock: Making the Punishment Fit the Crime, 46 Tax Notes 935, 939 (1990) (insubstantial common stock capitalization might mean that the preferred stock bears the ~~<downside>~~ **"downside"** risk of the corporate assets ~~<and thus may not constitute>~~**, violating the spirit of** section 1504(a)(4) ~~<stock}>~~**)**.

also ruled that ownership interests (notes and debentures) in an insolvent corporation did not constitute stock where the issue was whether the notes and debentures offered a potential significant participation in the growth of the corporation within the meaning of Treasury Regulation § 1.382-2T(f)(18)(iii)(A) and the corporation represented that it would have sufficient assets (not taking into account future growth of assets), in conjunction with the cash flow from its projected future earnings and proceeds of anticipated additional debt financing, to meet all required payments of principal and interest on the notes and debentures. **See** Priv. Ltr. Rul. 9441036 (July 14, 1994); see also Priv. Ltr. Rul. 8940006 (Apr. 20, 1989) (preferred stock issued in bankruptcy reorganization was not stock for purposes of section 382; issuing corporation represented that (i) it would have sufficient assets (not taking into account future growth of assets), in conjunction with the cash flow from its projected future earnings, to meet all required payments on the preferred stock, including required payments on preferred stock issued in lieu of cash dividends, and (ii) the fair market value of the assets of the issuing corporation would exceed the face amount of the outstanding debt plus the par value of the preferred stock).

On the date of issue, the annual dividend rate for the preferred stock of Liquids was not materially in excess of the prevailing market rate for preferred stock having similar terms and issued by a corporation having a credit rating similar to that which the issuing corporation would have on the date of issuance if it were rated. The preferred stock of Liquids represented approximately 67 percent of the equity capital of Liquids on the date it was issued. The fair market value of the assets of Liquids will at all times exceed the face amount of such corporation's outstanding debt plus any accrued but unpaid interest plus the liquidation value (including accrued but unpaid dividends) of its preferred stock. All dividends on the Liquids preferred stock will be paid currently. The current earnings and profits and net cash flow of Liquids for each year will each exceed the annual dividend on its preferred stock.

We have found no authority addressing the effect, if any, under section 1504(a)(4) of having a substantial portion of a corporation's capital represented by preferred stock. We understand that the IRS has refused to rule on this issue, suggesting that the IRS might challenge the treatment of such preferred stock.[9] We believe that any such challenge would be based on the participation test, and we further believe that the facts described do not provide any basis for a court to conclude that the preferred stock of Liquids participates in corporate growth to any significant extent. Accordingly, we believe the preferred stock of Liquids is described in section 1504(a)(4).

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9 See Priv. Ltr. Rul. 8937022 (June 19, 1989) (par value of nonparticipating preferred stock represented 72 percent of the par value of the entire corporation; no indication given as to fair market value of respective classes; IRS did not rule on the section 1504(a) issue); see also Richard B. Engel, The Section 1504(a) Affiliation Test, 20 Tax Adviser 615 (1989) (identifying the refusal by the IRS to rule whether preferred stock was section 1504(a)(4) stock when it constituted a substantial percentage of the corporate structure).

C. Classification of Partnership

The <~~Internal Revenue~~> Code defines a partnership as including <~~"a~~>**"a** syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation.<~~"~~>**"** Section 7701(a)(2); see also section 761(a). This definition subsumes two issues: (1) whether an arrangement is a syndicate, etc., through or by means of which a business, financial operation or venture is carried on, and (2) if so, whether the arrangement is otherwise classified as a corporation for tax purposes.

As to the first issue, the leading case is Commissioner v. Culbertson, 337 U.S. 733 (1949), in which the Supreme Court stated that the test is:

> <~~[W]hether~~> **whether**, considering all the facts -- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent -- the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Id. at 742 (footnote omitted). The Tax Court has focused on a number of factors, none of which is conclusive, in attempting to determine the intent of the parties to form a partnership. See S. & M. Plumbing Co. v. Commissioner, 55 T.C. 702, 707 (1971) (acq.) <~~("four~~>**("four** basic attributes<~~"~~>**"** of a partnership are the intent of the parties, the contribution of money, property and/or services, an agreement for joint proprietorship and control, and an agreement to share profits); Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964) (the agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise).

Based on the fact that the partners of Partnership intend to form a partnership and the fact that the documents are consistent with this intent, including all of the relevant indicia of partnership, we believe that Partnership will constitute a partnership for federal income tax purposes if it is not otherwise classified as an <~~"association"~~>**"association"** taxable as a corporation. In general an unincorporated domestic entity that has two or more members and that was formed on or after January 1, 1997 will be treated as a partnership unless it elects to be classified as an association. Treas. Reg. §§ 1.7701-3(a), -3(b). The Partnership will not elect to be classified as an association.

An entity that otherwise qualifies as a partnership for federal income tax purposes may nevertheless be subject to taxation as if it were a corporation if it is a publicly traded partnership within the meaning of section 7704. For taxable years of a partnership beginning after December 31, 1995, publicly traded status can be avoided if interests in the partnership are not traded on an established securities market, are offered and sold within the United States and are not registered under the Securities Act of 1933, and if not more than 100 persons own, directly or indirectly through a partnership, a grantor trust, or an S corporation, interests in the partnership. Treas. Reg. <§>§§ 1.7704-1(a)(1)(i), -1(h). None of the interests in Partnership are traded on an established securities market. All of the interests in Partnership were offered and sold within the United States and were issued in transactions that were not required to be registered under the Securities Act of 1933. Less than 100 persons own, directly or indirectly through partnerships, grantor trusts, or S corporations, an interest in Partnership.

Accordingly, we believe Partnership should be classified as a partnership and should not be a publicly traded partnership.

D. Contributions to OPI and Liquids

1. Section 351

Generally, gain or loss is not recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the transferee corporation. Section 351(a). Control, for these purposes, means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. Sections 351(a), 368(c).

Pursuant to the Enron/OPI Contribution Agreement, Enron transferred the Note to OPI on March 21, 1997 and transferred the Building to OPI on April 14, 1997.[10] Pursuant to the EN-BT

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10 Enron did not receive any stock in exchange for its contribution of assets to OPI **or Liquids**. Given Enron's **initial** ownership of 100 percent of the common stock of OPI ~~<at all times>~~ **and Liquids**, the issuance of additional shares of common stock to Enron would have been meaningless. See Commissioner v. Morgan, 288 F.2d 676 (3d Cir. 1961); King v. United States, 79 F.2d 453 (4th Cir. 1935)<>**. Under such circumstances, we believe the federal income tax consequences of the contributions by Enron to OPI and Liquids should be determined as if Enron had received stock of the transferee in exchange for the contributed assets. See** Lessinger v.

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Subscription Agreement and the PCI Subscription Agreement, EN-BT and PCI transferred cash to OPI on March 27, 1997. Transfers by different persons at different times may be aggregated in determining whether the transferors of property are in control of a corporation immediately after the exchange. "The phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." Treas. Reg. § 1.351-1(a)(1)

A binding commitment is not required in order for transfers to be treated as part of a single section 351 transaction. See Turner Construction Co. v. United States, 364 F.2d 525 (2d Cir. 1966); Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940); Von's Inv. Co. v. Commissioner, 92 F.2d 861, 863-64 (9th Cir. 1937); Stanley, Inc. v. Schuster, 295 F. Supp. 812 ~~<(S.D.Oh>~~**(S.D. Oh**. 1969), aff'd, **421 F.2d 1360** (6th ~~<cir)>~~ **Cir. 1970)**; Baker Commodities, Inc. v. Commissioner, 48 T.C. 374 (1967), **aff'd, 415 F.2d 519 (9th Cir. 1969)**; Marcher v. Commissioner, 32 B.T.A. 76, 80 (1935); Rev. Rul. 78-294, 1978-2 C.B. 141, obsoleted by T.D. 8665, 1996-1 C.B. 35~~<)>~~. Rather, the test that has most commonly been applied is whether the transfers are mutually interdependent, as that test is described in American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949) ("Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series?") In American Bantam Car, the issuance of shares in exchange for a contribution of assets to a newly formed corporation and the issuance of preferred shares to the public pursuant to an underwriting contract entered into five days after the asset transfer were treated as separate transactions. Although contemplated under the same general plan, the sale of preferred stock to the public was "entirely secondary and supplemental to the principal goal of the plan -- to organize the new corporation and exchange its stock for . . . assets. The understanding with the underwriters for disposing of the preferred stock, however important, was not a *sine qua non* in the general plan, without which no other step would have been taken. While the incorporation and exchange of assets would have been purposeless one without the other, yet both would have been carried out even though the contemplated method of marketing the preferred might fail." **American Bantam Car,** 11 T.C. at 406-07.[11]

Commissioner, 85 T.C. 824 (1985), rev'd on other issues, 872 F.2d 519 (2d Cir. 1989); Rev. Rul. 64-155, 1964-1 C.B. 138. ~~<Accordingly, we have analyzed the contributions by Enron as if it had received common stock in exchange as part of a section 351 transaction. If Enron were not treated as having received stock in exchange for its contributions, we believe the transfers by Enron should be treated as contributions to capital and the tax consequences to Enron and OPI should be the same. Sections 118, 362, 1012; Rev. Rul. 83-73, 1983-1 C.B. 84>~~

11 See also Turner Construction, **364 F.2d 525** (issuance of stock to employees and issuance of stock in exchange for assets of business were mutually interdependent, although issuance of stock to employees was delayed seven months while it was decided exactly which employees were to get how much stock); Commissioner v. National Bellas Hess, **Inc.**, 220 F.2d 415 (8th Cir. 1955) (incorporation followed by public stock offering were not mutually

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The predominant purpose of Enron and its Affiliates for participating in the recapitalization of OPI was to generate income for financial accounting purposes. The contribution to OPI of the Building and the contributions to OPI by EN-BT and PCI were essential to obtaining the desired financial accounting results. In the absence of such contributions, the contribution of the Note to OPI would not have accomplished the predominant purpose for the recapitalization of OPI. We understand that Enron would not have made any contributions to OPI if it had not believed that, within a short period of time, the transfer of the Building would occur in accordance with the terms of the Enron/OPI ~~<Contributions>~~ **Contribution** Agreement and EN-BT and PCI would execute and make contributions in accordance with their respective subscription agreements.

As reflected in the Intent Letter, the transfer by Enron, EN-BT, and PCI were all contemplated as part of a single plan for recapitalizing OPI. In addition, on March 21, 1997, the ~~<Articles>~~ **Certificate** of Incorporation of OPI ~~<were>~~ **was** amended to provide for the shares ultimately issued to EN-BT and PCI, the Board of Directors of OPI adopted resolutions authorizing the issuance of such shares to EN-BT and PCI, and the sole stockholder of OPI authorized the issuance of such shares. On March 27, 1997, PCI and EN-BT subscribed for shares, and OPI issued shares, on the terms established on March 21, 1997. While there was, on March 21, 1997, no binding commitment on the part of OPI, EN-BT, or PCI with respect to the contributions and stock issuances that occurred on March 27, 1997, we believe the above documents establish that the terms on which the PCI and EN-BT contributions were ultimately made were defined on March 21, 1997.

Based on the facts described above, we believe that the transfers by Enron on March 21 and April 14 and the transfers by EN-BT and PCI on March 27 should all be treated as mutually interdependent and as part of a single section 351 transaction. Immediately after the transfers by Enron, EN-BT, and PCI, those corporations owned all of the stock of OPI. Accordingly, we believe the contributions by Enron to OPI should be nontaxable transfers described in section 351.

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interdependent; Tax Court could properly determine sale of stock to the public did not have any intended controlling relationship on whether the exchange of property and stock would have been carried out; it may have been understood that organizers would attempt to sell stock to the public, but it was a gamble whether it could be done under the economic conditions obtaining in 1932); ~~<H.B>~~ **H. B**. Zachry Co. v. Commissioner, 49 T.C. 73 (1967) (exchange of assets for stock, followed three days later by exchange of cash for preferred stock, respected as separate transactions; valid business purpose for each transaction standing by itself; only the assets exchanged for stock were required by corporation to carry out its corporate function); Baker Commodities, **48 T.C. 374** (while there appears to have been no written agreement, multiple transfers to a corporation were integrated where, as a result of lengthy negotiations, a plan to transfer various assets to a corporation to be owned equally by the parties had been "carefully formulated and agreed to by all the participants"); Scientific Instrument Co. v. Commissioner, 17 T.C. 1253 (1952), **aff'd, 202 F.2d 155 (6th Cir. 1953)** (core steps of plan were formation of new corporation and transfer to it of assets of old corporation; effectiveness did not depend on new capital; initial transfer of assets not mutually interdependent with sale of stock to public pursuant to underwriting contract entered into before initial asset transfer).

Enron transferred the stock of Operations and OPI transferred the Note to Liquids on March 21, 1997 pursuant to the Enron/Liquids Contribution Agreement and the OPI/Liquids Contribution Agreement. Immediately after those contributions, Enron and OPI owned all of the stock of Liquids. Accordingly, we believe the contributions by Enron and OPI to Liquids should be nontaxable transfers described in section 351.

2. Section 357(c)

Section 357(c) provides for the recognition of gain from the sale or exchange of property in a section 351 exchange to the extent that the sum of liabilities of a transferor assumed by the transferee corporation plus liabilities to which property contributed by the transferor is subject exceeds the adjusted basis of the property contributed by the transferor. The aggregate adjusted tax basis of the Note and the Building in the hands of Enron exceeded the sum of the aggregate amount of liabilities of Enron assumed by OPI pursuant to the Enron/OPI Contribution Agreement and the aggregate amount of liabilities to which assets transferred pursuant to the Enron/OPI Contribution Agreement to OPI by Enron were subject. As discussed above, we believe the transfers by Enron on March 21 and April 14 should be treated as part of a single section 351 <~~transactions~~> **transaction**. Accordingly, we believe section 357(c) should not be applicable to Enron's transfers to OPI.

3. Basis Effects

In general, the basis of stock received by a transferor in a section 351 transaction equals the basis of the property exchanged for such stock, decreased by the amount of any liabilities transferred to the issuing corporation. Section 358(a)(1), (d). If a transferor receives stock of more than one class in a section 351 transaction, the basis of the property transferred is allocated among all of the stock received in proportion to the fair market <~~values~~> **value** of the stock of each class. Treas. Reg. § 1.358-2(b)(2). In general, the basis of property received by a corporation in exchange for its stock in a section 351 transaction equals the basis of the property in the hands of the transferor immediately before the exchange. Section 362(a).

Accordingly, we believe that (1) Enron's adjusted basis in the common stock of OPI should be increased by **the excess of** Enron's **aggregate** adjusted <~~basis~~> **bases** in the Note **and the Building** immediately before Enron's contribution of <~~the Note to OPI~~> **those assets to OPI over the amount of the liabilities represented by the Lease Agreement**, (2) Liquids' adjusted basis in the stock of Operations immediately after the contribution of such stock to Liquids should equal Enron's adjusted basis in the stock of Operations immediately before Enron's contribution of such stock to Liquids, (3) OPI's adjusted basis in each of the Note and the Building immediately after they were received by OPI should equal Enron's adjusted basis in the Note and the Building, respectively, immediately before they were contributed to OPI, and <~~(3)~~> **(4)** OPI's adjusted basis in the common and preferred stock of Liquids immediately after OPI's contribution of the Note to Liquids should equal OPI's adjusted basis in the Note immediately before such contribution (i.e., Enron's adjusted basis in the Note immediately before it was contributed to OPI) and such basis should be allocated between the common stock and the preferred stock of Liquids in proportion to the fair market value of the stock of each class received by OPI.

4. Earnings and Profits Effects

The consolidated return regulations modify the determination of the earnings and profits of a member of a consolidated group ("P") by adjusting the earnings and profits of P to reflect a subsidiary's ("S") earnings and profits for the period that S is a member of the consolidated group. Treas. Reg. § 1.1502-33(a)(1). The purpose for these modifications (the "earnings and profits rules") is to treat P and S as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent. Id. Adjustments to the earnings and profits of P under these rules are in addition to adjustments under other rules of law (e.g., section 312), subject to the limitation that P's earnings and profits must not be adjusted in a manner that has the effect of duplicating an adjustment. Treas. Reg. § 1.1502-33(a)(2).

The general rule is that S's earnings and profits are "tiered up" to P. Under Treasury Regulation § 1.1502-33(b)(1), P's earnings and profits are adjusted to reflect changes in S's earnings and profits in accordance with the applicable principles of Treasury Regulation § 1.1502-32 (the "investment adjustment <~~rules)~~> **rules")**, S's earnings and profits are allocated among S's shares under the principles of Treasury Regulation § 1.1502-32(c) of the investment adjustment rules, and the principles of the investment adjustment rules are modified in that P's earnings and profits adjustment is determined by reference to S's earnings and profits, rather than S's taxable and tax-exempt items.

The earnings and profits rules contain a provision that deals with a change in location of a subsidiary within the group. Treas. Reg. § 1.1502-33(f)(2). Under this rule, if the location of a member changes within a group, "appropriate adjustments" must be made to the earnings and profits of the members to prevent the earnings and profits from being eliminated. For example, if P transfers all the stock of S to another member in a section 351 transaction, the transferee's earnings and profits are adjusted immediately after the transfer to reflect the earnings and profits of S immediately before the transfer. Id. Accordingly, we believe the transfer by Enron of all of the common stock of Operations to Liquids should cause all of the earnings and profits of Operations to "tier up" to Liquids.

The earnings and profits rules contain an anti-avoidance rule that provides for adjustments as necessary to carry out the purposes of the rules if any person acts with a principal purpose contrary to the purpose of the rules, to avoid the effect of the rules, or to apply the rules to avoid the effect of any other provision of the consolidated return regulations. ~~<Treasury Regulation>~~ **Treas. Reg.** § 1.1502-33(g). The primary earnings and profits effect of the transfer of Operations to Liquids is the duplication of all of Operation's earnings and profits in Liquids.

We believe that the statement of the purpose of the earnings and profits rules (to treat a parent and a subsidiary as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent) is consistent with this effect. The rules cause the earnings and profits of Operations to "tier up" to Liquids, which is a higher-tier member in the Enron group as a result of the contribution of the Operations stock to Liquids. Reflecting the earnings and profits of Operations in Liquids is consistent with treating the Enron consolidated group as a single entity. Accordingly, we do not believe that the earnings and profits anti-avoidance rule should be applicable to the contribution of Operations to Liquids.

E. OPI Contribution to Partnership

1. In General

In general, gain or loss is not recognized by a partnership or its partners on the contribution of property to a partnership in exchange for a partnership interest. Section 721(a). In general, the basis of property contributed to a partnership by a partner is equal to the adjusted basis of such property to the contributing partner at the time of the contribution. Section 723. Accordingly, we believe no gain or loss should be recognized on the contribution by OPI to Partnership and Partnership should have a basis in the Building equal to the adjusted basis of the Building in the hands of Enron immediately prior to the contribution.

2. Section 707

Notwithstanding the general rule of section 721(a), a purported "contribution" of property to a partnership would be taxable if it were a disguised sale of property. Section 707(a)(2)(B). In order for the contribution by OPI to Partnership to be treated as part of a disguised sale, there would have to be a related transfer of money or property from Partnership to OPI that, when viewed in combination with OPI's contribution, is properly characterized as a sale or exchange of property. Id. Transfers from Partnership to OPI that are more than two years after the contribution by OPI, and distributions of Partnership's net cash flow from operations (as that term is defined in Treasury Regulation § 1.707-4(b)(2)) that are made to the partners in accordance with their minimum percentage interests in Partnership profits are presumed not to be part of a disguised sale unless the facts and circumstances clearly establish that the transfer is part of a sale. Treas. Reg. §§ 1.707-3(d), -4(b). The transfer of a liability to a partnership (whether by assumption or by taking property subject to the liability) is not treated as a transfer of property from the partnership to the partner if the liability is a "qualified liability" (and the contribution is not otherwise treated as a disguised sale) or if the contributing partner's share of that liability after the transfer equals the full amount of the liability. Treas. Reg. §§ 1.707-5(a)(1), -5(a)(5).

OPI transferred to Partnership the liability associated with the Building. The liability associated with the Building is a qualified liability if the amount of the liability does not exceed the fair market value of the Building and the liability is allocable under the rules of Treasury Regulation § 1.163-8T to capital expenditures with respect to the Building. Treas. Reg. § 1.707-5(a)(6). For federal income tax purposes, the lessee under the Lease Agreement is treated as the owner of the Building and the obligations created by the Lease Agreement are treated as a liability of the lessee secured by the Building. The liability represented by the Lease Agreement is allocable under the rules of Treasury Regulation § 1.163-8T to capital expenditures with respect to the Building. The amount of the liability represented by the Lease Agreement does not exceed the fair market value of the Building. The sublease to Enron is a true lease for federal income tax purposes. Accordingly, we believe that such liabilities should be qualified liabilities and the transfer of liabilities under the Lease Agreement to Partnership should not be treated as part of a disguised sale.

VI. CONCLUSION

This opinion letter is based upon existing statutory, regulatory, judicial and administrative authority in effect as of the date of this opinion letter, any of which may be changed at any time with retroactive effect. In addition, our analysis is based solely on the documents we have examined, the representations you have made, the facts that we have assumed with your consent, and the additional information that we have obtained. If any of the facts contained in these documents or in such additional information are, or later become, inaccurate, or if any of the representations you have made or any of the assumptions that we have made are, or later become, inaccurate, our conclusions could well be different and this opinion cannot be relied upon. Similarly, our opinion is qualified by the preceding discussion and analysis and cannot be relied upon if we have not been informed of any material or relevant fact that would adversely affect our analysis.

**PRIVILEGED AND CONFIDENTIAL
SUBJECT TO ATTORNEY-CLIENT PRIVILEGE
AND WORK PRODUCT DOCTRINE**

Our opinion is rendered solely for your benefit and is not to be relied upon by any other person without our prior written consent. Finally, our opinion letter is limited to the specific issues described above.

Sincerely,

KING & SPALDING

By: ______________________
William S. McKee

By: ______________________
Abraham N.M. Shashy, Jr.

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PRIVILEGED AND CONFIDENTIAL
SUBJECT TO ATTORNEY-CLIENT PRIVILEGE
AND WORK-PRODUCT DOCTRINE

July 29, 1997

R. Davis Maxey, Esquire
Senior Director, Tax Research
Corporate Tax
Enron Corp.
1400 Smith Street
Houston, TX 77002-7361

Re: Stock Purchase

Dear Dave:

You have requested our opinion with respect to certain federal income tax consequences of the purchase by Enron Pipeline Company ("Enron Pipeline") of preferred stock of Enron Liquids Holding Corp. ("Liquids") from Enron Leasing Partners, L.P. ("Partnership").

This document is subject to the attorney-client privilege and the work-product doctrine. It contains the legal opinions, thoughts, impressions and conclusions of King & Spalding with respect to certain federal income tax matters. King & Spalding, as special tax counsel for Enron Corp. ("Enron"), has prepared this document at the request of Enron for its sole use. It has been prepared to aid Enron, among other things, in anticipation of possible future litigation regarding the federal income tax matters referenced above and covered herein. In that regard, this document has been prepared to help define, and as part of, the litigation strategy of Enron in the event of any challenge to the federal income tax treatment claimed with respect to the transactions that it addresses.

I. STATEMENT OF FACTS

Enron directly owns all of the common stock, which is all of the outstanding stock, of each of Enron Pipeline, Enron Capital & Trade Resources Corp. ("ECTR"), Enron Power Corp., and Enron Cayman Leasing, Ltd. ("Enron Cayman"). Enron Power Corp. owns all of the common stock, which is all of the outstanding stock, of Enron Development Corp. ("EDC"). Enron owns all of the

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outstanding common stock of Organizational Partner, Inc. ("OPI"). All of the outstanding shares of Series A preferred stock of OPI are owned by Potomac Capital Investment Corporation ("PCI") and all of the outstanding shares of Series B preferred stock of OPI are owned by EN-BT Delaware, Inc. ("EN-BT"). The common stock of Liquids is owned 80 percent by Enron and 20 percent by OPI. The preferred stock of Liquids is owned by Partnership. OPI is a limited partner in Partnership with a 98 percent interest in capital and profits. EN-BT is a limited partner in Partnership with a one percent interest in capital and profits. Enron Property Management Corp. ("Enron GP"), a wholly-owned subsidiary of Enron Cayman, is the general partner of Partnership with a one percent interest in capital and profits.

As of April 28, 1997 there was outstanding an intercompany indebtedness from ECTR to Enron in an amount in excess of $600 million. This indebtedness was incurred for working capital advances made by Enron to ECTR prior to April 28, 1997 and for obligations of ECTR to third parties that were satisfied on behalf of ECTR by Enron prior to April 28, 1997. As of April 28, 1997, there was outstanding an intercompany indebtedness from EDC to Enron in an amount in excess of $400 million. This indebtedness was incurred for working capital advances made by Enron to EDC prior to April 28, 1997 and for obligations of EDC to third parties that were satisfied on behalf of EDC by Enron prior to April 28, 1997.

On April 29, 1997, ECTR issued to Enron a $600 million note (the "$600 Million ECTR Note") and EDC issued to Enron a $400 million note (the "EDC Note"), in each case reflecting a portion of the existing intercompany debt between the issuer and Enron. At the time of the issuance of the $600 Million ECTR Note, ECTR's assets, liabilities, and anticipated cash flows were such that it would have been commercially reasonable for an unrelated person to lend ECTR $600 million on terms substantially the same as those of the $600 Million ECTR Note. At the time of the issuance of the EDC Note, EDC's assets, liabilities, and anticipated cash flows were such that it would have been commercially reasonable for an unrelated person to lend EDC $400 million on terms substantially the same as those of the EDC Note. On April 29, 1997, Enron contributed the $600 Million ECTR Note and the EDC Note to Enron Pipeline. On May 14, 1997, ECTR issued two notes, one in the principal amount of $198 million (the "$198 Million ECTR Note") and one in the principal amount of $402 million (the "$402 Million ECTR Note"), in amendment and restatement of the $600 Million ECTR Note. Payment by ECTR to Enron Pipeline of interest on the $600 Million ECTR Note for the period from April 29, 1997 to May 14, 1997 was reflected in intercompany accounts in accordance with the usual and customary procedures followed by Enron and its wholly-owned subsidiaries with respect to intercompany debts.

On May 14, 1997, Enron Pipeline purchased 1,980 shares of Liquids preferred stock from Partnership (the "Purchase") in exchange for $198 million (the "Purchase Price") in the form of the $198 Million ECTR Note. At that time, Enron guaranteed the $198 Million ECTR Note.

II. DOCUMENTS EXAMINED

In rendering this opinion, we have examined and relied upon the following documents:

Certificate of Amendment of Certificate of Incorporation of Organizational Partner, Inc., filed March 21, 1997.

Certificate of Amendment of Certificate of Incorporation of Enron Liquids Holding Corp., filed March 21, 1997.

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between PCI and OPI ("PCI Subscription Agreement").

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between EN-BT and OPI ("EN-BT Subscription Agreement").

Letter, dated March 27, 1997, from PCI to Enron, relating to representations by PCI and liquidity of OPI.

Letter, dated March 27, 1997, from EN-BT to Enron, relating to representations by EN-BT and liquidity of OPI.

Letter, dated March 27, 1997, from Enron to EN-BT, relating to representations by Enron.

Limited Partnership Agreement of Enron Leasing Partners, L.P., effective as of March 27, 1997, by and among Enron GP, OPI, and EN-BT ("Partnership Agreement").

Promissory Note of ECTR, dated April 29, 1997, in the amount of $600 million.

Promissory Note of ECTR, dated May 14, 1997, in the amount of $198 million.

Promissory Note of ECTR, dated May 14, 1997, in the amount of $402 million.

Promissory Note of EDC, dated April 29, 1997, in the amount of $400 million.

Contribution Agreement, dated as of April 29, 1997, by and between Enron and Enron Pipeline ("Enron/Enron Pipeline Contribution Agreement").

Stock Purchase Agreement, dated as of May 14, 1997, between Partnership and Enron Pipeline ("Purchase Agreement").

Guaranty of Obligations, dated as of May 14, 1997, by Enron in favor of Partnership, relating to the $198 Million ECTR Note.

In our examination of documents and in our reliance upon them in issuing this opinion, we have assumed, with your consent, that all documents submitted to us as photocopies faithfully reproduce the originals, that the originals are authentic, that all documents submitted to us have been duly executed and validly signed to the extent required in substantially the same form as they have been provided to us, that each executed document constitutes the legal, valid, binding and enforceable agreement of the signatory parties, that all representations and statements set forth in the documents are true and correct, and that all obligations, covenants, conditions or terms imposed on the parties by any of the documents have been or will be performed or satisfied in accordance with their terms. We have further assumed that, for our examination in connection with this opinion, you have disclosed to us all of the documents that are relevant to the transactions that are the subject of this opinion and that there are no undocumented agreements related to these transactions that modify or alter the effect of any documents listed above or that create any additional obligations or rights among the parties to those documents. We are not aware of any documents related to these transactions that would alter our opinion as set forth below.

Any capitalized terms not defined herein have the same meaning as in the appropriate documents from the list above.

III. ASSUMPTIONS

In rendering this opinion, we have relied upon the facts as set forth in the Statement of Facts in Section I above, which you have represented to us are true to the best of your knowledge and belief. In addition, you have consented to our reliance, in rendering this opinion, on the following assumptions:

1. Enron and its Affiliates[1] will at all times act in accordance with the form of the transactions as reflected in the documents listed above.

2. The predominant purpose of Enron and its Affiliates for participating in the Purchase was to generate income for financial accounting purposes. The accounting treatment of the Purchase

[1] For purposes of this letter, the "Affiliates" of a person are those persons directly or indirectly controlling, controlled by, or under common control with such person.

provides Enron and its Affiliates with significant and material benefits. Partnership and the Purchase were structured to achieve this purpose without increasing or decreasing, on a present value basis (determined using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period), the aggregate federal income tax liability of the Enron consolidated group or those Affiliates of Enron that are included on Enron's consolidated financial statements.

3. Neither OPI's nor Partnership's holding period with respect to the stock of Liquids has at any time been subject to reduction under section 246(c)(4).[2] Enron's holding period with respect to the stock of Enron Pipeline has not at any time been subject to reduction under section 246(c)(4).

4. On the date of the Purchase, the terms of the Partnership Agreement were commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree. The Purchase Price was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of the purchased shares of Liquids preferred stock on the date of the Purchase.

5. The terms of any transactions, including any loan, lease, license, or fee for services, between any of OPI, Enron GP, Partnership and members of the Enron consolidated group[3] are commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree.

6. Each of Enron, Enron Pipeline, ECTR, EDC, Liquids, OPI, and Enron GP will at all times represent itself to third parties as a separate entity in all transactions, observe all corporate and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Partnership will at all times represent itself to third parties as a separate entity in all transactions, observe all partnership and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees

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2 All references to sections are to the Internal Revenue Code of 1986 (the "Code"), as amended and in effect as of the date of this letter, unless otherwise noted. All references to regulations are to U.S. Treasury Department regulations, as most recently adopted, amended, or proposed, as the case may be, as of the date of this letter, unless otherwise noted.

3 As used in this letter, the term "consolidated group" has the same meaning as in the consolidated return regulations. Treas. Reg. § 1.1502-1(h) (a consolidated group is an affiliated group of corporations filing consolidated returns for the tax year). References to the "Enron consolidated group" are to the consolidated group of which Enron is the parent.

for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Each of the entities listed in the preceding two sentences holds assets having a fair market value of at least $10 million. In addition, each of Enron, Enron Pipeline, ECTR, EDC, Liquids, and OPI has been in existence for at least two years and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons.

7. It is anticipated that Partnership will remain in place for at least five years. While additional stock of Liquids held by Partnership may be sold or redeemed over time, it is anticipated that at least 40 percent of the preferred stock of Liquids will be retained by Partnership for at least two years after March 27, 1997.

8. Enron Pipeline's current and accumulated earnings and profits for the taxable year ending December 31, 1997 will exceed the aggregate amount of the Purchase Price plus any distributions made or deemed made by Enron Pipeline to its shareholders during such year.

9. Enron Pipeline will not, during any 85 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all dividends resulting from such purchases ("Purchase Dividends") were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 85 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 85 day period is greater than 10 percent of the shareholder's basis in such share.

10. Enron Pipeline will not, during any 365 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all Purchase Dividends were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 365 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 365 day period is greater than 20 percent of the shareholder's basis in such share.

11. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using a discount rate that is less than or equal to the after-tax

weighted average cost of capital of the Enron consolidated group during the relevant period) on the date of the Purchase of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer will equal or exceed the present value (computed using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period) on the date of the Purchase of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Purchase.

12. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the recapitalization of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, the operations and investments of OPI and Partnership, and the Purchase. These transactions are considered to produce a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, if the sum of the present values (computed using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period), on March 20, 1997, of the hypothetical federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, determined as if the transactions had not occurred, exceeds the sum of the present values (computed using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period), on March 20, 1997, of the actual federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates.

13. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Purchase on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any.

14. The Purchase will not (i) alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Purchase) by members of the Enron consolidated group to nonmembers of the Enron consolidated group that are treated as made out of earnings and profits or (ii) result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Purchase on the earnings and profits of members of the Enron consolidated group.

15. No member of the Enron consolidated group will dispose of any stock of Liquids or Enron Pipeline except to another member of the Enron consolidated group. Neither Enron nor any

Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Purchase.

16. OPI will have taxable income from nondividend sources that exceeds its deductible expenses.

For purposes of rendering this opinion, you have also consented to our reliance on the additional information that we have obtained through consultation with officers, employees or legal representatives of OPI, Enron GP, Partnership, and members of the Enron consolidated group, as specifically set out in this letter.

IV. OPINION

Based upon our analysis of the pertinent authorities as they apply to the information relied upon, it is our opinion that, for federal income tax purposes:

1. Enron's adjusted basis in the stock of Enron Pipeline should be increased by the aggregate amount of Enron's adjusted basis in the ECTR Note and the EDC Note immediately before Enron's contribution of those notes to Enron Pipeline.

2. Under section 304, the payment by Enron Pipeline to Partnership for the Purchase of the Liquids preferred stock should be treated as a distribution (the "Deemed Distribution") in redemption of the stock of Enron Pipeline for purposes of sections 302 and 303.

3. The Deemed Distribution should be treated as a distribution subject to section 301 and as a dividend under section 301(c)(1).

4. The adjusted basis of the Liquids preferred stock retained by Partnership should be increased by an amount equal to Partnership's adjusted basis in the Liquids stock sold to Enron Pipeline.

5. The adjusted basis of OPI's interest in Partnership should be increased by its distributive share of the Deemed Distribution.

6. OPI should be treated, for purposes of section 243, as having received its distributive share of the Deemed Distribution from Enron Pipeline and should be treated as having satisfied the holding period requirement of section 246(c).

7. Section 246(b) should not limit OPI's section 243 deduction with respect to its distributive share of the Deemed Distribution.

8. It is more likely than not that OPI will be treated as owning 20 percent or more of the stock of Enron Pipeline for purposes of section 243(c)(2).

9. Section 1059 should not be applicable to reduce Partnership's basis in the retained Liquids preferred stock, to reduce OPI's basis in its interest in Partnership, or to trigger gain on the Deemed Distribution.

For purposes of providing you with information that may be relevant in connection with sections 6662 and 6664, we specifically state, without modifying the strength of the opinion set forth above, that in reaching the opinion set forth above we concluded, based on our analysis of the pertinent facts and authorities in the manner described in Treasury Regulation § 1.6662-4(d)(3)(ii), that there is substantial authority (within the meaning of Treasury Regulation § 1.6662-4(d)) for the tax treatment of the items as set forth above and there is a greater than 50 percent likelihood that the tax treatment of the items as set forth above will be upheld in litigation if challenged by the Internal Revenue Service (the "IRS").

V. LEGAL ANALYSIS

A. Basis of Enron Pipeline Stock

Pursuant to the Enron/Enron Pipeline Contribution Agreement, Enron transferred the $600 Million ECTR Note and the EDC Note to Enron Pipeline on April 29, 1997. Enron did not receive any stock in exchange for its contribution of these assets to Enron Pipeline. Given Enron's ownership of 100 percent of the common stock of Enron Pipeline, the issuance of additional shares of common stock to Enron would have been meaningless. See Commissioner v. Morgan, 288 F.2d 676 (3d Cir. 1961); King v. United States, 79 F.2d 453 (4th Cir. 1935). Under such circumstances, we believe that the federal income tax consequences of the contribution by Enron to Enron Pipeline should be determined as if Enron had received stock of Enron Pipeline in exchange for the contributed assets. See Lessinger v. Commissioner, 85 T.C. 824 (1985), rev'd on other issues, 872 F.2d 519 (2d Cir. 1989); Rev. Rul. 64-155, 1964-1 C.B. 138.

Generally, gain or loss is not recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the transferee corporation. Section 351(a). Control, for these purposes, means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. Sections 351(a), 368(c). Immediately after the contribution, Enron owned all of the stock of Enron Pipeline. Accordingly, we believe the contribution by Enron to Enron Pipeline should be treated as a transfer described in section 351.

In general, the basis of stock received by a transferor in a section 351 transaction equals the basis of the property exchanged for such stock, decreased by the amount of any liabilities transferred to the issuing corporation. Sections 358(a)(1), 358(d); Treas. Reg. § 1.358-2(b)(2). In general, the basis of property received by a corporation in exchange for its stock in a section 351 transaction equals the basis of the property in the hands of the transferor immediately before the exchange. Section 362(a).

Accordingly, we believe that (1) Enron's adjusted basis in the common stock of Enron Pipeline should be increased by an amount equal to Enron's aggregate adjusted bases in the $600 Million ECTR Note and the EDC Note immediately before Enron's contribution of those assets to Enron Pipeline and (2) Enron Pipeline's adjusted basis in each of the $600 Million ECTR Note and the EDC Note immediately after the contribution should equal Enron's adjusted basis in each of those assets immediately before the contribution.[4]

B. The Deemed Distribution

1. In General

Under section 304, if one person controls each of two corporations, and in return for property one of the corporations (the acquiring corporation) acquires stock of the other corporation from the person so in control, then such property is treated for purposes of sections 302 and 303 as a distribution in redemption of the stock of the acquiring corporation. Section 304(a)(1). Control for these purposes is defined as ownership of 50 percent of the vote or value of all classes of stock. Section 304(c)(1). A modified version of the constructive ownership rules of section 318 is applied to determine ownership. Section 304(c)(3).

Enron owns all of the outstanding stock of Enron Pipeline. Enron owns in excess of 50 percent of the value of all of the shares of OPI. OPI is a partner in Partnership. Applying the constructive ownership rules of sections 304(c) and 318, Partnership constructively owns all of the outstanding stock of Enron Pipeline that is directly owned by Enron. Sections 304(c)(3), 318(a)(3)(A), 318(a)(3)(C). Similarly, Partnership constructively owns all of the stock of Liquids that is directly owned (whether before or after the Purchase) by Enron, Enron Pipeline, or OPI. Sections 304(c)(3), 318(a)(2)(C), 318(a)(3)(A), 318(a)(3)(C). Accordingly, we believe that

[4] We believe that the tax consequences should be the same if the transfer were treated as a contribution to capital rather than an exchange for stock. See Sections 118, 362, 1012; Rev. Rul. 83-73, 1983-1 C.B. 84.

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AND WORK PRODUCT DOCTRINE**

Partnership owns, directly or constructively, all of the stock of both Enron Pipeline and Liquids, and therefore controls both of those corporations for purposes of section 304. Absent the application of a rule that overrides section 304, we believe the acquisition of stock of Liquids by Enron Pipeline from Partnership should be subject to section 304(a)(1) and the property transferred from Enron Pipeline to Partnership should be treated as a distribution (the "Deemed Distribution") in redemption of stock of Enron Pipeline.[5]

The determination of whether the Deemed Distribution in redemption of stock of Enron Pipeline is treated as a capital transaction under section 302(b) or as a distribution subject to section 301 is made by reference to the stock of Liquids. Section 304(b)(1). Applying the relevant constructive ownership rules, Enron Pipeline's, Enron's, and OPI's direct ownership of Liquids stock should be attributed to Partnership, with the result that Partnership should be treated as owning all of the stock of Liquids both before and after the Purchase for purposes of applying section 302(b). Sections 304(b)(1), 318(a)(2)(C), 318(a)(3)(A), 318(a)(3)(C). Because Partnership's ownership of Liquids is not diminished by the Purchase, we believe the transaction should be treated as subject to section 301. See Sections 302(b), 302(d); United States v. Davis, 397 U.S. 301 (1970).

Under section 301(c)(1) and section 316, the Deemed Distribution will be treated as a dividend to the extent of the earnings and profits of the distributing corporation. Under section 304, the determination of whether the Deemed Distribution is a dividend is made as if the Deemed Distribution were made by Enron Pipeline to the extent of its earnings and profits, and then by Liquids to the extent of its earnings and profits. Section 304(b)(2). Given current and accumulated earnings and profits of Enron Pipeline for the 1997 taxable year in excess of the aggregate amount of the Purchase Price plus all other actual or deemed distributions by Enron Pipeline in 1997, the full amount of the Purchase Price should be treated as a dividend from Enron Pipeline.

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5 If a subsidiary acquires stock of its parent from a shareholder of the parent, section 304(a)(2) treats the property transferred to the shareholder of the parent as a distribution in redemption of the stock of the parent. Prior to the Purchase, the stock of Enron Pipeline could be attributed to Liquids under the constructive ownership rules of section 304(c), making Enron Pipeline a subsidiary of Liquids. Literally read, the parent/subsidiary rules of section 304(a)(2) take precedence over brother/sister rules of section 304(a)(1). We believe that section 304(a)(1) rather than section 304(a)(2) should apply where a parent/subsidiary relationship exists only by reason of constructive ownership. See Treas. Reg. § 1.304-2(c) *Example 1* (applying section 304(a)(1) to a brother-sister sale); Rev. Rul. 92-86, 1992-2 C.B. 199 (applying section 304(a)(1) to a brother-sister sale); Broadview Lumber Co. v. United States, 561 F.2d 698, 709 (7th Cir. 1977) (stating, in dicta, that section 304(a)(2) should only apply when the parent corporation controls the subsidiary without relying on constructive ownership). If the statute were construed so as to allow for the application of section 304(a)(2) in brother-sister sales, section 304(a)(1) would become extremely narrow in scope. We believe that Congress did not intend such a result. See S. Rep. No. 83-1622, at 239 (1954) (stating section 304(a)(1) applies to brother-sister sales).

2. Consequences of Dividend Treatment

Enron Pipeline should reduce its earnings and profits by the amount of the section 304 dividend. See H.R. Rep. No. 98-861, at 1223 (1984).

Under section 304(a)(1), Partnership should be treated as making a capital contribution of the purchased Liquids stock to Enron Pipeline. For purposes of determining the tax consequences to Enron Pipeline of this deemed contribution to capital, the IRS appears to take the position that Partnership should be treated as having made the contribution as a shareholder of Enron Pipeline, without regard to the fact that it does not actually own any stock in Enron Pipeline. See Treas. Reg. § 1.304-2(a) (referring to section 362(a) for the determination of the basis of the stock that is deemed contributed to the acquiring corporation); Rev. Rul. 71-563, 1971-2 C.B. 175 (applying Treasury Regulation § 1.304-2(a) and section 362(a) to determine the basis of stock in the hands of the acquiring corporation; selling corporation did not directly own any stock of the acquiring corporation); Rev. Rul. 70-496, 1970-2 C.B. 74 (same); compare Section 362(a) (general rule providing carryover basis for contributions to capital) with Section 362(c)(1) (special rule providing for zero basis in property other than money received as a contribution to capital that is not contributed by a shareholder as such). Accordingly, we believe that Enron Pipeline should take a carryover basis in the Liquids stock.

If Partnership were an actual shareholder of Enron Pipeline, we believe Partnership's basis in its Enron Pipeline stock should be increased by an amount equal to its basis in the Liquids stock deemed contributed to Enron Pipeline. Treas. Reg. § 1.304-2(a). In the absence of any direct ownership of Enron Pipeline stock, it is not entirely clear what happens to the basis of the transferred Liquids stock. See Coyle v. United States, 415 F.2d 488, 493 (4th Cir. 1968) (in dicta, the court noted that increasing the basis of the constructively held stock of the acquiring corporation or increasing the basis of the directly held stock of the issuing corporation would be reasonable solutions to the potential basis allocation problem created by the taxpayer's lack of any direct ownership of the acquiring corporation in a section 304 transaction). Where the transferor retains shares of the transferred corporation, the IRS has adopted the position that the basis of the transferred shares attaches to the basis of the retained shares. Rev. Rul. 71-563, 1971-2 C.B. 175. But cf. Priv. Ltr. Rul. 8710035 (Dec. 9, 1986), revoked by Priv. Ltr. Rul. 9437004 (June 10, 1994) (basis of transferred issuing corporation stock disappears where seller had only constructive ownership of stock of purchaser; no mention of potential for adding basis to the single share of issuing corporation stock retained by the seller). Given the rejection of alternative approaches by either the IRS or the courts,[6] we believe that Partnership should increase its basis in the retained shares of Liquids stock by the amount of its basis in the Liquids stock deemed contributed to Enron Pipeline in the section 304 transaction.[7]

Finally, we believe that each partner's distributive share of Partnership's dividend income from the Purchase should increase the basis of such partner's interest in Partnership without reduction for

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6 One alternative approach would be to increase the basis of the Enron Pipeline stock in the hands of Enron. See Coyle, 415 F.2d at 493; see also Treas. Reg. § 1.302-2(c) *Example (2)* (in the case of a direct redemption from a shareholder of all stock held by that shareholder, if the redemption is treated as a dividend because of constructive ownership by the shareholder, the basis in the redeemed shares is allocated to the shares held by the person from whom ownership was attributed); Levin v. Commissioner, 385 F.2d 521, 528 n.29 (2d Cir. 1967) (citing Treasury Regulation § 1.302-2(c) for the proposition that taxpayer's basis in redeemed shares would attach to constructively held shares). The IRS, however, has consistently taken the position that no basis adjustments attributable to deemed distributions and contributions resulting from a section 304 transaction are made with respect to constructively held stock. See Rev. Rul. 70-496, 1970-2 C.B. 74 (no adjustments to parent's basis in stock of its wholly-owned subsidiary for deemed distribution by the subsidiary in excess of earnings and profits or for the deemed contribution to capital of the subsidiary in connection with subsidiary's purchase of stock from another subsidiary that was 70 percent-owned by parent; basis of transferred stock disappears where transferor does not own any stock of the acquiring corporation or of the acquired corporation after the transfer); Priv. Ltr. Rul. 8710035 (Dec. 9, 1986), revoked, Priv. Ltr. Rul. 9437004 (June 10, 1994) (section 304 transaction has no effect on parent's basis in stock of consolidated wholly-owned subsidiary that acquired stock from another consolidated subsidiary); cf. Rev. Rul. 71-563, 1971-2 C.B. 175 (basis of transferred shares of issuing corporation added to basis of retained shares of issuing corporation where transferor did not directly own any shares of the acquiring corporation).

Another approach would be to allow the basis in the transferred shares to disappear. The IRS has adopted this approach where the transferor does not directly own any stock of either the acquiring corporation or the issuing corporation. Rev. Rul. 70-496. The courts, however, have rejected the proposition that basis simply disappears in a transaction. See Coyle, 415 F.2d at 493 ("In any event, it is clear that taxpayer's basis [in the shares transferred in a section 304 transaction] will not disappear.")(dicta); Levin, 385 F.2d at 528 n.29 (in rejecting as without merit taxpayer's argument that dividend treatment of a redemption imposed a tax on gross receipts, court stated that "[h]er basis does not disappear; it simply is transferred to her son.").

7 Legislation has been proposed that would amend section 304(a)(1) to treat Enron Pipeline's purchase of Liquids stock as if Partnership had transferred the Liquids stock to Enron Pipeline in exchange for stock of Enron Pipeline in a section 351(a) transaction and Enron Pipeline had then redeemed the stock issued in the exchange. The effective date of this amendment, as proposed, would be for distributions and acquisitions after June 8, 1997. The fictional issuance of stock created by this amendment may be inconsistent with the positions taken by the IRS in Revenue Ruling 70-496 and Revenue Ruling 71-563. While the Treasury Department explanations of similar proposals by the President state that the amendment would "clarify" the treatment of a section 304 transaction, the committee reports on the pending legislation make no reference to the provision being a clarification. We do not believe that a statement in a Treasury Department explanation of Presidential proposals is effective to revoke outstanding revenue rulings. Accordingly, we do not believe that current law, including the published positions of the IRS, has been changed by the proposal of this legislation.

any dividends received deduction that may be allowable to such partner. Section 705(a)(1)(A) and (B); Treas. Reg. § 1.705-1(a)(2)(ii) (a partner's basis is increased by tax-exempt receipts of the partnership).

3. Substance Over Form Doctrine

The above analysis is based on the form of the Purchase. If the form of the Purchase were not respected, the tax consequences could be different. For the reasons set forth below, we believe that the substance over form doctrine should not apply to adversely affect the conclusions reached in this opinion.

The tax consequences of a transaction are generally based on the substance of the transaction. Where the form reflects the substance, the tax consequences of the form are generally recognized. Where the form of a transaction does not reflect its substance, however, a variety of judicial approaches have been used to determine the tax consequences of the transaction. These approaches may include refusing to recognize a participant in a transaction as a separate taxable entity, disregarding a transaction as a sham, and disregarding the transitory ownership of property.

a. Separate Taxable Entity

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the Supreme Court established the test for determining whether a corporation will be recognized as a separate taxable entity, stating that "so long as [the purpose for forming the corporation] is the equivalent of a business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Id. at 439. The level of activity necessary to constitute the "carrying on of business" within the meaning of the Moline Properties test appears to be quite minimal.[8] In practice, it seems to require little more than the observance of bookkeeping formalities, maintenance of separate bank accounts, having employees, executing contracts where appropriate, and representing the corporation to third parties as an independent organization. The separate entity tests set forth in Moline Properties have been applied to partnerships. Campbell County State Bank, Inc. v. Commissioner, 37 T.C. 430, 441-42 (1961) (acq.), rev'd on another issue, 311 F.2d 374 (8th Cir. 1963).

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[8] See Britt v. United States, 431 F.2d 227, 235 (5th Cir. 1970); Hospital Corp. of America v. Commissioner, 81 T.C. 520, 579 (1983) (nonacq. on other issues); Strong v. Commissioner, 66 T.C. 12, 24 (1976), aff'd without published opinion, 553 F.2d 94 (2d Cir. 1977); see also, B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 2.07[2] (6th ed. 1994).

Each of Enron, Enron Pipeline, ECTR, EDC, Liquids, OPI, and Enron GP will at all times represent itself to third parties as a separate entity in all transactions, observe all corporate and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Partnership will at all time represent itself to third parties as a separate entity in all transactions, observe all partnership and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Each of the entities listed in the preceding two sentences holds assets having a fair market value of at least $10 million. In addition, each of Enron, Enron Pipeline, ECTR, EDC, Liquids, and OPI has been in existence for at least two years and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons. OPI and Enron GP entered into a substantial joint venture (Partnership) with an unrelated person (EN-BT). Partnership has entered into financial transactions with unrelated parties. Transactions with third parties are generally considered sufficient business activity to satisfy the Moline Properties test. For example, obtaining a loan from third parties has been found to be sufficient business activity to prevent taxpayers from disavowing the separate status of a corporation that admittedly served no business purpose. See Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945). Based on the above facts, we believe that each corporation described above and Partnership should be respected as a separate entity for federal income tax purposes.

b. Sham

The sham transaction doctrine is a judicially created theory under which a transaction can be ignored for tax purposes if, in effect, the transaction affects nothing but tax consequences to the parties. The most recent Supreme Court discussion of the sham transaction doctrine is the case of Frank Lyon Co. v. United States, 435 U.S. 561 (1978), in which the Court upheld the sale and leaseback of a building against the government's argument that the transaction was really a financing. Modern sham transaction theory originated in the Court's frequently quoted defense of a "genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . ." Lyon, 435 U.S. at 583-84.

A two-pronged test for sham transactions emerged from that quotation. In order to find a sham, a court must determine both that the taxpayer was motivated by no business purposes other than obtaining tax benefits and that the transaction had no economic substance, independent of its tax consequences. See Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985). The business purpose test is a subjective analysis of the taxpayer's state of mind, while the economic substance test is objective, based upon the particular facts and circumstances.

Transactions between parent and subsidiary corporations and among other related persons are subject to a heightened level of scrutiny by the IRS and are often the focus of sham transaction attacks. While transactions among related corporations often are suspect, they are not *per se* subject to recharacterization under the sham transaction doctrine. Indeed, the consolidated return regulations promulgated under section 1502 set forth myriad rules prescribing the treatment to be accorded transactions among members of a consolidated group. Such transactions may result in items of income, deduction, gain, or loss being eliminated, deferred, or disallowed, but such items are not disregarded on the basis that they arise from sham transactions.

In order to fail the business purpose portion of the sham test in Rice's Toyota World, a taxpayer can have no motive other than tax purposes. The predominant purpose for the Purchase is to generate income for financial accounting purposes. This effect of the Purchase provides Enron and its Affiliates with significant and material benefits. The formation and capitalization of Partnership and the Purchase were structured to achieve the desired accounting benefits without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements.

Improving a company's balance sheet has been recognized as a valid business purpose. See Lyon, 435 U.S. at 577-78 (effect of debt on company's balance sheet has "distinct element of economic reality"); Newman v. Commissioner, 902 F.2d 159, 163 (2d Cir. 1990) (business purposes in entering into operating agreement rather than lease for balance sheet purposes); Priv. Ltr. Rul. 9017061 (Jan. 31, 1990) (improvement of balance sheet for company's lenders is business purpose for section 355); Tech. Adv. Mem. 8803001 (Sept. 29, 1987) (movement of assets from non-member to member corporation of affiliated group to improve consolidated balance sheet is business purpose for section 368(a)(1)(C)), revoked by Tech. Adv. Mem. 8941004 (July 11, 1989) (based on insufficiency of facts submitted at time of examination). While the accounting benefits in the instant case are derivative of the tax consequences of the Purchase, we believe that the purpose to obtain accounting benefits without either increasing or decreasing tax liability on a present value basis should be sufficient to satisfy the business purpose portion of the sham test in Rice's Toyota World.

The economic substance test depends upon all of the facts and circumstances. Following the Purchase, 1,980 shares of Liquids preferred stock is held by Enron Pipeline and Partnership holds the $198 Million ECTR Note. The economics to Partnership and its partners, including EN-BT will reflect this change in the assets owned by Partnership. We believe that this shift in investments should be sufficient to satisfy the economic substance portion of the test.

c. Transitory Ownership

The IRS might argue, given the short period of time that Partnership owned the Liquids preferred stock that was acquired by Enron Pipeline in the Purchase, that Partnership's ownership of such shares should be disregarded. Presumably, in order to account for the actual positions of the parties, such an argument would rely on a recharacterization of the transactions relating to the recapitalizations of Liquids and OPI on March 21, 1997, the capitalization of Partnership on March 27, 1997, and the Purchase as follows: (1) an acquisition by Enron of the Liquids preferred stock from Liquids in exchange for the note of Houston Pipe Line Company, dated as of March 21, 1997 (the "Houston Pipe Note"); (2) a sale by Enron of 1,980 shares of Liquids preferred stock to Enron Pipeline for the $198 Million ECTR Note; (3) a contribution by Enron of the $198 Million ECTR Note and the remaining shares of Liquids preferred stock to OPI; and (4) a contribution of the $198 Million ECTR Note and the Liquids preferred stock by OPI to Partnership.

We believe an attempt to recharacterize the transactions in such a manner should not succeed. Such a recharacterization would reorder, but not reduce the number of, the steps relative to the transaction as actually structured. Where two different routes are equally consistent with the substance of the transactions, produce the equivalent end result, and have the same number of steps, the courts have generally rejected attempts to substitute hypothetically equivalent steps for the steps actually taken in the absence of an inconsistency between the tax consequences of the form of the transaction and the policy underlying the applicable statutory provision. See Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989), and cases cited therein. Moreover, in the instant case, a reordering of the steps would not duplicate the economics of the transactions as structured, because the ownership of all of the Liquids preferred shares by Partnership gave EN-BT (as a partner in Partnership) and EN-BT and PCI (as shareholders of OPI) an interest in the benefits and burdens of ownership of all of that stock, albeit for a short period of time.

The IRS has taken the position that a reordering of steps is appropriate under some circumstances. See Rev. Rul. 91-47, 1991-2 C.B. 16 (substance of transaction, which would be reflected in reordered steps, controls to prevent avoidance and carry out the clear policy underlying enactment of section 108(e)(4)); Rev. Rul. 87-66, 1987-2 C.B. 168 (contribution of foreign corporation's stock to a domestic corporation followed by liquidation of the foreign corporation treated as transfer of foreign corporation's assets to domestic corporation followed by liquidation of foreign corporation for purposes of applying section 897 to transactions; in a letter to a lawyer who criticized the ruling, then Associate Chief Counsel D. Kevin Dolan defended the effects of the resequencing based on the policy of Congress to impose recognition unless there is basis preservation in the interest subject to taxation under section 897(a)); Priv. Ltr. Rul. 8823056 (Mar. 10, 1988) (reordering of successive section 351 steps, apparently at the request of, or possibly without the objection of, the taxpayer); Priv. Ltr. Rul. 8351136 (Sept. 23, 1983) (same). Thus it appears that, where there is a policy justification for resequencing steps, or where the taxpayer consents to the resequencing, the IRS considers the creation of steps that never took place to be permissible.

In the instant case, respecting the steps as actually undertaken does not appear to violate any clear principle of tax policy. Gain or loss, if any, to Enron on a sale of Liquids stock to Enron Pipeline would be deferred under the consolidated return regulations, and would remain deferred following a contribution of the $198 Million ECTR Note by Enron to OPI. Treas. Reg. §§ 1.1502-13, -80(b). In contrast, the Purchase generates a tax liability on the resulting section 304 dividend and increased bases in the Liquids stock retained by Partnership and in the interests of the partners in Partnership. As discussed below, we do not believe these results, under the facts of the instant case, should be considered to be inconsistent with the principles established in the consolidated return regulations, with the principles of subchapter K, or with the objectives of section 1059. Accordingly, we believe the transactions as structured should not be considered to violate any clear tax policy principles and should not be resequenced to produce a different tax result from that of the actual transactions.

4. <u>Consolidated Return Regulations</u>

The consolidated return regulations, in some circumstances, may alter what would otherwise be the tax consequences of a transaction where the transaction involves one or more members of a consolidated group. For the reasons set forth below, we believe that the consolidated return regulations should not apply to adversely affect the conclusions reached in this opinion.

a. <u>Inapplicability of Section 304 Within a Consolidated Group</u>

Treasury Regulation § 1.1502-80(b) provides that section 304 does not apply to the acquisition of a corporation's stock in an intercompany transaction occurring on or after July 24, 1991. A sale of Liquids stock from Enron to Enron Pipeline would be an intercompany transaction and therefore would not be subject to section 304. A sale between Partnership and Enron Pipeline, however, is not an intercompany transaction because Partnership is not a member of the Enron consolidated group.[9] We do not believe the principles underlying Treasury Regulation § 1.1502-80(b) have any application to transactions that actually occur between persons who are not members of the same consolidated group.

[9] Even if Partnership were treated, under Treasury Regulation § 1.701-2(c), as an aggregate rather than an entity for purposes of applying Treasury Regulation § 1.1502-80(b), Treasury Regulation § 1.1502-80(b) should not be applicable because none of OPI, Enron GP, and EN-BT should be a member of the Enron consolidated group.

The rule of Treasury Regulation § 1.1502-80(b) was adopted as "the simplest way to implement the purposes of section 304(b)(4) for a consolidated group. . . ." T.D. 8402, 1992-1 C.B. 302, 303. Section 304(b)(4) requires that "proper adjustments" be made to the adjusted basis of stock of a member of an affiliated group that is held by the group, and to the earnings and profits of members of the group, to the extent necessary to carry out the purposes of the section. Section 304(b)(4) was adopted to prevent the use of section 304 transactions within an affiliated group to shift built-in gain within the group, allowing the disposition of appreciated stock of a subsidiary outside the group without the payment of the corporate level tax on the appreciation. See H.R. Conf. Rep. No. 100-495, at 969-70 (1987); H.R. Rep. No. 100-391, pt. 2, at 1084 (1987). Where stock is never held by a member of the affiliated group, the concerns addressed by section 304(b)(4) would not appear to be present. Accordingly, we do not believe the issuance of the Liquids preferred stock to OPI and the contribution of such stock to Partnership followed by the sale of some of the Liquids preferred stock to Enron Pipeline subject to section 304 should be considered inconsistent with the principles underlying Treasury Regulation § 1.1502-80(b).

b. Intercompany Transaction Rules

In general, Treasury Regulation § 1.1502-13, which contains the intercompany transaction rules of the consolidated return regulations (the "intercompany transaction rules"), applies to transactions between corporations that are members of the same consolidated group immediately after the transaction. Treas. Reg. §§ 1.1502-13(a)(1), -13(b)(1). Partnership is not a member of the same consolidated group as Enron Pipeline at any time. Therefore, the Purchase is not an intercompany transaction and, absent the application of the anti-avoidance rule of Treasury Regulation § 1.1502-13(h), the intercompany transaction rules should not be applicable.

The intercompany transaction anti-avoidance rule of Treasury Regulation § 1.1502-13(h) provides as follows: "If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section." The purpose of the intercompany transaction rules is "to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)." Treas. Reg. § 1.1502-13(a)(1). The examples under the intercompany transaction anti-avoidance rule provide the only available guidance on the types of transactions that have a principal purpose to avoid the purposes of the intercompany transaction rules. Treas. Reg. § 1.1502-13(h)(2). These examples suggest that a transaction may be considered to avoid the purposes of the intercompany transaction rules if it (i) invokes or avoids the effects of those rules, either by interposing an unnecessary intercompany transaction or by avoiding an equivalent and more direct intercompany transaction, for the purpose of altering the consolidated taxable income or consolidated tax liability of the group as compared to an equivalent alternative transaction (Examples 1, 3, 4) or (ii) is structured to affirmatively use the intercompany transaction rules for the purpose of altering the taxable income of a nonmember and the relationship between the transaction and consolidated taxable income or consolidated tax liability is artificially created (Example 2). See also Prop. Treas. Reg. § 1.1502-13(h)(2) *Example 2* (1994) (proposed example deleted in final regulations; would have applied anti-avoidance rule to transaction that did not involve an intercompany transaction and that did not avoid a more direct intercompany transaction).

Even if, despite the economic differences, the acquisition of the Liquids stock by OPI and Partnership followed by the sale of the Liquids stock to Enron Pipeline were viewed as an indirect route adopted to avoid an intercompany transaction in which Enron invests in the Liquids preferred stock, Enron Pipeline purchases a portion of such stock from Enron, and the $198 Million ECTR Note and the remaining Liquids preferred stock are contributed to OPI and then to Partnership, the transactions as structured do not, under the facts as we understand them, alter the consolidated taxable income or consolidated tax liability of the Enron consolidated group as compared to an intercompany sale between Enron and Enron Pipeline. Where no member of the Enron consolidated group disposes of stock of Liquids or Enron Pipeline outside the group and no action is taken to utilize high basis in the stock of Liquids or Enron Pipeline that may result from the Purchase, the taxable income and tax liability of the consolidated group should not be affected by the investment in the Liquids preferred stock and the Purchase of a portion of such stock by Enron Pipeline, without regard to whether it is Enron or OPI that makes the investment or whether it is Enron or Partnership that is the seller of the shares.

The issuance of preferred stock by Liquids in exchange for the Houston Pipe Note should not be a taxable event, whether the investment is made by Enron or OPI. Under the transactions as structured, the section 304 dividend by Enron Pipeline does not affect the group's taxable income or tax liability, and Enron Pipeline takes the Liquids stock with a carryover basis. Under the intercompany transaction alternative, Enron's gain or loss, if any, on the sale of Liquids stock directly to Enron Pipeline would be deferred under the intercompany transaction rules. No member of the Enron consolidated group will dispose of any stock of Liquids or Enron Pipeline except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. Although the reduction in Enron Pipeline's earnings and profits attributable to the section 304 dividend may prevent subsequent distributions by Enron Pipeline to Enron from constituting dividends, these dividends would be eliminated in the consolidated return, and thus would not affect taxable income. We believe that, under these facts, there should be no difference in the tax liability or taxable income of the Enron consolidated group resulting from the Purchase and resulting from a hypothetical intercompany transaction in which Enron invests directly in Liquids preferred stock and then sells a portion of such stock to Enron Pipeline.

In the absence of any alteration in the consolidated taxable income or the consolidated tax liability of the Enron consolidated group, we believe any application of the intercompany transaction anti-avoidance rule would have to be based on the effects of the Purchase on the separate taxable income or tax liability of a nonmember. In Example 2 under the intercompany transaction anti-avoidance rule, a nonmember holds an obligation of a member with an unrealized loss. The holder becomes a member of the group temporarily, triggering the loss in the obligation under the rules of Treasury Regulation § 1.1502-13(g) when the obligation becomes an intercompany obligation. While the transaction also results in the inclusion of discharge of indebtedness income on the consolidated return, this effect appears to be ignored in determining the applicability of the anti-avoidance rule. Rather, it is a principal purpose to accelerate the loss, which is carried to the holder's separate return years, that is cited as the reason for applying the anti-avoidance rule to treat the obligation as not becoming an intercompany obligation. This example suggests that, under some circumstances, the affirmative use of the intercompany transaction rules to alter the separate taxable income of a nonmember may be inconsistent with the purposes of the intercompany transaction rules (i.e., to provide rules to clearly reflect consolidated taxable income). We believe that Example 2 should be strictly limited to factual situations in which (i) a transaction is structured to affirmatively use the intercompany transaction rules for the purpose of altering the taxable income of a nonmember and (ii) the relationship between the transaction and consolidated taxable income or consolidated tax liability is artificially created (e.g., because the status of a participant as a member of the group is transitory).

In the case of the Purchase, there is no affirmative application of the intercompany transaction rules. Rather, the tax consequences of the Purchase are determined without the application of any consolidated return rules because Partnership is not a member of the Enron consolidated group. Based on the absence of either an alteration of consolidated taxable income or consolidated tax liability or a positive use of the intercompany transaction rules to alter a nonmember's separate taxable income or tax liability, we believe the intercompany transaction anti-avoidance rule should not be applicable to the Purchase.

c. <u>Earnings and Profits Rules</u>

Treasury Regulation § 1.1502-33 contains rules (the "earnings and profits rules") for adjusting the earnings and profits of members of the group where one member owns stock of another member. These rules may require adjustments to the earnings and profits of members of the Enron consolidated group in connection with the Purchase. We have not analyzed the specific earnings and profits adjustments that would be required under these rules. We have, however, considered whether the earnings and profits effects of the Purchase could trigger the application of the anti-avoidance rule contained in the earnings and profits rules.

Treasury Regulation § 1.1502-33(g) provides as follows:

> If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

The purpose for the modifications made by the earnings and profits rules is to treat a parent and a subsidiary as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent. Treas. Reg. § 1.1502-33(a)(1). The preamble to the regulations describes the earnings and profits system as "fundamentally concerned with measuring dividend paying capacity. . . ." T.D. 8560, 1994-2 C.B. 200, 201.

The primary earnings and profits effects of the Purchase on members of the Enron consolidated group is the reduction under section 312 in the earnings and profits of Enron Pipeline attributable to the section 304 dividend by Enron Pipeline. The potential for distortions of earnings and profits from a section 304 transaction has been specifically considered and addressed by Congress. In the case of a section 304 transaction between members of an affiliated group, section 304(b)(4) requires that "proper adjustments" be made to the earnings and profits of members of the group to the extent necessary to carry out the purposes of section 304. The consolidated return regulations implement this directive in the context of members of a consolidated group by denying the application of section 304 to intercompany transactions. Treas. Reg. § 1.1502-80(b). Since Enron Pipeline and Partnership are not affiliates, section 304(b)(4) and Treasury Regulation § 1.1502-80(b) should not be applicable. Given provisions which specifically deal with potential earnings and profits distortions produced within an affiliated group by section 304 transactions, we believe a court would be reluctant to create further exceptions under a more general anti-avoidance provision.

Moreover, the Purchase will not (i) alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Purchase) by members of the Enron consolidated group to nonmembers of the Enron consolidated group that are treated as made out of earnings and profits or (ii) result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Purchase on the earnings and profits of members of the

Enron consolidated group. Accordingly, we believe the earnings and profits adjustments required by the transactions considered herein should not be considered to produce a result that is contrary to the purpose of the earnings and profits rules or that avoids the effect of the earnings and profits rules or any other provision of the consolidated return regulations.

d. Investment Adjustment Rules

Treasury Regulation § 1.1502-32 contains rules (the "investment adjustment rules") for adjusting the basis of stock of a subsidiary member of the group that is owned by another member. These rules modify the otherwise applicable basis rules by adjusting the shareholder/member's basis in the subsidiary's stock to reflect the subsidiary's distributions and items of income, gain, deduction, and loss taken into account for the period that the subsidiary is a member of the consolidated group. Treas. Reg. § 1.1502-32(a)(1). The amount of adjustments is the net amount of the subsidiary's taxable income or loss, tax-exempt income, noncapital, nondeductible expenses, and distributions with respect to the subsidiary's stock. Treas. Reg. § 1.1502-32(b)(2). Distributions with respect to the subsidiary's stock are allocated to the shares of the subsidiary's stock to which they relate. Treas. Reg. § 1.1502-32(c)(1).

As discussed above, the IRS has consistently taken the position that basis adjustments attributable to the deemed distributions and contributions resulting from a section 304 transaction are made with respect to stock held directly by the taxpayer receiving the deemed distribution or making the deemed contribution, but not with respect to stock that is held constructively by such taxpayer. See Rev. Rul. 71-563, 1971-2 C.B. 175; Rev. Rul. 70-496, 1970-2 C.B. 74. Based on this authority, we believe that distributions and contributions that are deemed to occur under section 304 with respect to stock that is constructively held by a taxpayer should not be treated as being made through the shareholder from whom ownership is attributed (the "direct" shareholder) for purposes of determining the federal tax effects of such deemed transactions on the direct shareholder. Accordingly, we believe Enron should not be treated as having either received a distribution from or made a contribution to Enron Pipeline in connection with the Purchase for purposes of applying the investment adjustment rules (or other applicable basis rules of the Code).

We have not analyzed the specific earnings and profits adjustments that would be required under the investment adjustment rules. We have, however, considered whether the basis effects of the Purchase could trigger the application of the anti-avoidance rule contained in the investment adjustment rules. This anti-avoidance rule calls for adjustments to be made to carry out the purpose of the investment adjustment rules if a person acts "with a principal purpose which is contrary to the purpose of [the investment adjustment rules], to avoid the effect of [the investment adjustment rules], or to apply [the investment adjustment rules] to avoid the effect of any other provision of the consolidated return regulations." Treas. Reg. § 1.1502-32(e)(1). The purpose of the investment adjustment rules is to treat the shareholder/member and the subsidiary as a single entity so that consolidated taxable income reflects the group's income. Treas. Reg. § 1.1502-32(a)(1).

The examples under the investment adjustment anti-avoidance rule suggest that it is applicable where stock ownership or affiliated status is manipulated in order either to obtain the benefits of positive investment adjustments without bearing the burden of corresponding negative investment adjustments (Examples 1, 4, 5) or to shift basis among group members or among classes of stock, thereby reducing gain recognition on an anticipated sale (Examples 2, 3). Treas. Reg. § 1.1502-32(e)(2) *Examples 1-5*. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Purchase on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any. No member of the Enron consolidated group will dispose of any stock of Liquids or Enron Pipeline except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. Based on these facts, we believe that neither Enron nor any of its Affiliates should be considered to have a principal purpose which is contrary to the purposes of the investment adjustment rules, to avoid the effect of the investment adjustment rules, or to apply the investment adjustment rules to avoid the effect of any other provision of the consolidated return regulations.

C. <u>Dividends Received Deduction</u>

Subject to certain limitations, a corporation is allowed a deduction for a percentage of the amount "received as dividends" from a domestic corporation which is subject to taxation under Chapter 1 of Subtitle A of the Code. Section 243.

1. <u>Receipt of Dividend from a Domestic Corporation</u>

In determining its income tax, each partner must take into account separately, as part of the dividends received by it from domestic corporations, its distributive share of dividends received by the partnership with respect to which the partner is entitled to a deduction under part VIII of subchapter B (currently sections 241-250). Section 705(a)(2); Treas. Reg. § 1.701-1(a)(5). The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of section 701(a) is determined as if such item were realized directly from the source from which realized by the partnership. Section 702(b); Treas. Reg. § 1.702-1(b). Based on this authority we believe that each partner in a partnership should be treated, for purposes of section 243, as having received its distributive share of a partnership's dividend income directly from the source from which the partnership received the dividend.

Section 304 was amended in 1984 to clarify, among other things, the source of deemed distributions. Pursuant to those amendments, section 304(b)(2) provides that the determination of the amount which is a dividend and the source thereof is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. The effect of this amendment was described in the legislative history as follows:

> [I]n all cases . . . the characterization of a distribution as a dividend, and the source of the dividend will be determined by treating the distributions as made by the acquiring corporation directly to the selling shareholder to the extent of the earnings and profits of the acquiring corporation and then as made by the issuing corporation directly to the selling shareholder to the extent of its earnings and profits. Thus, any dividend received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the corporation which is treated as having made the distribution.

H.R. Rep. No. 98-861, at 1223 (1984). The fiction of a dividend made directly to the seller by the acquiring corporation to the extent of the acquiring corporation's earnings and profits has been respected by the IRS for purposes of section 243 where the seller has only constructive ownership of stock of the acquiring corporation. See Priv. Ltr. Rul. 8609054 (Dec. 3, 1985), modified on another issue, Priv. Ltr. Rul. 8737027 (June 12, 1987) (dividends received deduction allowed to seller that had only constructive ownership of stock of acquiring corporation). Accordingly, we believe that, for purposes of section 243, Partnership should be treated as having received the Deemed Distribution directly from Enron Pipeline and OPI should be treated as having received its distributive share of the Deemed Distribution directly from Enron Pipeline.

2. Section 246(c)

No deduction is allowed in respect of any dividend on any share of stock which is held by the taxpayer for 45 days or less. Section 246(c)(1)(A). For purposes of determining the period for which the taxpayer has held any share of stock, any day which is more than 45 days after the date on which such share becomes ex-dividend is not taken into account. Section 246(c)(3)(B). The holding period is reduced for periods where the taxpayer's risk of loss is diminished. Section 246(c)(4).

Implicit in the provisions of section 702, which contemplate that a partner may be entitled to a dividends received deduction with respect to dividends received by a partnership, is that the holding period requirements of section 246(c)(1) can be satisfied with respect to stock that a corporation owns indirectly through a partnership. It is unclear whether this holding period requirement should be applied at the partner or the partnership level. Treating a partnership as an entity, it would appear to be the holding period of the partnership in the stock that should be taken into account. Treating a partnership as an aggregate, it would appear that the holding period of the partner with respect to its interest in the partnership also should be taken into account. Cf. Treas. Reg. § 1.856-3(g) (real estate investment trust deemed to own its proportionate share of assets of partnership in which it is a partner; holding period with respect to sale of property by partnership is shorter of partnership's holding period in asset or partner's holding period in partnership interest); Priv. Ltr. Rul. 9615004 (Dec. 19, 1995) (extending aggregate treatment prescribed by statute for purposes of section 851(b)(2) to determine satisfaction by regulated investment company of section 854 requirements relating to sections 243, 246, and 246A; holds regulated investment company will be deemed to hold its proportionate share of assets of a partnership for the period that the partnership held the assets or for the period the regulated investment company has held its interest in the partnership, whichever is shorter).

In addition to the lack of certainty as to how the holding period requirement of section 246(c) is applied to a dividend received through a partnership, in the context of a section 304 transaction involving constructive ownership, the identity of the stock on which the dividend is paid is not clear. In the instant case, prior to the Purchase, Enron had a holding period in the common stock of Enron Pipeline and Liquids, OPI had a holding period in the common stock of Liquids, Partnership had a holding period in the preferred stock of Liquids, and each partner had a holding period in its interest in Partnership in excess of the 45 days required by section 246(c)(1). Accordingly, whether one looks to the holding period of the stock of the acquiring corporation (Enron Pipeline) or to the holding period of the stock of the issuing corporation (Liquids), whether one considers directly held stock or constructively held stock, and whether or not one takes into account the holding period of the partners in their partnership interests, we believe the holding period requirement of section 246(c)(1) should be satisfied.

In the case of stock having a preference in dividends, the required holding period is extended to 90 days if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days. Section 246(c)(2). If the section 304 dividend were treated as paid on the Liquids preferred stock, the IRS might argue that the 90 day holding period is applicable if the earnings and profits that support the dividend were accrued over a period of more than 366 days. The IRS might further argue that the disposition in the Purchase of some of the Liquids preferred shares prevented those shares from satisfying the 90 day holding period requirement, triggering the application of section 246(c) to deny the dividends received deduction. Such an argument requires that the section 304 dividend be treated as paid on the transferred Liquids preferred stock, which is inconsistent with the directive of section 304(b)(2) and its legislative history that the section 304 distribution be treated as made first by Enron Pipeline to the extent of its earnings and profits. Moreover, where the basis of the redeemed shares is added to the basis of the retained shares, and assuming the 90 day holding period will be satisfied with respect to the retained shares prior to any disposition of those shares, we believe the case for applying section 246(c)(2) to deny the dividends received deduction would be weak.

3. Section 246(b)

Section 246(b) imposes limits on the aggregate amount of section 243 deductions, based on the taxable income of the taxpayer, computed with certain adjustments. Section 246(b)(2). In essence, section 246(b) denies a taxpayer the benefit of the dividends received deduction to the extent the dividend is offset by other deductions. OPI will have taxable income from nondividend sources that exceeds its deductible expenses. Accordingly, we believe section 246(b) should not limit OPI's section 243 deduction.

4. Section 243(c)

Section 243(a)(1) provides for a deduction equal to 70 percent of the dividend amount, with certain exceptions that are not applicable to the instant case. Section 243(c) increases this percentage to 80 percent in the case of any dividend received from a 20 percent-owned corporation. A 20 percent-owned corporation is defined as any corporation if 20 percent or more of the stock of such corporation (by vote and value) is "owned" by the taxpayer. Section 243(c)(2). This definition raises the issues of whether a partner is treated as "owning" stock owned by a partnership and whether constructive ownership under section 304 is taken into account in determining "ownership."

With respect to the issue of whether a partner should be treated as owning stock owned by a partnership, the IRS has taken the position that ownership through a partnership is ownership for purposes of the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation. See Rev. Rul. 71-141, 1971-1 C.B. 211 (allowing section 902 credit to partners who hold 20 percent interests, indirectly through a partnership, in foreign corporation); T.D. 8708, 1997-10 I.R.B. 14 (amending Treasury Regulation § 1.902-1(a)(1) to change the definition of a domestic shareholder from one that "owns directly" the requisite stock to one that "owns" such stock). Based on this authority, we believe that it is more likely than not that, for purposes of section 243(c), OPI will be treated as owning 98 percent (its share of profits and capital) of any stock that Partnership is treated as owning.

With respect to the issue of whether constructively held stock will be taken into account in determining ownership of the payor corporation in a section 304 transaction, we again look to the statement in the legislative history of the 1984 amendment to section 304 that any dividends received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the acquiring corporation (to the extent of its earnings and profits). The IRS has cited this legislative history in ruling that a section 304(a)(1) dividend qualifies for the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation, even though the transferor corporation did not own directly any stock in the acquiring corporation. Rev. Rul. 92-86, 1992-2 C.B. 199. Of particular importance is the fact that section 902, like section 246(c), does not invoke the constructive ownership provisions of section 318. See First Chicago Corporation v. Commissioner, 96 T.C. 421 (1991) (corporation not allowed to aggregate its ownership with that of its affiliated members so as to meet the requisite ownership of section 902); Rev. Rul. 85-3, 1985-1 C.B. 222 (section 902 does not allow indirect ownership through subsidiaries to satisfy the section 902 ownership requirement). Nevertheless, Revenue Ruling 92-86 explicitly holds that the transferor corporation's constructive ownership as determined under section 304(c) is counted for purposes of determining the existence and amount of direct ownership under section 902. Based on the legislative history of section 304 and the IRS's position in Revenue Ruling 92-86, we believe that Partnership should be treated as "owning" the stock of Enron Pipeline that it constructively owns for purposes of section 304.

D. Section 1059

Section 1059 provides for the reduction (but not below zero) of a corporation's basis in stock by the amount of the dividends received deduction allowable with respect to certain "extraordinary" dividends received with respect to such stock. Extraordinary dividends that trigger the application of section 1059 include (i) a dividend that equals or exceeds 10 percent of the corporation's adjusted basis in the stock of the payor and that is received on stock that the corporation has not held for more than two years before the dividend announcement date or (ii) any amount treated as a dividend in the case of any redemption of stock which is non pro rata as to all shareholders. Sections 1059(a)(1), 1059(e)(1). The reduction occurs immediately before any sale or disposition of the stock. Section 1059(d)(1). Any excess of the dividends received deduction over the basis of the stock is treated as gain upon disposition of the stock. Section 1059(a)(2). The IRS takes the position, and we assume for purposes of this discussion, that a partnership is treated as an aggregate for purposes of applying section 1059, with each partner treated as owning its share of the stock owned by the partnership. Treas. Reg. § 1.701-2(f) *Example 2*. The discussion refers to Partnership and the application of section 1059 to Partnership, with the understanding that the dividends received deduction that causes a portion of the dividend to be nontaxable is that of its partners.

While Treasury has been given broad regulatory authority by section 1059(g), to date there have been no regulations or other administrative authorities addressing the application of section 1059 to a section 304 transaction. The difficulties in determining whether section 1059 should be applied in the instant case arise from the fact that Partnership does not own directly any stock of the payor of the dividend, Enron Pipeline. Section 1059 assumes that the recipient of a dividend owns stock of the payor with a basis and holding period that can be referenced to determine whether the dividend is extraordinary and with a basis that could be reduced if the dividend is extraordinary.

Pending legislation includes a proposal that would treat a section 304(a)(1) transaction as if (1) the seller had transferred the stock of the issuing corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation then redeemed the shares it was treated as issuing. Under this fiction, the acquiring corporation is treated for all purposes (including basis determinations and the application of section 1059) as redeeming the stock issued to the selling corporation. The legislation also proposes to amend section 1059 so that a section 304 dividend would be treated as an extraordinary dividend (without regard to the holding period of the stock of the payor or the amount of the dividend) and that only the basis of the transferred shares would be taken into account for purposes of section 1059.

The committee reports relating to the proposed legislation explain that the concerns addressed by section 304:

> are most relevant where the shareholder is an individual. Different concerns may be present if the shareholder is a corporation, due in part to the presence of the dividends received deduction. . . . [I]n some situations where the selling corporation does not own any stock of the acquiring corporation before or after the transaction (except by attribution), it is possible that current law may lead to inappropriate results.
>
> As one example, in certain related party sales, the selling corporation may take the position that its basis in any shares of stock it may have retained (or possibly any shares of the acquiring corporation it may own) need not be reduced by the amount of the dividends received deduction. This can result in an inappropriate shifting of basis.

H.R. Rep. No. 105-148, at 465 (1997); S. Rep. No. 105-33, at 143 (1997).

We believe that the proposed legislation reflects (1) a change in view of the proper application of the policies of section 304 in the context of corporate sellers, (2) a change in view of the proper manner for applying section 1059 in the context of a section 304 transaction, and (3) a change in the view of appropriate shares to look to in making basis adjustments under section 1059. We believe that the law relating to the interaction of sections 304 and 1C59 prior to the effective date of the pending proposals, if and when they are enacted, should be determined by reference to the policies of sections 304 and 1059 as reflected in their past legislative histories, and should not be influenced by the changes of view reflected in the proposed legislation. Furthermore, in the absence of any direct ownership by the seller of stock of the acquiring corporation in a section 304 transaction, we believe that it is questionable whether section 1059 is applicable. Nevertheless, in the absence of any clear authority on the issue of whether section 1059 can be applied in such a situation, we have analyzed the issue of how the extraordinary dividend determination might be made if section 1059 were applicable.

1. Pro Rata Redemption

A threshold question in the case of a redemption of stock is whether the redemption is pro rata as to all shareholders. No guidance has been issued on the meaning of "pro rata" for these purposes. The application of section 304, and the resulting deemed redemption of stock of Enron Pipeline from Partnership, is based on Partnership's constructive ownership of all of the stock of Enron Pipeline. Where the only ownership by a taxpayer of stock of the redeeming corporation is constructive, we believe the "non pro rata" test of section 1059(e) should be applied by reference to this same constructive ownership.

In other contexts, a redemption from a shareholder that owns 100 percent of the stock of a corporation by attribution is treated as being pro rata. See United States v. Davis, 397 U.S. 301 (1970) (application of attribution rules make 25 percent shareholder a 100 percent shareholder; treated as "sole shareholder" for purposes of section 302; Congress clearly mandated that pro rata distributions be treated under rules of section 301 rather than under section 302; redemption was essentially equivalent to a dividend); Rev. Rul. 81-289, 1981-2 C.B. 82 (describing the distribution in Davis as "precisely pro rata"). Based on Partnership's constructive ownership of 100 percent of all of the stock of Enron Pipeline, we believe Partnership should be viewed as the sole shareholder of Enron Pipeline for purposes of testing whether a deemed redemption from Partnership of stock of Enron Pipeline is "pro rata as to all shareholders." Accordingly, we believe the deemed redemption of Enron Pipeline stock from Partnership should be treated as pro rata for purposes of section 1059(e).

2. Two-Year Holding Period

Where a redemption is pro rata, a second threshold question for application of section 1059 is whether the stock with respect to which the dividend is received has been held by the corporation for more than two years. For this purpose, the holding period of stock is determined under rules similar to the rules of sections 246(c)(3) and 246(c)(4). Section 1059(d)(3). For the reasons discussed below, we believe it is the holding period in the Enron Pipeline stock that should be relevant in applying section 1059. Accordingly, we believe that to the extent that, on the date of the Purchase, Enron had a holding period in excess of two years with respect to the stock of Enron Pipeline, section 1059 should not be applicable.

Enron Pipeline is the corporation that is treated as redeeming its stock under section 304(a)(1) and as the payor of the section 304 dividend under section 304(b)(2)(A). The legislative history of section 1059 states that "if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to stock of the shareholder which is not redeemed." H.R. Conf. Rep. No. 98-861, at 817 (1984). Accordingly, we believe the stock with respect to which the Deemed Distribution is made should be stock of Enron Pipeline that is owned by Partnership and that remains outstanding after the transaction. Where a taxpayer does not directly own any stock of the redeeming corporation, we believe that the holding period test of section 1059 should be applied by looking to the holding period of stock that is constructively held by the taxpayer.

We believe that looking to the holding period of the Enron Pipeline stock in applying the threshold rules of section 1059 is consistent with the purpose of section 304 to ensure that Code provisions relating to dividend treatment of direct redemptions are not circumvented through the use of indirect redemptions. It is the common ownership by Enron of Enron Pipeline and Liquids that results in the application of section 304, and it is the earnings and profits of Enron Pipeline that support the dividend characterization of the deemed redemption. Under these facts, we believe that the direct redemption, the tax consequences of which section 304 is intended to mimic, should be considered to be a redemption by Enron Pipeline of its stock from Enron. If Enron Pipeline had redeemed a portion of its stock directly from Enron, section 1059 would not have been applicable to the extent that Enron's holding period in the stock of Enron Pipeline exceeded two years. Similarly, in a purchase by Enron Pipeline of Liquids stock directly from Enron, we believe it would be the holding period in the stock of Enron Pipeline that would be considered relevant for purposes of determining whether section 1059 would be applicable to such a transaction.

Section 1059 was enacted to address certain tax arbitrage opportunities presented by the effective rate of tax on dividend income as compared to the effective rate of tax on income that could be offset by a capital loss. See H.R. Rep. No. 98-432, pt 2, at 1186 (1984). Section 1059 is concerned with the creation of a noneconomic tax loss where a corporation purchases stock in anticipation of an extraordinary dividend, receives the dividend, and then sells the stock for a loss (resulting from the decline in value of the stock attributable to the payment of the dividend). See H.R. Rep. No. 98-432, pt. 2, at 1184 (1984); S. Prt. No. 98-169, vol. I, at 170 (1984). The IRS may argue that, despite the technical satisfaction of the two-year holding period requirement with respect to the stock of Enron Pipeline, application of section 1059 is necessary to effectuate the intent of Congress to prevent tax arbitrage because the recipient of the dividend (Partnership) holds an asset (the retained Liquids stock) with respect to which a potential noneconomic tax loss (i.e., an excess of basis over value) has been created in connection with the section 304 transaction. The IRS might argue further that, to the extent Partnership has a holding period of less than two years in the Liquids stock, the literal language of section 1059 should yield to the underlying purpose of the statute to prevent tax arbitrage and section 1059 should be applicable.

While this argument has some initial appeal, an examination of the facts indicates that the distortion between basis and economics in the instant case is created by the combined fictions of sections 304 and 318, which treat a sale of stock as if it were a dividend from, and a contribution to the capital of, a corporation in which the taxpayer has no direct ownership of stock, rather than by the effects of an extraordinary dividend addressed by section 1059. The excess of basis over value in the stock of Liquids retained by Partnership is not attributable to a reduction in the value of Liquids due to a dividend distribution, but rather to an increase in the basis of the retained Liquids stock with respect to a deemed contribution to capital to another corporation (Enron Pipeline). Moreover, where it is the earnings and profits of Enron Pipeline that support the dividend characterization of the section 304 deemed redemption, we believe the holding period with respect to the Liquids stock should be considered irrelevant in the context of the objectives of section 1059.

The lack of any distortion caused by the dividend portion of a section 304 transaction (as opposed to the basis adjustment relating to the deemed capital contribution) can be demonstrated by comparing the economic and tax consequences of a direct dividend, a direct redemption, and a section 304 transaction in which the stock of the acquiring corporation and the stock of the issuing corporation are held directly by a common parent. Assume the following facts:

Initially X, a corporation unrelated to Parent, owns all 100 outstanding shares of Acquiring;

At the beginning of Year 1, Parent purchases 75 shares of the stock of Acquiring from X for their fair market value of $75;[10]

During Years 1 through 3, Acquiring accumulates $20 of earnings and profits and the fair market value of Parent's 75 shares of Acquiring's stock increases to $90;

At the end of Year 3, Parent purchases 75 shares of the 100 outstanding shares of Issuing from an unrelated party for their fair market value of $75.

At the beginning of Year 4, Acquiring does one of the following three things:

(i) pays a dividend of $20 pro rata to Parent and X;

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10 The example assumes 75 percent ownership because special rules alter the effects of sections 304 and 1059 in the case of transactions between affiliates. See Sections 304(b)(4), 1059(c)(2).

(ii) redeems $20 worth of its stock pro rata from Parent and X; or

(iii) purchases 15 shares of Issuing stock from Parent for their fair market value of $15 (i.e., the value of the Issuing stock has not changed since the purchase by Parent).

Economically, each of the first two transactions (the direct dividend and the direct redemptions) would result in a $20 reduction in the overall value of Acquiring and no change in the relative ownership of Acquiring by Parent and X. The value and basis of Parent's stock in Acquiring is $75 after the distribution. The distribution does not create any potential tax loss for Parent, because the value of the earnings and profits on which the dividend characterization of those distributions is based is not reflected in Parent's basis before the distribution. Consistent with the absence of any potential for tax arbitrage at which section 1059 is directed, section 1059 is not applicable, based on Parent's two-year holding period in its 75 shares of Acquiring stock.

The economics of the third transaction above (the paradigm section 304 transaction) are different from those of the direct dividend and the direct redemptions. In the paradigm section 304 transaction, the overall value of Acquiring and the relative interests of Parent and X in Acquiring are unchanged. There is no net reduction in the value of Parent's 75 shares of Acquiring, but the basis of those shares is increased by the deemed capital contribution of the Issuing shares with a $15 basis. As a result, Parent holds 75 shares of Acquiring with a value and basis of $90. As with the direct dividend and the direct redemption transactions discussed above, the paradigm section 304 transaction does not create any potential tax loss for Parent where the value of the earnings and profits on which the dividend characterization of the section 304 deemed redemption is based is not reflected in Parent's basis before the transaction. Consistent with the absence of any potential for tax arbitrage at which section 1059 is directed, the threshold requirement of section 1059 of a holding period of two years or less would not be met based on Parent's two-year holding period in its 75 shares of Acquiring stock.[11]

Given that none of what might be considered economically equivalent transactions (a direct dividend distribution from Enron Pipeline to Enron, a direct redemption of Enron Pipeline stock from Enron, and the dividend portion of a section 304 transaction in which Enron Pipeline purchases stock of Liquids from Enron (with no affiliation among the parties)) would be subject to section 1059 to the extent that Enron had a holding period of more than two years in the Enron Pipeline stock, and that none of those transactions appears to violate the spirit of section 1059, we believe a court should not consider the holding period of tne retained Liquids stock to be relevant to the application of

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11 Some redemption from X might be required to avoid section 1059(e)(1)(B), which overrides the two-year threshold requirement in the case of non pro rata redemptions. It is unclear how one would determine whether a section 304 deemed redemption is pro rata for purposes of section 1059(e).

section 1059 to the Purchase. Rather, we believe a court should recognize that the distortions between basis and value created in the retained Liquids stock are attributable to the fictions created by section 304 and section 318 in which there is a deemed capital contribution to a corporation in which the contributor has no direct ownership.[12]

Congress viewed acquisitions of stock in anticipation of the payment of an extraordinary dividend as the acquisition of two assets: the right to distributions to be made with respect to the stock and the underlying stock itself. In such cases, Congress concluded that it was appropriate to reduce the basis of the underlying stock to reflect the value of the distribution that was not taxed to a corporate distributee. See H.R. Rep. No. 98-432, pt. 2, at 1186 (1984); S. Prt. No. 98-169, vol. I, at 172 (1984).

Congress used objective rather than subjective criteria to identify transactions that were appropriately treated as "two asset" acquisitions (i.e., those acquisitions in which a portion of the basis of the shareholder is attributable to the value of an anticipated distribution). The statute provides a dual test for its application, requiring both a holding period of two years or less as of the dividend announcement date (presumably as an indication that the dividend might have been

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12 In the event that, contrary to our conclusion above, a court were to accept the IRS's argument that it is appropriate to apply section 1059 to the Purchase, two approaches to a liberal application of section 1059 might be suggested by the IRS, consistent with the positions it has adopted in Revenue Rulings 70-496 and 71-563. The IRS might argue that section 1059 should be applied to reduce the basis of the Liquids stock retained by Partnership (which was increased by the basis of the Liquids stock transferred to Enron Pipeline) with a corresponding reduction in the bases of the partners' interests in Partnership. Alternatively, the IRS might argue that, while basis reductions cannot be made in constructively held stock, the section 1059 consequences of an extraordinary dividend could be visited on the constructive owner/dividend recipient by treating the nontaxed portion of an extraordinary dividend as an amount that did not reduce basis by reason of the limitation on reducing basis below zero. Section 1059(a)(2).

Of these two approaches, we believe the reduction of basis in the retained Liquids stock should be more appealing to a court, because it does not require the application of any further fictions. If and when the Liquids stock is disposed of, the basis adjustment would be triggered. The section 1059(a)(2) approach, under existing law, would require expansion of the nonliteral interpretation of section 1059 and the fictions of section 304 to identify a disposition of stock that would trigger gain under section 1059(a)(2). While the IRS might argue that the fictionally redeemed stock of Enron Pipeline is owned by Partnership (with a zero basis) and is disposed of in the section 304 deemed redemption, such an approach would be inconsistent with the view of the courts that the fictions created by section 304 "do not change the reality that . . . stock is not actually redeemed." Broadview Lumber Co., 561 F.2d at 702 (quoting Webb v. Commissioner, 67 T.C. 293, 307 (1976), aff'd, 572 F.2d 135 (5th Cir. 1978)). Moreover, we believe a court should consider triggering gain recognition at the time of the section 304 transaction, based on a deemed disposition of fictional stock having a zero basis, as being inconsistent with the purposes of section 1059. Section 1059 was enacted to deal with the potential for tax arbitrage based on the differing treatment of dividend income and capital losses on the sale of stock. No loss could ever be recognized on the deemed disposition of fictional zero basis stock.

anticipated at the time of the acquisition and thus reflected as a separate asset in the acquisition transaction) and a dividend in excess of a specified percentage of the basis in the stock (presumably to exclude regular dividends, the tax arbitrage potential of which is addressed by section 246(c)). Subject to certain express statutory exceptions, where the objective two-year holding period requirement is not met, the statute does not apply, regardless of whether the shareholder in fact anticipated an extraordinary dividend or whether the value of an extraordinary dividend is in fact reflected in the shareholder's basis in the stock. In effect, there is an irrebuttable presumption that the distortion between basis and economics created by a dividend distribution and addressed by section 1059 is not present where a shareholder has a holding period in excess of two years as of the dividend announcement date.

We believe the holding period threshold in section 1059 serves as an objective substitute for an inquiry into whether an extraordinary dividend distribution is made with respect to stock having a basis that reflects the value of the earnings and profits that fund the extraordinary dividend. We believe that it is consistent with the purposes of section 1059 to look to the holding period in the stock of the corporation having the earnings and profits that fund a dividend to determine whether the two-year threshold of section 1059 is satisfied. Accordingly, we believe that to the extent that, on the date of the Purchase, Enron had a holding period of more than two years with respect to the stock of Enron Pipeline, section 1059 should not be applicable to the Purchase.

3. Threshold Percentage

The IRS might argue that the relevant holding period for Partnership is the shorter of the period for which it has constructively owned Enron Pipeline stock and Enron's holding period in the Enron Pipeline stock. We believe that the period of constructive ownership by Partnership of Enron Pipeline stock should not be considered relevant for the purposes of applying section 1059. Accordingly, we believe such an argument should be rejected by a court. If such an argument were, nevertheless, accepted, or if Enron did not have a holding period in excess of two years in the stock (or some portion of the stock) of Enron Pipeline on the date of the Purchase, then the characterization of the dividend resulting from the Purchase as extraordinary would become significant.

In general, the term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds 10 percent (5 percent in the case of stock which is preferred as to dividends) of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends received within an 85 day period, or exceeds 20 percent of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends having ex-dividend dates within a 365 day period. Section 1059(c).

Enron Pipeline will not, during any 85 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all Purchase Dividends were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 85 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 85 day period is greater than 10 percent of the shareholder's basis in such share. Enron Pipeline will not, during any 365 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all Purchase Dividends were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 365 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 365 day period is greater than 20 percent of the shareholder's basis in such share. Based on these facts, we believe a dividend attributable to the Purchase and deemed made with respect to stock of Enron Pipeline should not be treated as exceeding the threshold percentage.[13]

E. Section 269

Under certain circumstances, section 269 may alter what would otherwise be the tax consequences of a transaction. For the reasons set forth below, we believe section 269 should not apply to adversely affect the conclusions reached in this opinion.

Section 269 applies to the acquisition of control of a corporation or the acquisition of property from a corporation (other than a subsidiary or a sister corporation) with a carryover basis when the principal purpose of such acquisition is the "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which . . . would not otherwise [be]

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13 The IRS might argue that the threshold tests of section 1059 should be applied by reference to the retained stock of the issuing corporation (Liquids) where that is the only stock that the dividend recipient (Partnership) owns directly. In support of such a position, the IRS might point to the fact that the determination of whether the redemption is a sale or exchange is made by reference to the ownership of stock of the issuing corporation, without regard to the identity of the corporation that is deemed to have made the redemption or to have paid the dividend, and that the basis attributable to the deemed capital contribution of the redeemed shares to the acquiring corporation attaches to the retained shares of the issuing corporation, in the absence of any direct ownership of stock of the acquiring corporation. As discussed in the text, we believe that the threshold test of section 1059 should be applied by reference to the stock of the acquiring corporation (Enron Pipeline), where such corporation is treated as making the redemption under section 304(a)(1) and as having made the section 301 distribution under section 304(b)(2)(A). In the event that, contrary to our views, a court were to apply the threshold tests of section 1059 by reference to the stock of the issuing corporation (Liquids), the dividend attributable to the Purchase would exceed the 5 percent/85 day threshold percentage requirement of section 1059 relating to dividends on preferred stock.

enjoy[ed]." For this purpose, control is defined as 50 percent of vote or value. The following acquisitions of control or carryover basis property (from a corporation other than a subsidiary or a sister corporation) occurred in connection with the formation of Partnership and the Purchase:

Enron acquired control of Enron Cayman;

Enron and Enron Cayman acquired control of Enron GP;

Partnership and OPI acquired control of Liquids;

Liquids acquired control of Enron Operations Corp.;

OPI acquired the Houston Pipe Note and real estate from Enron; and

Enron Pipeline acquired the $600 Million ECTR Note and the EDC Note from Enron.

In order to apply section 269, it is necessary first to identify the benefit of a deduction, credit, or other allowance that stems from, and could not have been obtained in the absence of, the specified acquisition of control or the carryover of basis. <u>See</u> <u>Zanesville Investment Co. v. Commissioner</u>, 335 F.2d 507, 512 (6th Cir. 1964); <u>Cromwell Corp. v. Commissioner</u>, 43 T.C. 313, 320 (1964) (acq.); <u>Commodores Point Terminal Corp. v. Commissioner</u>, 11 T.C. 411, 417 (1948) (acq.); Tech. Adv. Mem. 9134003 (May 6, 1991); Gen. Couns. Mem. 39472 (Aug. 2, 1985). We question whether any such deduction, credit, or other allowance is made available by any of the acquisitions listed above.

Obtaining the desired accounting benefits does not depend on any of the acquisitions of control described above. It might be argued that the acquisition of the $600 Million ECTR Note and the EDC Note by Enron Pipeline potentially allows Enron to obtain the benefit of a deduction on the ultimate disposition of the Liquids stock retained by Partnership <u>if</u> section 1059 would have been applicable to the Purchase in the absence of such contributions. The carryover basis in those notes, however, is irrelevant to the application of section 1059. The basis increase in Enron's stock of Enron Pipeline, which may have relevance to the application of the section 1059 threshold percentage test, could have been achieved by a contribution of cash. We believe that the availability of an alternative means to obtain the same results suggests that the benefits are "otherwise available" to Enron.

Even if the required deduction, credit, or other allowance could be identified, it is necessary to show that tax avoidance or evasion by obtaining the benefit of such item was <u>the</u> principal purpose for an acquisition of control. The predominant purpose for the formation of Partnership and the

Purchase was to generate income for financial accounting purposes. Additional purposes for the formation of Partnership included risk shifting and raising minority equity capital. While the accounting benefits are derivative of the tax consequences of the Purchase, the formation of Partnership and the Purchase were structured to achieve these purposes without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements. We believe that these facts present a strong case for refuting any claim that <u>the</u> principal purpose of any of these transactions was the evasion or avoidance of tax.

Accordingly, we believe that section 269 should not be applicable to any of these acquisitions.

F. <u>Partnership Anti-abuse Rule</u>

The IRS, in regulations promulgated under section 701, has stated that it has the power, under certain circumstances, to alter what would otherwise be the tax consequences of transactions involving partnerships. Treas. Reg. § 1.701-2 (the "partnership anti-abuse rule"). For the reasons set forth below, we believe the regulations under section 701 should not apply to adversely affect the conclusions reached in this opinion.

Under the partnership anti-abuse rule:

> [I]f a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of Subchapter K.

Treas. Reg. § 1.701-2(b).

In the absence of any purpose to reduce the present value of the aggregate federal tax liability of the partners of Partnership, the partnership anti-abuse rule should not be applicable. In order to apply this threshold test, it is necessary to determine a baseline aggregate federal tax liability of the partners in order to determine whether a transaction reduces the present value of the partners' aggregate federal tax liability. In determining the tax reduction purpose of a transaction, it seems logical to look at the tax position the taxpayer would have been in if it had not done the transaction. In order to do this, one must determine the scope of a "transaction" in order to determine the tax effects of not doing the transaction.

The maximum scope of a transaction for these purposes would include a particular step that produces a tax benefit (the "goal step") and all other steps ("related steps") that would not have been done if the goal step were not done. In the instant case, the goal step would be creating the potential for deductions with respect to tax basis in excess of the book value of assets ("excess basis"). The related steps would be all elements of the creation of the structure, including the recapitalization of OPI and Liquids and the formation and capitalization of Enron GP and Partnership. Under this view of what constitutes the transaction, two of the partners of Partnership (Enron GP and EN-BT) would not exist if the transaction were not done. Moreover, the assets held by OPI would not have been owned by OPI if the transaction were not done. It seems reasonable to believe that the tax liability of a partner that does not exist or that would not have held its assets in the absence of the transaction would be determined by looking to the tax liability of the persons that initially owned the assets that were actually transferred to the partner. Under this view, the baseline would be the present value of the aggregate tax liability of the Enron consolidated group and the consolidated group of which EN-BT is a member (the "EN-BT consolidated group") if no steps were taken to recapitalize OPI or Liquids or to form and capitalize Partnership, Enron GP, and EN-BT.

Given a baseline that includes the tax liability of the Enron consolidated group, it would seem that any comparison of (i) the aggregate tax liability of the partners to (ii) the baseline tax liability should include the effects of the transaction on the tax liabilities that are included in the baseline, including the tax liability of the Enron consolidated group. Thus, the effects on the Enron consolidated group tax liability of transferring assets (and related income) from the Enron consolidated group to OPI and of transactions between the Enron consolidated group and OPI or Partnership (e.g., the interest payments from Enron to Partnership on Partnership investments in Enron securities) would have to be taken into account along with the net tax liability of OPI and changes in the tax liability of the EN-BT consolidated group attributable to the transaction.

A more limited view of what constitutes a "transaction" would include the goal step and those other steps ("enabling steps") that are required in order to make the goal step possible. In the instant case, the enabling steps would be the steps required to create the excess basis (e.g., the Purchase) and any steps taken to utilize that basis (e.g., section 732(c) distributions). Under this view, the baseline would be the tax liability of the partners if all transactions except the Purchase occurred. (In the absence of excess basis attributable to the Purchase, the effects of any steps taken to utilize such excess basis should become neutral.) The effects on the Enron consolidated group of the recapitalization of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, and investments by OPI and Partnership would be the same in the baseline as in the actual transaction, and accordingly would be irrelevant under this view. The change in tax liabilities as compared to the baseline would be attributable to the transaction increasing the income of the partners by the amount of the dividend income in excess of the dividends received deduction and decreasing the income of the partners by the amount of the deductions attributable to excess basis. The timing of these effects would be affected by the time at which the partners trigger deductions attributable to the excess basis.

A minimum view of what constitutes a "transaction" would treat each separate step as a transaction. In the instant case, under this view, each step of the related transactions (e.g., the recapitalization of OPI and Liquids, the formation of Partnership, the Purchase, a section 732(c) distribution, or a triggering of deductions attributable to excess basis) would be a transaction. The baseline could be the tax liability of the partners determined as if any one step was not done. Under this view, reductions in the aggregate tax liability of the partners could be caused by transactions that invoke specific provisions of subchapter K to create a tax benefit (e.g., a section 732(c) distribution that converts basis in one asset into basis in another asset that has a greater tax benefit to the partners), or by the triggering of a deduction of excess basis.

In the absence of any authority indicating which of these approaches is most appropriate, we have considered the potential application of the partnership anti-abuse rule under each approach. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the recapitalization of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, any investments by OPI and Partnership, and the Purchase. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Purchase on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any. Accordingly, we believe that under either the maximum or a limited view of the meaning of the term "transaction" in the partnership anti-abuse regulation, the regulation should not be applicable.

Under a minimum view of what constitutes a transaction, certain transactions (e.g., the triggering of a deduction, a liquidating distribution subject to section 732(c)), when viewed in isolation, may reduce the tax liability of the partners. If it were determined that a transaction reduced the present value of the partners' aggregate tax liability, it would be necessary to determine whether that effect is inconsistent with the intent of subchapter K.

The tax reduction effects of a transaction that triggers a deduction attributable to the Purchase could be duplicated without the use of a partnership (although the accounting benefits of the transaction could not be duplicated without a partnership). We believe that tax results that could be achieved without the use of a partnership should not be considered to be inconsistent with the intent of subchapter K.

The analysis of transactions that invoke specific provisions of subchapter K (e.g., section 732(c)) to create a tax benefit is more difficult if such benefits would not be available in the absence of Partnership. The anti-abuse rule includes a list of factors that may be indicative of the proscribed effect. The first negative factor is that the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. Treas. Reg. § 1.701-2(c)(1). This factor is apparently applied as if all transactions occur. See Treas. Reg. § 1.701-2(d) *Example 6*, *Example 7*, *Example 8*. Assuming transactions that result in a reduction of the partners' aggregate federal tax liability as compared to direct ownership of the assets (e.g., transactions that invoke section 732(c) to convert a capital deduction into a more beneficial ordinary deduction), we believe there is a risk that the IRS would argue that the transaction produces results that are inconsistent with the intent of subchapter K.

The partnership anti-abuse rule provides little guidance on when the application of a provision of subchapter K in accordance with its terms should be viewed as producing results that are inconsistent with the intent of subchapter K. While the text of the abuse-of-subchapter K rule is illustrated by a series of eleven examples, these examples confuse as much as elucidate the interpretation of the abuse-of-subchapter K rule. All three of the "bad" examples (i.e., examples that permit the Commissioner to recast the transactions) involve a partnership that was formed with a view to achieving a particular tax result, a partner who became a partner with a view to achieving such a result, and/or property that is introduced into the transaction to achieve the desired result, suggesting that these factors cause a literal application of the rules of subchapter K to produce results that are inconsistent with the intent of subchapter K. Several of the "good" examples (i.e., examples where the abuse-of-subchapter K rule is not violated), however, also involve partnerships that were formed with a view to achieving a favorable (sometimes very favorable) tax result. The conclusory statements in the examples provide no substantive analysis distinguishing the "good" tax planning examples from the "bad" tax planning examples. In the absence of a transaction that is virtually identical to an example in the regulations, we believe the anti-abuse rule should not be interpreted to alter the application of a mechanical rule of subchapter K.

The IRS might argue that the mechanical rules of subchapter K should not be applied literally based on general factors rather than particular examples, and in particular based on a substantial tax avoidance purpose at the time the partnership is formed, or on the magnitude of the tax benefits created by its application. Absent clearly expressed legislative intent to the contrary, the unambiguous language of a statute is controlling under all but rare and exceptional circumstances. See Crooks v. Harrelson, 282 U.S. 55, 60 (1930). If the intent of Congress in drafting a rule (e.g., to allocate basis in proportion to the relative bases of the distributed property under section 732(c)) is clear, the regulation cannot change that rule. If the statute is silent or ambiguous, then the regulation may fill the gap with a reasonable interpretation. See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-43 (1984); see also National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 476-77 (1979). We believe the intent of Congress to have the mechanical rules of subchapter K apply without regard to tax motivations is clear. In view of this Congressional intent, we believe a regulatory interpretation of a mechanical rule that alters its application based on the presence or absence of tax motivation or the magnitude of tax benefits should not be considered a reasonable interpretation.

The overriding purpose of the drafters of subchapter K in 1954 was to eliminate confusion. The "vital need" was "clarification." S. Rep. No. 83-1622, at 89 (1954). Beyond the need for clarification, the drafters cited the principles of "simplicity, flexibility and equity as between the partners." Id. Conditioning the application of the literal language of provisions of subchapter K on the presence or absence of a tax avoidance motive would operate to defeat these stated legislative purposes. Moreover, the contemporary legal context in 1954 indicates that tax avoidance motives were not relevant, unless specifically made so by statute. Prior to 1954, the Supreme Court had clearly stated that the tax motivation of taxpayers does not alter what would otherwise be the result of the application of the tax law to a transaction. See Gregory v. Helvering, 293 U.S. 465, 469 (1935); Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-96 (1930). The Supreme Court had also implicitly extended this principle to partnerships. See Commissioner v. Culbertson, 337 U.S. 733 (1940); see also Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935). The issue of the effect of a tax avoidance motivation on the validity of partnerships had been clearly presented to and considered by Congress prior to 1954 in the context of family partnerships. The Congressional response was to disregard tax motivation. See Sections 191 and 3797(a)(2) of the Internal Revenue Code of 1939. Congress, when it wanted to, clearly knew how to address the issue of tax avoidance in general, and in the context of partnerships. See Section 129 of the Internal Revenue Code of 1939; Section 704(b)(2) as enacted in 1954. Moreover, despite repeated examples of tax motivated uses of partnerships since 1954, Congress has failed to enact a broad, general, subjective intent based limitation on the literal application of the provisions of subchapter K. Instead, Congress has repeatedly addressed tax avoidance transactions involving partnerships by enacting specific rules which generally are applied based on objective factors. See, e.g., Sections 704(c)(1)(B), 707(a)(2), 737.

The examples in the abuse-of-subchapter K rule suggest that the rule is also intended to expand upon judicial doctrines, primarily by requiring that the tax motivation for a transaction be taken into account in applying those doctrines. Generally, the courts have not taken tax motivation into account in determining whether a transaction is a sham, a transaction has a substantial business purpose, the step transaction doctrine is applicable, or the substance of a transaction matches its form. See, e.g., Knetsch v. United States, 364 U.S. 361, 365 (1960); Gregory v. Helvering, 293 U.S. 465, 469 (1935). But cf. Sheldon v. Commissioner, 94 T.C. 738 (1990). In contrast to the virtual unanimity in the courts with respect to the role of tax avoidance motivation under these doctrines, some controversy has arisen in recent years with respect to the issue of the role of tax motives in the determination of whether the profit motive requirement of various Code provisions (e.g., sections 162, 165(c)(2), 183, and 212) has been satisfied. While the test is often described as requiring a primary purpose of realizing a profit, the cases generally have considered the relative weight of profit motive only in comparison to personal motives. See Portland Golf Club v. Commissioner, 497 U.S. 154 n.16 (1990); Snyder v. United States, 674 F.2d 1359 (10th Cir. 1982). In commercial transactions, where personal motives are not at issue, in some cases the courts have analyzed the facts of the transaction to determine whether a profit motive existed. In general, the finding of a profit motive has been sufficient for the courts to hold in favor of the taxpayer without further analysis. See, e.g., Lyon v. United States, 435 U.S. 561 (1978); Levy v. Commissioner, 91 T.C. 838 (1988). There have, however, been some tax shelter cases in which the courts have expanded their inquiry to consider the primacy of the profit motive as compared to the tax motive. See, e.g., Estate of Baron v. Commissioner, 83 T.C. 542 (1984), aff'd, 798 F.2d 65 (2d Cir. 1986); Fox v. Commissioner, 82 T.C. 1001 (1984). It remains to be seen whether tax motivation will play a significant role in the determination of whether a profit motive requirement within a particular Code provision is satisfied.

It has long been settled case law that tax motivation does not affect the qualification of an organization as a partnership. See Culbertson, 337 U.S. 733. Furthermore, to date there has been no decision applying a "primarily for profit" requirement to the definition of partnerships or to any provision of subchapter K. But see Brannen v. Commissioner, 78 T.C. 471 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984) (dissent by J. Whitaker, suggesting that profit motive identical to that required under section 162 would be required for a partnership to be recognized for tax purposes). Sixty years of case law consistently denies any relevance of a tax avoidance motivation in applying the substance over form doctrine and in determining whether there is a valid business purpose for a transaction. Moreover, case law and legislation consistently have denied relevance to tax avoidance motivation in determining whether an organization is a partnership for tax purposes. Finally, there have been repeated reenactments of the entire Code in the context of that case law. Based on this legal history, we believe that the partnership anti-abuse rule should not be considered a reasonable interpretation of the statute to the extent that it requires that what would otherwise be the tax consequences of a transaction be modified based on the presence of a tax motivation for a partnership transaction.

We believe that a court should not interpret the partnership anti-abuse rule as overriding specific mechanical rules provided in subchapter K in the absence of an example that cannot reasonably be distinguished from the transaction on its facts. In the event that the partnership anti-abuse rule were nevertheless interpreted as being applicable to a particular transaction, we believe that a court should find the regulation to be invalid to the extent that it alters the clear rules of subchapter K based on the presence of a tax motivation.

G. Application of Section 482

Section 482 gives the IRS the authority, under certain circumstances, to alter what would otherwise be the tax consequences of a transaction. For the reasons set forth below, we believe section 482 should not apply to adversely affect the conclusions reached in this opinion.

Section 482 grants broad authority to the Secretary of the Treasury to allocate gross income, as necessary to clearly reflect income, among two or more entities that are controlled by the same interests. We assume, for purposes of discussion, that Enron and Partnership are under common control by virtue of Enron's control over Partnership's managing partner, Enron GP.

The threshold requirement for application of section 482 is that a transaction does not reflect arm's-length dealing between the parties. See Simon J. Murphy Co. v. Commissioner, 231 F.2d 639, 644-45 (6th Cir. 1956) (describing limits of predecessor of section 482, court stated that allocation not permitted where related parties deal with each other at arm's length; in case before court, failure of return to clearly reflect income was inherent in accrual method, not due to control over related parties); Haag v. Commissioner, 88 T.C. 604, 615 (1987), aff'd, 855 F.2d 855 (8th Cir. 1988) (to determine whether a reallocation is necessary to clearly reflect income or to prevent the evasion of taxes, court must decide whether the agreement reflected arm's-length dealing); Van Dale Corp. v. Commissioner, 59 T.C. 390, 398 (1972) (unless the tax benefit stems from less than arm's-length dealings, the threshold point for applying section 482 is simply not reached); Seminole Flavor Co. v. Commissioner, 4 T.C. 1215, 1229-31 (1945) (nonacq.) (court rejected government's argument that contract was for purpose of evading tax based on finding that terms of contract were arm's length); Treas. Reg. § 1.482-1(b)(1) (purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer; standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer); Tech. Adv. Mem. 7927009 (Mar. 22, 1979) (conditioning application of section 482 on finding that control relationship was utilized to effect the transaction at bargain sale price). Given EN-BT's interest in Partnership, and terms of the Purchase Agreement that were, at the time the transaction was entered into, commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree, we believe that section 482 should not be applicable to reallocate the section 304 dividend or the basis adjustments resulting from the Purchase among the entities.

VI. CONCLUSION

This opinion letter is based upon existing statutory, regulatory, judicial and administrative authority in effect as of the date of this opinion letter, any of which may be changed at any time with retroactive effect. In addition, our analysis is based solely on the documents we have examined, the representations you have made, the facts that we have assumed with your consent, and the additional information that we have obtained. If any of the facts contained in these documents or in such additional information are, or later become, inaccurate, or if any of the representations you have made or any of the assumptions that we have made are, or later become, inaccurate, our conclusions could well be different and this opinion cannot be relied upon. Similarly, our opinion is qualified by the preceding discussion and analysis and cannot be relied upon if we have not been informed of any material or relevant fact that would adversely affect our analysis.

Our opinion is rendered solely for your benefit and is not to be relied upon by any other person without our prior written consent. Finally, our opinion letter is limited to the specific issues described above.

Sincerely,

KING & SPALDING

By: Abraham N.M. Shashy, Jr.
Abraham N.M. Shashy, Jr.
for himself and William S. McKee

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AND WORK-PRODUCT DOCTRINE

October 2, 2000

Enron Corp.
1400 Smith Street
Houston, TX 77002-7361

Re: Redemption of Stock of Enron Liquids Holding Corp.

Ladies and Gentlemen:

In our capacity as special tax counsel, you have requested our opinion with respect to certain federal income tax consequences of the March 31, 1998 acquisition by Enron Liquids Holding Corp. ("Liquids") of its stock from its shareholders (the "Redemption").

This document is subject to the attorney-client privilege and the work-product doctrine. It contains the legal opinions, thoughts, impressions and conclusions of King & Spalding with respect to certain federal income tax matters. King & Spalding, as special tax counsel for Enron Corp. ("Enron"), has prepared this document at the request of Enron for its sole use. It has been prepared to aid Enron, among other things, in anticipation of possible future litigation regarding the federal income tax matters referenced above and covered herein. In that regard, this document has been prepared to help define, and as part of, the litigation strategy of Enron in the event of any challenge to the federal income tax treatment claimed with respect to the transactions that it addresses.

In rendering this opinion, we have relied upon the certificate of incorporation of Liquids, as amended by certificates of amendment filed on December 23, 1992, March 21, 1997, and March 31, 1998 (the "Liquids Certificate"), the representations and assumptions set forth in your letter to us, dated September 27, 2000, a copy of which is attached, and the additional information that we have obtained through consultation with officers, employees, or legal representatives of Organizational Partner, Inc. ("OPI"), Enron Property Management Corp. ("Enron GP"), Enron Leasing Partners, L.P. ("Partnership"), and members of the consolidated

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group, within the meaning of Treasury Regulation § 1.1502-1(h),[1] of which Enron is the parent (the "Enron consolidated group").

I. OPINION

Based upon our analysis of the pertinent authorities as they apply to the information relied upon, it is our opinion that, for federal income tax purposes:

1. The amounts received by Liquids shareholders in the Redemption should be treated as dividend distributions ("Redemption Dividends") from Liquids.

2. The adjusted basis of the Liquids preferred stock retained by Partnership should be increased by an amount equal to Partnership's adjusted basis in the Liquids preferred stock transferred to Liquids in the Redemption.

3. The adjusted basis of OPI's interest in Partnership should be increased by its distributive share of the Redemption Dividends received by Partnership.

4. Section 1059 should not be applicable to reduce Partnership's basis in the retained Liquids preferred stock, to reduce OPI's basis in its interest in Partnership, or to trigger gain to Partnership with respect to any portion of the Redemption Dividends received by Partnership.

For purposes of providing you with information that may be relevant in connection with sections 6662 and 6664, we specifically state, without modifying the strength of the opinion set forth above, that in reaching the opinion set forth above we concluded, based on our analysis of the pertinent facts and authorities in the manner described in Treasury Regulation § 1.6662-4(d)(3)(ii), that there is substantial authority (within the meaning of Treasury Regulation § 1.6662-4(d)) for the tax treatment of the items as set forth above and there is a greater than 50 percent likelihood that the tax treatment of the items as set forth above will be upheld in litigation if challenged by the Internal Revenue Service (the "Service").

II. LEGAL ANALYSIS

A. Dividend Treatment

Liquids acquired shares of its stock from its shareholders in exchange for property in the Redemption. For purposes of the relevant sections of the Code, stock is treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is canceled, retired, or held as treasury stock. Section

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[1] All references to sections are to the Internal Revenue Code of 1986 (the "Code"), as amended and in effect as of the date of this letter, unless otherwise noted. All references to regulations are to U.S. Treasury Department regulations, as most recently adopted, amended, or proposed, as the case may be, as of the date of this letter, unless otherwise noted.

317(b). A distribution in redemption of stock from a shareholder is treated as a sale or exchange of stock if the redemption is not essentially equivalent to a dividend, is substantially disproportionate with respect to the shareholder, or is in complete redemption of all of the stock of the corporation owned by the shareholder. Sections 302(a), 302(b).

We believe that a pro rata redemption from all shareholders cannot satisfy any of these conditions. In the Redemption, 3.25 percent of each class of stock held by each shareholder was acquired by Liquids in exchange for cash or notes. While the pro rata nature of a redemption might be determined by reference to a number of factors, we believe that a redemption of the identical percentage of each class of stock of a corporation should be considered pro rata with respect to all such factors. Accordingly, we believe the Redemption should be treated as pro rata and as a distribution of property to which section 301 applies. Section 302(d).

Under section 301(c)(1) and section 316, a distribution is treated as a dividend to the extent of the earnings and profits of the distributing corporation. Liquids' current and accumulated earnings and profits for the taxable year ended December 31, 1998 exceeded the aggregate amount of the promissory notes and cash transferred by Liquids to Enron, Enron Pipeline Company ("Pipeline"), OPI, and Partnership in exchange for stock on March 31, 1998 plus any other distributions made or deemed made by Liquids to its shareholders during such taxable year. Accordingly, we believe that the full amount of the Redemption proceeds received by each shareholder should be treated as a dividend from Liquids to such shareholder.

Regulations under section 7701(l) permit the Commissioner to recharacterize an arrangement in which a corporation has outstanding fast-pay stock as an arrangement between shareholders of the corporation if a principal purpose for the structure of the arrangement is the avoidance of any tax imposed by the Code. Treas. Reg. § 1.7701-3(c). Such a recharacterization could be applied for taxable years ending after February 26, 1997. Treas. Reg. § 1.7701-3(g). Stock is fast-pay stock if it is structured so that dividends paid by the corporation with respect to the stock are economically a return of the holder's investment. Treas. Reg. § 1.7701-3(b)(2)(i). Stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of section 302(d) unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement. Treas. Reg. § 1.7701-3(b)(2)(ii).

The predominant purpose of Enron and its Affiliates[2] for participating in the Redemption was to generate income for financial accounting purposes. The accounting treatment of the Redemption provided Enron and its Affiliates with significant and material benefits. Partnership and the Redemption were structured to achieve this accounting benefit without increasing or decreasing, on a present value basis (computed using a discount rate that is less than or equal to the lesser of the applicable federal rate as defined in section 1274(d) or the after-tax weighted average cost of capital of the Enron consolidated group (the "Discount Rate") during the relevant

2 For purposes of this letter, the "Affiliates" of a person are those persons directly or indirectly controlling, controlled by, or under common control with such person.

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period), the aggregate federal income tax liability of the Enron consolidated group and those Affiliates of Enron that are included in Enron's consolidated financial statements.

Neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a transaction in which Partnership is treated for federal income tax purposes as receiving a dividend in connection with a redemption, purchase, or other acquisition of Liquids stock from Partnership by Enron or an Affiliate of Enron (a "Dividend Transaction"). A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer equals or exceeds the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Dividend Transaction.

Neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT Delaware, Inc. ("EN-BT"), Potomac Capital Investment Corporation ("PCI"), and their Affiliates, in the aggregate, from the 1997 restructuring of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, the operations and investments of OPI and Partnership, and any Dividend Transactions. These transactions are considered to produce a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, if the sum of the present values (computed using the Discount Rate during the relevant period), on March 20, 1997, of the hypothetical federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates. determined as if the transactions had not occurred, exceeds the sum of the present values (computed using the Discount Rate during the relevant period), on March 20, 1997, of the actual federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates.

None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Redemption on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any. The Redemption (i) has not altered and will not alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Redemption) by members of the Enron consolidated group to nonmembers of the Enron consolidated group that are treated as having been made out of earnings and profits and (ii) has not resulted and will not result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Redemption on the earnings and profits of members of the Enron consolidated group.

No member of the Enron consolidated group has disposed or will dispose of any stock of Liquids on or after March 30, 1998 except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron has taken or will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Redemption.

Based on these facts, we believe that Dividend Transactions, and the Redemption in particular, should not be considered to have a principal purpose of tax avoidance. Accordingly, we believe that the Redemption should not cause stock of Liquids to be recharacterized under the fast-pay stock regulations as an arrangement between shareholders of Liquids even if such stock were determined to be fast-pay stock.

B. Basis Effects

Under section 302, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Treas. Reg. § 1.302-2(c). The examples in Treasury Regulation § 1.302-2(c) suggest that the "proper adjustment" is to increase the basis of stock retained by the taxpayer by the amount of the taxpayer's basis in the redeemed stock. See Treas. Reg. § 1.302-2(c) *Example (1)*, *Example (3)*. Accordingly, we believe the proper adjustment in the case of the Redemption should be to increase the basis of the remaining Liquids stock held by a shareholder by the amount of the basis of the Liquids stock that is redeemed from that shareholder.

We believe that each partner's distributive share of Partnership's dividend income from the Redemption should increase the basis of the partner's interest in Partnership and that there should not be any reduction in such basis for any dividends received deduction that may be allowable to the partner. Section 705(a)(1)(A) and (B); Treas. Reg. § 1.705-1(a)(2)(ii) (a partner's basis is increased by tax-exempt receipts of the partnership).

C. Section 1059

Under certain circumstances, a corporation must reduce its basis in a share of stock with respect to which it receives an extraordinary dividend by the amount of the dividends received deduction attributable thereto, and must recognize gain to the extent of any excess of such dividends received deduction over such basis. Section 1059(a).

1. Pro Rata Redemptions

Dividends attributable to a redemption which is not pro rata as to all shareholders trigger application of these rules. Section 1059(e). The Redemption involved the acquisition from each shareholder of identical percentages of Liquids common and preferred stock. Such a redemption has no effect on the relative interests of any shareholder. We believe the Redemption should be considered pro rata for purposes of section 1059(e).

2. Extraordinary Dividends

Extraordinary dividends received with respect to a share of stock that has not been held for more than two years before the dividend announcement date also trigger application of the basis reduction and gain recognition rules of section 1059. The Redemption occurred within two years of Partnership's acquisition of the Liquids preferred stock. Accordingly, we believe that if the Redemption is properly characterized as an extraordinary dividend, the basis reduction and gain recognition rules of section 1059 would be applicable.

In general, the term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds 10 percent (5 percent in the case of stock which is preferred as to dividends) of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends having ex-dividend dates within an 85-day period (the "Quarterly Test"), or exceeds 20 percent of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends having ex-dividend dates within a 365-day period (the "Annual Test"). Section 1059(c).

The statute does not specify the date on which a taxpayer's basis is determined for purposes of applying the Quarterly Test or the Annual Test. The statute provides that, under some circumstances, the taxpayer may elect to apply the Quarterly Test and the Annual Test by substituting the fair market value of a share of stock as of the day before the ex-dividend date for the adjusted basis of the share. Section 1059(c)(4). In addition, the statute provides that any reduction of basis is treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates. Section 1059(d)(1). Accordingly, we believe that the adjusted basis that should be used in applying the Quarterly Test or the Annual Test is the adjusted basis as of the day before the ex-dividend date for the particular dividend being tested.[3]

It is not entirely clear, in the case of a redemption of stock, how one identifies the exact shares with respect to which the resulting dividend is treated as paid. Based on the information that we have relied on, we believe that the maximum amount of dividends that might be aggregated with respect to all preferred stock of Liquids for any 85 day period that included March 31, 1998 (a "Relevant 85 Day Period") should not exceed $47,968,750 (the amount of the notes and the cash transferred to Enron, Pipeline, and Partnership on March 31, 1998, excluding the amount of the note issued to Enron in exchange for common stock of Liquids) and that the basis of the 7,759.35 shares of Liquids preferred retained by Partnership was at least $967,500,000 on March 30, 1998. Five percent of $967,500,000 is $48,375,000, an amount which exceeds the maximum amount of dividends described in the preceding sentence as being

[3] Note that if an aggregation of a current dividend with future dividends results in the aggregate amount failing either the Quarterly Test or the Annual Test, it is unclear when the resulting basis reduction occurs. If it were to occur immediately before the first dividend included in the aggregate amount, then it might cause other aggregations over different quarterly periods to fail to satisfy the Quarterly Test because there is no specific exclusion of basis adjustments required by section 1059(a)(1) in applying the Quarterly Test.

aggregated with respect to all preferred stock of Liquids for any Relevant 85 Day Period. Accordingly, we believe that the aggregate amount of all dividends properly taken into account by Partnership for purposes of applying the Quarterly Test to the Redemption should not exceed five percent of the basis on the day before the Redemption of the Liquids preferred shares retained by Partnership following the Redemption and the Redemption should not be treated as an extraordinary dividend with respect to Partnership by reason of application of the Quarterly Test.

The sum of (i) the aggregate of all amounts that were declared and paid as dividends with ex-dividend dates within any 365 day period that included March 31, 1998 (a "Relevant 365 Day Period") on all shares of Liquids preferred stock in the aggregate plus (ii) the aggregate of all amounts ("Redemption Amounts") that were paid by Liquids in exchange for preferred stock acquired in transactions that occurred within, or were effective on a record date within, any Relevant 365 Day Period plus (iii) the aggregate of all amounts of any other distributions or deemed distributions with respect to the Liquids preferred stock in the aggregate that occurred within, or were effective on a record date within, any Relevant 365 Day Period (each such dividend, stock acquisition, distribution, or deemed distribution being a "Relevant Transaction") did not exceed 20 percent of Partnership's adjusted basis for federal income tax purposes, as of the day immediately preceding any Relevant Transaction, of those shares of Liquids preferred stock that were held by Partnership immediately after such Relevant Transaction. The aggregate of all per share amounts with respect to all Relevant Transactions did not exceed 20 percent of the Partnership's adjusted basis per share of Liquids preferred stock as of the day immediately preceding any Relevant Transaction. Accordingly, we believe that the Redemption should not be treated as an extraordinary dividend with respect to Partnership by reason of application of the Annual Test.

3. <u>Disqualified Preferred Stock</u>

Any dividend with respect to disqualified preferred stock triggers application of the basis reduction and gain recognition rules of section 1059. Section 1059(f)(1). Disqualified preferred stock means any stock which is preferred as to dividends if:

> (A) when issued, such stock has a dividend rate which declines (or can reasonably be expected to decline) in the future,
>
> (B) the issue price of such stock exceeds its liquidation rights or its stated redemption price, or
>
> (C) such stock is otherwise structured --
>
> > (i) to avoid the other provisions of [section 1059], and

(ii) to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of stock.

Section 1059(f)(2).

The Liquids Certificate provides for preferred dividends to be paid on the Liquids preferred stock at a floating rate based on LIBOR. The spread over LIBOR is fixed in the Liquids Certificate and does not decline over time. The legislative history of section 1059(f) states that the provision is not intended to apply to dividends on floating rate or auction rate preferred stock whose dividend rate declines solely in response to changes in prevailing market conditions. Committee on Finance, 101st Cong., 1st Sess., Revenue Reconciliation Act of 1989, Explanation of Provisions Approved by the Committee on October 3, 1989, 64 (Comm. Print 1989). Accordingly, we believe the Liquids preferred stock should not be treated as described in section 1059(f)(2)(A).[4] Based on our review of the information that we have relied on, we believe that the issue price of the Liquids preferred stock does not exceed its liquidation rights or its stated redemption price. Accordingly, we believe the Liquids preferred stock should not be treated as described in section 1059(f)(2)(B).

Finally, neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a Dividend Transaction. A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer equals or exceeds the present value (computed using the Discount Rate during the relevant period) on the date of the

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[4] If the dividends resulting from redemptions of Liquids preferred stock were taken into account, and if it were expected that there would be a larger amount of redemptions in earlier years than in later years, it might be argued that the dividend rate on the Liquids preferred stock could reasonably be expected to decline over time. The legislative history of section 1059(f) identifies the provision as requiring basis reduction for the nontaxed portion of dividends on self-liquidating stock and states the reason for change as follows: "Corporate stockholders may receive dividends eligible for the dividends received deduction in circumstances where the dividends more appropriately should be characterized as a return of capital. . . . The committee believes that basis reduction in such cases is appropriate to accurately reflect the true economic effect of these types of transactions." H.R. Rep. No. 101-247, at 63 (1989). Section 1059 includes very specific and detailed rules for dealing with a variety of transactions. In particular, section 1059(f)(2)(A) specifically addresses shares having declining dividend rates and section 1059(e)(1)(A) specifically addresses redemption transactions. In addition to its more specific provisions, the statute contains antiabuse type provisions of more general applicability. See Section 1059(f)(2)(C). We believe that redemptions should be analyzed only under the specific provisions applicable to redemptions and under the more general provisions of section 1059. We believe that application of the provision that specifically addresses stock with a declining interest rate should be limited to stock that, in form, provides for a declining interest rate and should not be applied based on the characterization for tax purposes of a redemption transaction as a dividend.

Dividend Transaction of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Dividend Transaction. We believe that section 1059(f)(2)(C), which requires that stock be "structured" to avoid the other provisions of section 1059 and to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock, should be interpreted as a subjective intent test. See Tech. Adv. Mem. 200023003 (Dec. 21, 1999). We further believe that the proscribed intent to reduce taxes should not be present where there is no net reduction in the economic burden, on a present value basis, of the taxpayer's tax liabilities. Cf. H.R. Rep. No. 98-432, pt. 2, at 1185-86 (1984) (legislative history describing intent to discourage corporations from buying stock shortly before ex-dividend date and selling shortly after and concern that the failure to apply a two asset analysis in cases of extraordinary distributions when the taxpayer's holding period in the stock is short leads to such transactions; focus on short holding periods suggests that Congress did not feel a need to address transactions in which there was a substantial deferral (i.e., a reduced present value) of the tax benefit of the deduction from a sale of the stock after the dividend payment). While the combination of the dividends received deduction and a loss on the disposition of the Liquids preferred stock may result in a reduction in the absolute dollars of tax paid, we believe that the absence of any anticipated reduction, on a present value basis, of the economic tax burden[5] from this combination supports a conclusion that there was no intent to reduce taxes within the meaning of section 1059(f)(2)(C). Accordingly, we believe the Liquids preferred stock should not be treated as described in section 1059(f)(2)(C).

4. Conclusion

We believe that the basis reduction and gain recognition rules of section 1059 should not be applicable to Partnership with respect to the Redemption.

[5] The Discount Rate is less than or equal to the lesser of the applicable federal rate or the after-tax weighted average cost of capital of the Enron consolidated group. If the relevant economic test of whether there has been a present value reduction of tax burdens is whether the government has suffered an economic detriment on a present value basis, we believe that the government's cost of funds should be considered the appropriate discount rate. We further believe that the applicable federal rate should be considered to reflect the government's cost of funds for these purposes. Moreover, we note that the applicable federal rate is the rate mandated by regulation for determining the present value of tax benefits and detriments for certain purposes. See Treas. Reg. §§ 1.860E-2(a)(4), 1.475(c)-2(c). If the relevant economic test of whether there has been a present value reduction of tax burdens is whether the taxpayer has obtained an economic benefit on a present value basis, we believe the taxpayer's cost of funds should be considered the appropriate discount rate. We further believe that the after-tax weighted average cost of capital of a consolidated group should be considered to reflect the taxpayer's cost of funds for these purposes. Given transactions that produce a tax detriment to the taxpayer initially, with a tax benefit later in time, the more conservative of the two discount rates (i.e., the rate more favorable to the government) would be the lesser of these two rates.

D. Substance Over Form Doctrine

The tax consequences of a transaction are generally based on the substance of the transaction. Where the form reflects the substance, the tax consequences of the form are generally recognized.. Where the form of a transaction does not reflect its substance, however, a variety of judicial approaches have been used to determine the tax consequences of the transaction. These approaches include refusing to recognize a participant in a transaction as a separate taxable entity and disregarding a transaction as a sham.

1. Separate Taxable Entity

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the Supreme Court established the test for determining whether a corporation will be recognized as a separate taxable entity, stating that "so long as [the purpose for forming the corporation] is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Id. at 439. The separate entity tests set forth in Moline Properties have been applied to partnerships. Campbell County State Bank, Inc. v. Commissioner, 37 T.C. 430, 441-42 (1961), reversed on another issue, 311 F.2d 374 (8th Cir. 1963) (acq.). The level of activity necessary to constitute the "carrying on of business" within the meaning of the Moline Properties test appears to be quite minimal. Britt v. United States, 431 F.2d 227, 235 (5th Cir. 1970); Hospital Corp. of America v. Commissioner, 81 T.C. 520, 579 (1983) (nonacq. in part); Strong v. Commissioner, 66 T.C. 12, 24 (1976), aff'd without published opinion, 553 F.2d 94 (2d Cir. 1977). In practice, it seems to require little more than the observance of bookkeeping formalities, maintenance of separate bank accounts and books and records, having employees, executing contracts where appropriate, and representing the entity to third parties as an independent organization.

Each of Enron, Pipeline, Liquids, OPI, and Enron GP at all times has represented and will represent itself to third parties as a separate entity in all transactions, has observed and will observe all corporate and bookkeeping formalities, has maintained and will maintain separate bank accounts and books and records, has had and will have employees and/or has paid and will pay fees for services that would otherwise be rendered by employees, and has executed and will execute contracts in a manner consistent with its status as a separate entity. Partnership at all times has represented and will represent itself to third parties as a separate entity in all transactions, has observed and will observe all partnership and bookkeeping formalities, has maintained and will maintain separate bank accounts and books and records, has had and will have employees and/or has paid and will pay fees for services that would otherwise be rendered by employees, and has executed and will execute contracts in a manner consistent with its status as a separate entity. At all times during 1998, each of the entities described in the preceding two sentences held assets having a fair market value of at least $10 million. Prior to March 31, 1998, each of Enron, Pipeline, Liquids, and OPI had been in existence for at least two years and in 1998 each either was engaged in the active conduct of a trade or business or had engaged in financial or business transactions with unrelated persons. OPI and Enron GP entered into a substantial joint venture (Partnership) with unrelated persons (PCI and EN-BT). Transactions with third parties are generally considered sufficient business activity to satisfy the Moline Properties test. For example, obtaining a loan from third parties has been found to be sufficient business activity to prevent taxpayers from disavowing the separate status of a corporation that admittedly served no business purpose. See Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945); but see ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000) (treating the Moline Properties test as unitary test in which the absence of a nontax business purpose is fatal). Based on the above facts, we believe that each corporation described above and Partnership should be respected as a separate entity for federal income tax purposes.

2. Sham

The sham transaction doctrine is a judicially created theory under which a transaction can be ignored for tax purposes if, in effect, the transaction affects nothing but tax consequences to the parties. The most recent Supreme Court discussion of the sham transaction doctrine is the case of Frank Lyon Co. v. United States, 435 U.S. 561 (1978), in which the Court upheld the sale and leaseback of a building against the government's argument that the transaction was really a financing. Modern sham transaction theory originated in the Court's frequently quoted defense of a "genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . ." Frank Lyon Co., 435 U.S. at 583-84.

This quotation has led courts to focus on two elements in analyzing the substance of transactions: the objective economic substance of and the subjective business purposes for the transaction. If a tax-motivated transaction has neither of these elements, the transaction can be disregarded as a sham. See, e.g., ACM Partnership v. Commissioner, 73 T.C.M. 2189 (1997), aff'd 157 F.3d 231 (3d Cir. 1998), Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985); cf. ASA Investerings Partnership (treating the sham test as unitary test in which the absence of a nontax business purpose is fatal).

The predominant purpose of Enron and its Affiliates for participating in the Redemption was to generate income for financial accounting purposes. The accounting treatment of the Redemption provided Enron and its Affiliates with significant and material benefits. Partnership and the Redemption were structured to achieve this accounting benefit without increasing or decreasing, on a present value basis (computed using the Discount Rate), the aggregate federal income tax liability of the Enron consolidated group and those Affiliates of Enron that are included in Enron's consolidated financial statements.

Improving a company's balance sheet has been recognized as a valid business purpose. See Frank Lyon Co., 435 U.S. at 577-78 (effect of debt on company's balance sheet has "distinct element of economic reality"); Newman v. Commissioner, 902 F.2d 159, 163 (2d Cir. 1990) (business purposes in entering into operating agreement rather than lease for balance sheet purposes); Priv. Ltr. Rul. 9017061 (Jan. 31, 1990) (improvement of balance sheet for company's lenders is business purpose for section 355); Tech. Adv. Mem. 8803001 (Sept. 29, 1987), (movement of assets from non-member to member corporation of affiliated group to improve consolidated balance sheet is business purpose for section 368(a)(1)(C)), revoked by Tech. Adv. Mem. 8941004 (July 11, 1989) (based on insufficiency of facts submitted at time of examination).

The economic substance test depends upon all of the facts and circumstances. With respect to the Redemption, the Liquids stock that was acquired in the Redemption was outstanding for at least one year prior to the Redemption. Dividends were paid on the preferred stock held by Partnership and were shared economically among the partners, OPI, Enron GP, and EN-BT. The economics attributable to the increase in value of the Liquids common stock over time, as reflected in the purchase price established for the Redemption, was shared by the common shareholders, including OPI and, indirectly through OPI, EN-BT and PCI.

We believe, based on the combination of business purpose for and economic substance of the Redemption and the absence of any present value economic benefit from the tax consequences of Dividend Transactions, that the Redemption should be respected in accordance with its form.

E. Partnership Anti-abuse Rule

Under the partnership anti-abuse rule:

> [I]f a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of Subchapter K.

Treas. Reg. § 1.701-2(b). In the absence of any purpose to reduce the present value of the aggregate federal tax liability of the partners of Partnership, the partnership anti-abuse rule should not be applicable.

In order to apply this threshold test, it is necessary to determine a baseline aggregate federal tax liability of the partners in order to determine whether a transaction reduces the present value of the partners' aggregate federal tax liability. In determining the tax reduction purpose of a transaction, it seems logical to look at the tax position the taxpayer would have been in if it had not done the transaction. In order to do this, one must determine the scope of a "transaction" in order to determine the tax effects of not doing the transaction.

The maximum scope of a transaction for these purposes would include a particular step that produces a tax benefit (the "goal step") and all other steps ("related steps") that would not have been done if the goal step were not done. In the instant case, the goal step would be generating accounting benefits by creating the potential for deductions with respect to tax basis in excess of the book value of assets ("excess basis"). The related steps would be all elements of the establishment of the OPI/Partnership/Liquids investment structure. Under this view of what constitutes the transaction, Enron GP and EN-BT would not exist and OPI and Liquids would not have been recapitalized if the transaction had not been done. It seems reasonable to believe that the tax liability of a partner that does not exist or that would not have owned a substantial portion of its assets in the absence of the transaction would be determined by looking to the tax liability of the persons that own the assets that were transferred to the partner. Under this view, the baseline would be the present value of the aggregate tax liability of the Enron consolidated group, the shareholder of EN-BT, and PCI if no steps had been taken to set up the OPI/Partnership/Liquids structure.

Given a baseline that includes the tax liability of the Enron consolidated group, it would seem that any comparison of (i) the aggregate tax liability of the partners to (ii) the baseline tax liability should include the effects of the transaction on the tax liabilities that are included in the baseline, including the tax liability of the Enron consolidated group. Thus, the effects on the Enron consolidated group tax liability of transferring assets (and related income) from the Enron consolidated group to the OPI/Partnership/Liquids structure and of transactions between the Enron consolidated group and the OPI/Partnership/Liquids structure (e.g., interest payments from Enron to OPI or Partnership on investments in Enron securities) would have to be taken into account along with the net tax liability of OPI and changes in the tax liability of PCI and the shareholder of EN-BT attributable to the transaction.

A more limited view of what constitutes a "transaction" would include the goal step and those other steps ("enabling steps") that are required in order to make the goal step possible. In the instant case, the enabling steps would be the steps required to create the excess basis (e.g., the Redemption) and any steps taken to convert that basis into deductions. Under this view, the baseline would be the tax liability of the partners taking into account all steps involved in setting up the OPI/Partnership/Liquids structure but not taking into account the Redemption. The effects of the formation and capitalization of, and investments by, OPI and Partnership on the Enron consolidated group would be the same in the baseline as in the actual transaction, and accordingly would be irrelevant under this view. The change in tax liabilities as compared to the baseline would be attributable to the transaction increasing the income of the partners by the amount of the dividend income in excess of the dividends received deduction and decreasing the income of the partners by the amount of the deductions attributable to excess basis. The timing of these effects would be affected by the time at which the partners trigger deductions attributable to the excess basis.

A minimum view of what constitutes a "transaction" would treat each separate step as a transaction. In the instant case, under this view, each step (e.g., the restructuring of OPI or Liquids, the formation of Partnership, the Redemption, or a triggering of deductions attributable to excess basis) would be a transaction. The baseline could be the tax liability of the partners determined as if any one step was not done.

Based on our review of the information we have relied on, we believe that there should not be any present value tax benefit to the partners in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron when both dividend income and deductions attributable to the Redemption are taken into account. Similarly, we believe that there should not be any present value tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, taking into account all of the transactions described above. Finally, we believe that there should not be any present value tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the Redemption, when viewed in isolation. Accordingly, we believe that under any view of the meaning of the term "transaction" in the partnership anti-abuse regulation, the regulation should not be applicable to the Redemption.

III. RELIANCE

This opinion letter is based upon existing statutory, regulatory, judicial and administrative authority in effect as of the date of this opinion letter, any of which may be changed at any time with retroactive effect. In addition, our analysis is based solely on the documents we have examined, the representations you have made and the assumptions and the additional information we have relied on with your consent. If any of the facts contained in these documents is, or later becomes, inaccurate, or if any of the representations you have made or any of the assumptions or the additional information that we have relied on is, or later becomes, inaccurate, our conclusions could well be different and this opinion cannot be relied upon. Similarly, our opinion is qualified by the preceding discussion and analysis and cannot be relied upon if we have not been informed of any material or relevant fact that would adversely affect our analysis.

Our opinion is rendered solely for your benefit and is not to be relied upon by any other person without our prior written consent. Finally, our opinion letter is limited to the specific issues described above.

Very truly yours,

King & Spalding

EC2 000033827

Enron Corp.
P.O. Box 1188
Houston, TX 77251-1188
(713) 853-6161

PRIVILEGED AND CONFIDENTIAL
SUBJECT TO ATTORNEY-CLIENT PRIVILEGE

September 27, 2000

King & Spalding
1730 Pennsylvania Avenue, N.W.
Washington, D.C. 20006-4706

Ladies and Gentlemen:

In connection with your opinion (the "Opinion") relating to the acquisition by Enron Liquids Corp. ("Liquids") of its stock from its shareholders on March 31, 1998, we represent that the facts set forth below are true to the best of our knowledge and belief.

1. At all times during 1998, Enron Corp. ("Enron") directly owned all of the common stock, which was all of the outstanding stock, of each of Enron Pipeline Company ("Pipeline") and Enron Cayman Leasing, Ltd. ("Cayman").

2. At all times during 1998, (i) Enron owned all of the outstanding common stock of Organizational Partner, Inc. ("OPI"), (ii) Potomac Capital Investment Corporation ("PCI") owned all of the outstanding shares of Series A preferred stock of OPI, and (iii) EN-BT Delaware, Inc. ("EN-BT") owned all of the outstanding shares of Series B preferred stock of OPI.

3. Immediately before the March 31, 1998 acquisition of shares of Liquids (the "Redemption"), (i) the common stock of Liquids was owned 80 percent (13,583,085 shares) by Enron and 20 percent (3,395,771 shares) by OPI and (ii) the preferred stock of Liquids was owned 80.2 percent (8,020 shares) by Enron Leasing Partners, L.P. ("Partnership"), 10.45 percent (1,045 shares) by Pipeline, and 9.35 percent (935 shares) by Enron.

4. At all times during 1998, (i) OPI was a limited partner in Partnership with a 98 percent interest in capital and profits, (ii) EN-BT was a limited partner in Partnership with a one percent interest in capital and profits, and (iii) Enron Property Management Corp. ("Enron GP"), a wholly-owned subsidiary of Cayman, was the general partner of Partnership with a one percent interest in capital and profits.

5. On March 31, 1998, the following transactions were validly executed and effective in accordance with applicable state laws:

a. In exchange for 8.125 shares of Liquids common stock, Liquids issued to OPI a promissory note in the amount of $3,395,771.

b. In exchange for 260.65 shares of Liquids preferred stock, Liquids issued to Partnership a promissory note in the amount of $26,065,000 and transferred to Partnership cash in an amount equal to the accrued dividends on 260.65 shares of Liquids preferred stock.

c. In exchange for 33.9625 shares of Liquids preferred stock, Liquids issued to Pipeline a promissory note in the amount of $3,396,250 and transferred to Pipeline cash in an amount equal to the accrued dividends on 33.9625 shares of Liquids preferred stock.

d. In exchange for 30.3875 shares of Liquids preferred stock, Liquids issued to Enron a promissory note in the amount of $3,038,750 and transferred to Enron cash in an amount equal to the accrued dividends on 30.3875 shares of Liquids preferred stock.

e. In exchange for 32.5 shares of Liquids common stock, Liquids issued to Enron a promissory note in the amount of $13,583,085.

f. Liquids transferred to each of Enron, Pipeline, and Partnership cash in an amount equal to the accrued dividends that were payable on March 31, 1998 with respect to Liquids preferred shares held by such shareholder in excess of the shares involved in the exchanges described above.

6. At all times during 1998, each of Enron, Pipeline, Liquids, OPI, Enron GP, and Partnership held assets having a fair market value of at least $10 million. Prior to March 31, 1998, each of Enron, Pipeline, Liquids, and OPI had been in existence for at least two years and in 1998 each either was engaged in the active conduct of a trade or business or had engaged in financial or business transactions with unrelated persons.

7. At all times during 1998 and through the date of this letter, Partnership held in excess of 4,000 shares of preferred stock of Liquids.

8. Partnership's adjusted basis, for federal income tax purposes, in the 8,020 shares of Liquids preferred stock that it held immediately before the Redemption was at least $1 billion on March 30, 1998.

In addition to relying upon the representations set forth above, we consent to your assumption of the facts set forth below and your reliance on those assumptions:

1. Enron and its Affiliates[1] will at all times act in a manner that is consistent with the form of the transactions described in paragraph 5 above, as reflected in the documentation relating to those transactions.

2. The predominant purpose of Enron and its Affiliates for participating in the Redemption was to generate income for financial accounting purposes. The accounting treatment of the Redemption provided Enron and its Affiliates with significant and material benefits. Partnership and the Redemption were structured to achieve this accounting benefit without increasing or decreasing, on a present value basis (computed using a discount rate that is less than or equal to the lesser of the applicable federal rate as defined in section 1274(d)[2] or the after-tax weighted average cost of capital of the Enron consolidated group[3] (the "Discount Rate") during the relevant period), the aggregate federal income tax liability of the Enron consolidated group and those Affiliates of Enron that are included in Enron's consolidated financial statements.

3. The Liquids preferred stock was issued in exchange for consideration of $100,000 per share and $100,000 was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of a share of Liquids preferred stock on the date on which it was issued.

4. On the date of the Redemption, $100,000 plus accrued dividends was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of a share of Liquids preferred stock and $417,941.07772 was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of a share of Liquids common stock.

5. Each of Enron, Pipeline, Liquids, OPI, and Enron GP at all times has represented and will represent itself to third parties as a separate entity in all transactions, has observed and will observe all corporate and bookkeeping formalities, has maintained and will maintain separate bank accounts and books and records, has had and will have employees and/or has paid and will pay fees for services that would otherwise be rendered by employees, and has executed and will execute contracts in a manner consistent with its status as a separate entity. Partnership at all times has represented and will represent itself to third parties as a separate entity in all transactions, has observed and will observe all

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1 For purposes of this letter, the "Affiliates" of a person are those persons directly or indirectly controlling, controlled by, or under common control with such person.

2 All references to sections are to the Internal Revenue Code of 1986 (the "Code"), as amended and in effect as of the date of this letter, unless otherwise noted. All references to regulations are to U.S. Treasury Department regulations, as most recently adopted, amended, or proposed, as the case may be, as of the date of this letter, unless otherwise noted.

3 As used in this letter, the term "consolidated group" has the same meaning as in the consolidated return regulations. Treas. Reg. § 1.1502-1(h) (a consolidated group is an affiliated group of corporations filing consolidated returns for the tax year). References to the "Enron consolidated group" are to the consolidated group of which Enron is the common parent.

partnership and bookkeeping formalities, has maintained and will maintain separate bank accounts and books and records, has had and will have employees and/or has paid and will pay fees for services that would otherwise be rendered by employees, and has executed and will execute contracts in a manner consistent with its status as a separate entity.

6. At the time of the formation of Partnership, it was anticipated that Partnership would remain in existence for at least five years.

7. Liquids' current and accumulated earnings and profits for the taxable year ended December 31, 1998 exceeded the aggregate amount of the promissory notes and cash transferred by Liquids to Enron, Pipeline, OPI, and Partnership in exchange for stock on March 31, 1998 plus any other distributions made or deemed made by Liquids to its shareholders during such taxable year.

8. Liquids did not acquire any shares of Liquids stock, other than those shares acquired on March 31, 1998, in transactions that occurred within, or were effective on a record date within, any 85 day period that included March 31, 1998 (a "Relevant 85 Day Period").

9. The only dividend with respect to Liquids stock that had an ex-dividend date within any Relevant 85 Day Period was the preferred dividend paid on March 31, 1998.

10. Other than the Redemption and the preferred dividend paid on March 31, 1998, no distributions or deemed distributions with respect to Liquids stock occurred within, or were effective on a record date within, any Relevant 85 Day Period.

11. The sum of (i) the aggregate of all amounts that were declared and paid as dividends with ex-dividend dates within any 365 day period that included March 31, 1998 (a "Relevant 365 Day Period") on all shares of Liquids preferred stock in the aggregate plus (ii) the aggregate of all amounts ("Redemption Amounts") that were paid by Liquids in exchange for preferred stock acquired in transactions that occurred within, or were effective on a record date within, any Relevant 365 Day Period plus (iii) the aggregate of all amounts of any other distributions or deemed distributions with respect to the Liquids preferred stock in the aggregate that occurred within, or were effective on a record date within, any Relevant 365 Day Period (each such dividend, stock acquisition, distribution, or deemed distribution being a "Relevant Transaction") did not exceed 20 percent of Partnership's adjusted basis for federal income tax purposes, as of the day immediately preceding any Relevant Transaction, of those shares of Liquids preferred stock that were held by Partnership immediately after such Relevant Transaction.

12. The aggregate of all per share amounts with respect to all Relevant Transactions did not exceed 20 percent of the Partnership's adjusted basis per share of Liquids preferred stock as of the day immediately preceding any Relevant Transaction. For purposes of the preceding sentence, the per share amount of any Redemption Amount is such amount divided by the number of shares of Liquids preferred stock held by Partnership immediately after the payment of such amount.

13. Neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to a transaction in which Partnership is treated for federal income tax purposes as receiving a dividend in connection with a redemption, purchase, or other acquisition of Liquids stock from Partnership by Enron or an Affiliate of Enron (a "Dividend Transaction"). A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer equals or exceeds the present value (computed using the Discount Rate during the relevant period) on the date of the Dividend Transaction of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Dividend Transaction.

14. Neither Enron nor any Affiliate of Enron has taken or will take any action that resulted or will result in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the 1997 restructuring of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, the operations and investments of OPI and Partnership, and any Dividend Transactions. These transactions are considered to produce a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, if the sum of the present values (computed using the Discount Rate during the relevant period), on March 20, 1997, of the hypothetical federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, determined as if the transactions had not occurred, exceeds the sum of the present values (computed using the Discount Rate during the relevant period), on March 20, 1997, of the actual federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates.

15. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Redemption on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any.

16. The Redemption (i) has not altered and will not alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Redemption) by members of the Enron consolidated group to nonmembers of the Enron consolidated group that are treated as having been made out of earnings and profits and (ii) has not resulted and will not result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Redemption on the earnings and profits of members of the Enron consolidated group.

17. No member of the Enron consolidated group has disposed or will dispose of any stock of Liquids on or after March 30, 1998 except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron has taken or will take any action to

obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Redemption.

18. We have disclosed to you all of the documents that are relevant to the transactions that are the subject of the Opinion and there are no undocumented agreements related to those transactions that modify or alter the effect of any of those documents or that create any additional obligations or rights in any parties to those documents.

For purposes of rendering the Opinion, we consent to your reliance on additional information that you have obtained through consultation with officers, employees, or legal representatives of OPI, Enron GP, Partnership, and members of the Enron consolidated group.

Very truly yours,
Enron Corp.

By R. D. Maxey
R. Davis Maxey
Vice President - Tax Planning

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July 17, 1997

Enron Leasing Partners, L.P.
1400 Smith Street
Houston, Texas 77002

ATTORNEY-CLIENT PRIVILEGED

Ladies and Gentlemen:

We acted as special counsel to Enron Corp., then a Delaware corporation ("Enron"), Organizational Partner, Inc., a Delaware corporation ("OPI") and a 97 percent-owned subsidiary of Enron, and Enron Leasing Partners, L.P., a Delaware limited partnership ("Leasing Partners"), in connection with the transactions contemplated by (i) the Land and Facilities Lease Agreement (the "Lease"), dated as of April 14, 1997, between Brazos Office Holdings, L.P., a Delaware limited partnership ("Brazos"), and OPI, (ii) the Consent and Agreement (the "Lessee Consent"), of even date with the Lease, among OPI, Brazos and The Chase Manhattan Bank, a New York banking corporation, as agent (the "Agent") for the hereinafter defined Banks, (iii) the Parent Guaranty (the "Guaranty"), of even date with the Lease, executed by Enron, (iv) the Credit Agreement, of even date with the Lease, among Brazos, the lenders parties thereto (the "Banks") and the Agent (the "Credit Agreement"), (v) the Assignment and Assumption Agreement (the "Assignment"), of even date with the Lease, and (vi) the Sublease by and between Leasing Partners and Enron (the "Sublease"), of even date with the Lease. Unless otherwise noted, capitalized terms not otherwise defined herein have the meanings assigned to such terms in the Lease. You have requested our opinion with respect to certain federal income tax consequences of the transactions contemplated by the foregoing documents.

For the reasons set forth below, in our opinion Leasing Partners should be treated as the owner of the Building (as hereinafter defined) for federal income tax purposes.

FACTS

The Lease Transaction

On March 15, 1994, Enron renewed and restructured the lease financing covering an office building located at 1400 Smith Street, Houston, Texas (the "Building") with State Street Bank and

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Trust Company of Connecticut, National Association ("SSBTC"). SSBTC amended and restated the lease agreement (the "Prior Lease Agreement") covering the Building with Enron. SSBTC and Enron have terminated the Prior Lease Agreement. Upon termination of the Prior Lease Agreement, Enron had the right to reacquire the Building. Enron assigned its right to reacquire the Building to Brazos, which financed the acquisition of the Building through the Credit Agreement. Enron is not a member of the group of lenders providing financing under the Credit Agreement and has made no guarantees under the Credit Agreement. Brazos has a stated equity interest in the Building equal to 3 percent of the Acquisition Cost.

Pursuant to Section 5.01 of the Lease, Brazos leased the Building to OPI for an initial five-year term beginning April 14, 1997 and ending April 13, 2002. The Lease can be renewed at OPI's option for an initial renewal term of five years and thereafter for thirty Renewal Terms of one year, each in accordance with Section 11.03(a) of the Lease. If OPI chooses not to renew the Lease, or if OPI chooses to renew the Lease and Brazos is unable to obtain financing and equity contributions on terms acceptable to Brazos, its limited partners and OPI, Section 11.03(b) requires OPI either to purchase the Building for an amount of cash equal to the Acquisition Cost or arrange (at its own cost and expense) for the sale of the Building to a third party pursuant to Section 11.04 of the Lease.

Section 3.02(a) of the Lease provides that, for accounting and regulatory purposes, OPI and Brazos intend that the Lease be treated as an operating lease. For all other purposes of federal, state and local law, including income and *ad valorem* taxes and bankruptcy law, Section 3.02(b) of the Lease provides that OPI and Brazos intend that the Lease be treated as a financing transaction.[1] A Memorandum of Lease dated as of April 14, 1997 by and between Brazos and OPI was filed in the Office of the County Clerk of Harris County, Texas. In addition, two UCC financing statements relating to the Lease (the "Financing Statements") were filed in the UCC Records of Harris County, Texas and the Office of the Secretary of State of Texas, respectively.

OPI does not acquire record title to the Building as a result of the Lease. Under Section 11.01 of the Lease, after the third year of the Lease Term or at any time during any Renewal Term, OPI may terminate the Lease on any Basic Rent Payment Date and either purchase the Building for an amount of cash equal to the Acquisition Cost or arrange (at its own cost and expense) for the sale of the Building to a third party pursuant to Section 11.04 of the Lease. Under Section 11.02 of the

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[1] In this regard, Section 3.02(b) of the Lease provides that OPI and Brazos intend that (i) the Lease be treated as the repayment and security provisions of a loan by Brazos to OPI in the amount of the Acquisition Cost of the Building; (ii) all payments of Basic Rent, Additional Rent, proceeds of sale, and other amounts payable under the Lease be treated as payments of principal, interest and other amounts owing with respect to such loan, (iii) OPI be treated as entitled to all benefits of ownership of the Building and any part thereof; (iv) the Lease be treated as a mortgage and security agreement or other similar instrument from OPI, as mortgagor, to Brazos, as mortgagee, and as a security agreement in favor of Brazos as secured party encumbering the Building to secure such loan. Section 3.02(b) of the Lease further provides that the Agent and Assignees, collectively, shall have all the rights, powers and remedies of a mortgagee and secured party available under applicable law following a Potential Default or an Event of Default to take possession of and sell (whether by foreclosure, power of sale, or otherwise) the Building.

Lease, Brazos can terminate the Lease on any Basic Rent Payment Date in the event that certain circumstances arise in which Brazos incurs (or, in its reasonable judgment, in the future would incur) certain state or local taxes that are not indemnified pursuant to the Lease or in which the Lease (or related instruments) is deemed to require the payment or permit the collection of interest in excess of the Maximum Rate. In the event of a termination of the Lease by Brazos pursuant to Section 11.02 of the Lease, OPI is required either to purchase the Building for an amount of cash equal to the Acquisition Cost or arrange (at its own cost and expense) for the sale of the Building to a third party pursuant to Section 11.04 of the Lease.

Section 11.04(a)(i) of the Lease provides that if a sale of the Building to a third party results in sale proceeds greater than the Acquisition Cost, Brazos will pay to OPI the excess of the sale proceeds over the Acquisition Cost. If the sale proceeds are equal to or less than the Acquisition Cost, but greater than or equal to 25 percent of the Acquisition Cost, OPI is obligated under Section 11.04(a)(ii) of the Lease to pay to Brazos the excess of the Acquisition Cost over the sale proceeds. If the sale proceeds are less than 25 percent of the Acquisition Cost, OPI is obligated to pay Brazos, pursuant to Section 11.04(a)(iii) of the Lease, an amount equal to 75 percent of the Acquisition Cost plus an amount that Brazos determines in good faith to be the amount that the residual value of the Building was reduced in excess of that attributable to normal wear and tear, plus an amount that Brazos determines in good faith to be the amount the sale proceeds have been reduced due to certain Liens attaching to the Building that arise out of OPI's acts or failure to act.

Basic Rent under the Lease has two components: Basic Rent (Debt) and Basic Rent (Equity). In general, for any Basic Rent Payment Date (Debt), Basic Rent (Debt) equals the interest that would have been payable by Brazos under the Credit Agreement on such date if the Applicable Margin(s) (as defined in the Credit Agreement) were increased by the Brazos Margin (as specified in a letter dated February 24, 1997), provided that the interest rate under the Credit Agreement shall be deemed to be the Screen Rate.[2] Basic Rent (Equity) equals the product of the Equity Amount ($8,535,000) and a rate determined by formula. Under Section 6.03 of the Lease, OPI is required to pay Brazos, on demand, as Additional Rent, amounts required to reimburse Brazos for its costs and expenses (not previously included in Basic Rent) incurred in acquiring, financing and leasing the Building, as well as interest on any overdue amounts under the Lease.

Under Section 8.04 of the Lease, OPI may, at its expense, make additions and alterations to the Building so long as (i) no Event of Default has occurred and is continuing, (ii) the additions and alterations do not lessen the fair market value or impair the condition of the Building, (iii) the work is completed in a good and workmanlike manner in compliance with applicable Lease requirements (including insurance and legal requirements), (iv) no exterior walls or structural portion is demolished unless the structural integrity of the Building is maintained, and (v) the additions and

[2]Special rules apply in the case of an Event of Default under the Credit Agreement when no Event of Default has occurred and is continuing under the Lease.

alterations do not result in any Lien (except Permitted Encumbrances). OPI must notify Brazos if the costs of such alterations and additions exceed $5,000,000. Additions and alterations to the Building that are made at OPI's expense and that are not removable from the Building without impairing the functioning or resale value of the Building become the property of Brazos at the termination of the Lease.

Under Section 8.03 of the Lease, OPI is required to make all required reports to taxing authorities and, in general, to pay all taxes, assessments, levies, fees and all other charges (governmental or otherwise) which are imposed or levied upon or assessed against the Building, the Lease, the leasehold estate created by the Lease, the amounts payable pursuant to the Lease, or which arise in respect of the ownership, operation, occupancy, possession or use of the Property (other than certain franchise, estate, inheritance, transfer, federal income or similar taxes of Brazos or any Assignee). Section 9.01 of the Lease requires OPI to maintain liability and property damage insurance with respect to the Building at OPI's sole cost and expense. Section 8.02 of the Lease provides that OPI shall pay all costs, expenses, fees and charges incurred in connection with the ownership, use or occupancy of the property during the Lease Term and any Renewal Term thereof and shall at all times, at its own expense, keep the Building in good operating order, repair, condition and appearance. Under Sections 8.02 and 13.01 of the Lease, OPI assumes all risk of loss of or damage to the Building.

Pursuant to the Guaranty, Enron guarantees OPI's payments to Brazos under the Lease.

The Assignment

Pursuant to the Assignment, OPI assigned all of its rights under the Lease to Leasing Partners as a contribution to Leasing Partners in exchange for a 97 percent limited partner interest in Leasing Partners. The general partner of Leasing Partners is Enron Property Management Corp., a Delaware corporation and a wholly-owned subsidiary of Enron Cayman Leasing Ltd., a Cayman company and a wholly-owned subsidiary of Enron; the general partner has a 1 percent general partner interest in Leasing Partners. The remaining 2 percent limited partner interest in Leasing Partners is owned by an unrelated institutional investor.

Leasing Partners assumed all of OPI's obligations under the Lease. Enron's obligations under the Guaranty survived the Assignment. The Assignment was recorded in the real property records in Harris County, Texas.

The Sublease

OPI subleased the Building to Enron under the Sublease. Section 2.01 of the Sublease provides that the term of the Sublease is ten years (the "Initial Term"). Enron has the right to renew the Sublease for ten additional one-year terms (the "Renewal Terms"). Section 15.01 of the Sublease provides that, at the end of the Initial Term and the ten Renewal Terms. Enron can purchase the Building at its then-appraised fair market value.

Section 2.02 of the Sublease provides that, at the end of the first five years of the Initial Term, Enron can make a payment to OPI equal to $130,867,380. plus all other sums then due and owing under the Sublease (the "Cancellation Payment"), to terminate the Sublease. If Enron elects to make the Cancellation Payment and terminate the Sublease, Section 7.02 of the Sublease gives OPI the right to purchase any improvements made by Enron during the Sublease at the then fair market value of such improvements.

Base Rent under Section 3.01 of the Sublease is initially set at $25.8631 per square foot of rentable area in the Building ($32,716,821.50 per year), subject to adjustments provided in the Sublease. Under Section 5.01 of the Sublease, Enron is responsible for taxes, maintenance, utilities, insurance and other operating expenses of the Building.

Section 7.01 of the Sublease provides that, so long as no Default under the Sublease has occurred and is continuing, Enron can make additions and alterations to the Building, subject to limitations related to impairment of the Building's condition, quality of work and similar matters. Additions and alterations in excess of $5,000,000 must be approved by OPI, although the Sublease provides that OPI may not unreasonably withhold its approval.

Enron may assign its interest in the Sublease to Enron Property & Services Company, a Delaware corporation and a wholly-owned subsidiary of Enron.

REPRESENTATIONS

In connection with your request that we furnish this opinion, certain representations have been made with respect to the existence of certain facts. These constitute material representations relied upon by us as a basis for our opinion, and our opinion is conditioned upon the initial and continuing accuracy of these representations. Specifically, it has been represented that:

1. The rental payments under the Sublease approximate the fair rental value of the Building.

2. Leasing Partners has entered into the Sublease and the Assignment with the expectation of earning a profit.

3. The remaining economic useful life of the Building as of April 14, 1997 is at least 50 years.

4. The marginal federal income tax rates of OPI. Enron and the partners of Brazos are substantially identical.

5. Neither OPI nor Enron has any ownership interest in Brazos.

6. Leasing Partners and Enron will treat the Sublease as a true lease for accounting and all other purposes.

In addition to the facts and representations set forth above, our opinion is conditioned upon our understanding that the transactions will be carried out strictly in accordance with the documents described or referenced herein and that there are no other agreements, arrangements, or understandings other than those described or referenced herein.

LAW AND ANALYSIS

A. Authorities.

Rules for determining tax ownership of property are not provided in the Code[3] or related Treasury regulations. Instead, a body of court cases, revenue rulings and revenue procedures provide guidance for making a determination of tax ownership. All of the authorities are based on the proposition that the person claiming ownership must demonstrate sufficient attributes of ownership to be treated as the owner for federal income tax purposes, but none of the authorities sets forth a definitive standard for evaluating such attributes.

Nearly all of the authorities state that the substance of a transaction prevails over its form.[4] In examining the substance of a transaction, the analysis applied by various authorities can be divided into two parts: the presence or absence of economic substance in the transaction and the possession of the benefits and burdens of property ownership.

[3]References herein to the Code are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.

[4]*See, e.g., Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939) (at taxpayer's behest, a transaction in which the taxpayer transferred title to real estate to a bank and received back a 99-year lease with options to renew and to purchase the property was held to be, in substance, a financing transaction for tax purposes); Rev. Rul. 68-590, 1968-2 C.B. 66 (IRS applied *Lazarus* in determining that an acquisition of land from a corporation by a political subdivision through financing provided by industrial revenue bonds, followed by a leaseback to the corporation that included an option to renew and repurchase so that the lease term, including renewal terms, was 99 years, amounted to a financing arrangement).

1. *Frank Lyon Co. v. U.S.*

The leading authority for determining the tax ownership of leased property in the context of a sale-leaseback transaction is *Frank Lyon Co. v. U.S.*[5] In *Lyon*, Worthen Bank and Trust Company of Little Rock ("Worthen") was not permitted to own and finance its own building, then under construction, through conventional sources because of objections from federal and state banking regulators. In lieu of conventional financing, the banking authorities approved a sale-leaseback transaction involving the building.

Worthen leased the land under the bank building to Frank Lyon Co. ("Lyon"), a closely-held corporation engaged in the distribution of home furnishings, for a term of approximately 76 years.[6] Worthen constructed the bank building and sold it, in sections, for approximately $7,640,000 to Lyon. Lyon invested $500,000 of its own funds and financed the balance with recourse, institutional first mortgage financing payable over 25 years. Worthen then leased the building from Lyon for a primary term of 25 years. The lease included options to extend to a total term of approximately 65 years. In the eleventh, fifteenth, twentieth and twenty-fifth years of the lease, Worthen had an option to purchase the building for a fixed purchase price equal to (a) $500,000 plus six percent compound interest over the lease term, plus (b) the amount of the then-unpaid balance of the institutional financing. Worthen's rent for the primary term of the lease (the first 25 years) was the amount necessary to amortize fully the institutional financing. At the end of the primary term of the lease, if Worthen did not exercise its option to repurchase the building, Worthen could renew the lease for a rental stream that, after considering the ground rentals payable back to Worthen, repaid Lyon its $500,000 investment with six percent compound interest.

The Internal Revenue Service ("IRS"), in an audit of Lyon, determined that the transaction was a financing and disallowed the related deductions. The District Court ruled in Lyon's favor and held that the claimed deductions were allowable, concluding that the legal intent of the parties had been to create a bona fide sale-and-leaseback in accordance with the form and language of the documents evidencing the transactions. The Eighth Circuit reversed, in an opinion that found the benefits and burdens of ownership of the building had been retained by Worthen. Specifically, the Eighth Circuit noted that any appreciation in the value of the building would accrue to Worthen either upon destruction or condemnation or through its fixed price purchase options.

The Supreme Court reversed the decision of the Eighth Circuit in a frequently-cited holding:

> In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory

[5] 435 U.S. 561 (1978).

[6] The majority shareholder of Lyon also served on Worthen's board of directors.

realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the Parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts. It suffices to say that, as here, a sale-and-leaseback, in and of itself, does not necessarily operate to deny a taxpayer's claim for deductions.[7]

In reaching its conclusion, the Supreme Court focused first on the economic substance of the transaction. To distinguish *Lazarus*,[8] the Court looked to the number of parties involved in the transaction, placing a strong emphasis on the presence of an institutional investor unrelated to the parties in the transaction, noting that the structure resulted from the restrictions imposed on Worthen by the banking authorities and pointing out that the tax rates of the parties were not disparate. The Court pointed out that more than one party was interested in participating in the transaction but that Lyon won the opportunity, reasoning that if Lyon had not participated in the transaction another interested investor would have.

The Court found economic substance and indicia of ownership in the recourse nature of Lyon's liability on the mortgage to the institutional investor. The Court was influenced by the business risk to Lyon through the primary liability on the debt that Lyon assumed, noting that Lyon's use of its capital for the purpose of the financing made Lyon less able to obtain financing for other business needs. Further, the likelihood that Worthen would exercise its option to purchase the property was viewed by the Court as uncertain, leaving Lyon with the potential for ownership of the property after the lease term. The Court did not view the six-percent compound fixed rate of return on Lyon's investment in the event Worthen exercised the purchase option to compel treatment of the transaction as a financing for tax purposes.

Although a substantial focus of the Supreme Court in *Lyon* was the economic substance of the transaction at issue, the Court examined other factors, some of which are discussed above, that are generally viewed as indicative of which party in a transaction is the tax owner of property. For example, the relationship between the amounts due under the lease and the amount of the financing, the accounting treatment of the parties, the relationship among the parties, the risk of depreciation/loss borne by Lyon, the reasonableness of the rentals and option purchase prices, and the residual interest in the building owned by Lyon were factors considered by the Court. In its holding, the Court restated its test for respecting the status of a lessor as a question of whether the lessor retained "significant and genuine attributes of the traditional lessor status," apparently

[7] *Id. at* 583-584.

[8] *See* note 4, *infra*.

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referencing a type of benefits and burdens analysis in addition to the test for economic substance of a transaction. Various of the benefits and burdens factors considered by the Supreme Court in *Lyon*, as well as by other courts subsequent to the *Lyon* decision, are often advanced by the IRS as factors relevant in determining the tax ownership of leased property.[9]

2. Developments after *Frank Lyon Co.*

Since the Supreme Court decision in *Lyon*, courts have had a number of opportunities to consider the criteria for determining tax ownership of property, in the context of both sale-leasebacks and leveraged leases. A good example is the Tax Court's decision in *Torres v. Commissioner*,[10] in which it reviewed the tax ownership criteria in the context of a sale-leaseback. To evaluate the transaction in *Torres*, the Tax Court first applied an analysis similar to that of the Supreme Court in *Lyon* to determine whether the transaction in issue had sufficient economic substance to be recognized for federal income tax purposes. Specifically, the Tax Court determined that economic substance is present if the transaction has a business purpose and if the party claiming tax ownership has a reasonable expectation of profit apart from expected tax benefits (*i.e.*, a reasonable possibility that the purported owner could recoup its investment from the income potential and residual value of the property). Once the threshold issue of economic substance was resolved, the Tax Court went on to consider whether the transaction conferred sufficient benefits and burdens of ownership on Regency Associates, the putative owner-lessor of the subject equipment, for it to be considered the owner of the equipment for federal income tax purposes.

[9] *See* Rev. Rul. 55-540, 1955-2 C.B. 39 (enumerates factors considered by IRS in determining whether a putative lease of equipment is a lease or a conditional sales contract); Rev. Proc. 75-21, 1975-1 C.B. 715 (sets forth guidelines for advance ruling purposes in determining whether leveraged leases are true leases of property for federal income tax purposes). A discussion of factors set forth in Rev. Rul. 55-540 and Rev. Proc. 75-21, is set forth below. *See also* Rev. Rul. 83-47, 1983-1 C.B. 63 (a corporation that leased townhouses to potential buyers who could not qualify for mortgage loans with payments essentially equal to debt service on the properties and then sold the properties to the potential buyers once the buyers had built a good credit history was engaging in a financing arrangement).

[10] 88 T.C. 702 (1987). The facts in *Torres* are somewhat involved. Copylease was in the business of leasing photocopying equipment to end-users. Copylease sold the equipment subject to a lease to Curtis Corp. in exchange for $1,200,000 in cash and a nonrecourse note for $8,800,000. Copylease then leased the equipment back from Curtis Corp. Rental payments under the lease consisted of a fixed portion and a contingent portion based on the cash flow to Copylease from the leases. Torres was the general partner of a limited partnership known as Regency Associates. Simultaneously with the execution of the agreements between Curtis Corp. and Copylease, Regency Associates purchased from Curtis Corp. the equipment and lease rights that Curtis Corp. had acquired through the sale-leaseback transaction with Copylease. Regency Associates paid Curtis Corp. $115,000 in cash and delivered a nonrecourse note for $9,985,000. The nonrecourse note executed by Regency Associates required payment of principal and interest over a 15-year period. To the extent rental payments from Copylease were not made when due, Regency Associates could defer payment on the nonrecourse note to Curtis Corp. The Tax Court held that Regency was the owner of the equipment for federal income tax purposes.

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In *Torres*, the Tax Court considered a number of factors as indicative of the benefits and burdens of ownership outside the context of a sale-leaseback, including the passage of legal title, the treatment of the parties, the obligation of the seller to deliver a deed and of the buyer to make payments. In the context of a sale-leaseback, the Tax Court noted that such factors as whether the purchaser had the right of possession, paid property taxes, bore the risk of loss or damage to the property and received profit from the operation of the property were less relevant factors because such factors are the normal result of a lease transaction. The Tax Court considered several other factors to be of greater importance, including: a useful life that extended beyond the lease term, existence of a purchase option at less than fair market value, and a provision for renewal of the lease term at less than fair market value.

More recently, in *Regents Park Partners v. Commissioner*,[11] the Tax Court again applied both the economic substance analysis and the benefits and burdens analysis to determine that the partners in the partnership acquired basis in the property from the nonrecourse acquisition debt only up to the fair market value of the property, which was less than the outstanding indebtedness.

Recent decisions of the Tax Court, together with the Supreme Court's decision in *Frank Lyon Co.*, indicate that the factors relevant to the benefits and burdens of ownership should be weighed once a determination has been made that a transaction has economic substance. The following therefore divides factors to be considered in making a determination of tax ownership of property into two parts.

3. Factors indicating economic substance.

The foregoing authorities identify the following factors as indicative that a transaction has economic substance:

a. Parties. The Supreme Court in *Lyon* viewed the relationship between the parties, the relative tax rates of the parties and the existence of a third, independent party to the transaction as indicative that the form of the transaction advanced by the parties had economic substance.

b. Business Purpose. The existence of a business purpose for the transaction other than potential tax benefits was considered indicative of economic substance by the Tax Court in *Torres*.

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[11] 63 T.C.M. 3131 (1992) (partnership acquired buildings from HUD: buildings were purchased subject to non-recourse indebtedness that exceeded the appraised value of the buildings).

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c. Profit Expectation. The availability or expectation of profit by the parties to the transaction has been a factor indicating tax ownership of the property.[12]

4. Factors indicating benefits and burdens of ownership.

Once a determination is made that a transaction has economic substance, the benefits and burdens of ownership test is applied. Factors from the foregoing authorities that may be considered in determining which party has the benefits and burdens of ownership include, among others:

a. Possession. Possession of the property was listed by the Tax Court in *Regents Park* as a factor indicating ownership for federal income tax purposes. However, in *Torres*, the Tax Court noted that a lessor is not normally vested with the right of possession during the term of a lease. There, the Tax Court found the extension of the useful life of the property beyond the term of the lease so as to give the purchaser a meaningful future possessory right in the property to be more indicative of tax ownership in the context of a lease.

b. Property Taxes. Responsibility for the payment of property taxes was cited by the Tax Court in *Regents Park* as a factor indicating tax ownership of property. The Tax Court noted in *Torres* that "because net leases are common in commercial settings, it is less relevant that [the lessor] was not responsible for the payment of property taxes." [13]

c. Risk of Casualty Loss. According to the Tax Court in *Regents Park*, responsibility for the risk of loss or damage to the property is a factor indicating tax ownership of property. As with payment of property taxes, this is a responsibility that is often allocated to the lessee in a net lease; thus, the Tax Court recognized in *Torres* that the factor is less relevant in a commercial setting.[14]

d. Likelihood of Exercise of Renewal Option. The existence of a renewal option at a nominal amount indicated to the Tax Court in *Torres* that the arrangement is a financing rather than a lease, and favors treatment of the nominal lessee as the tax owner of the building.

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[12] *See Regents Park Partners v. Commissioner, supra*; Rev. Proc. 75-21, 1975-1 C.B. 715.

[13] *Torres v. Comm'r, supra* at 721 (1987).

[14] *Id.* at 721.

e. Treatment by Parties for Accounting and Other Purposes. The Supreme Court in *Lyon* stated its awareness that the treatment of a transaction for financial accounting purposes need not necessarily be the same as that for federal income tax purposes. However, the Court noted that consistency of treatment of the transaction for financial accounting purposes favored treating the nominal lessor as the tax owner of the property. In *Torres*, the Tax Court considered the treatment of the parties for accounting and other purposes to be relevant to a determination of which party bore the benefits and burdens of ownership.

f. Benefit of Appreciation/Risk of Depreciation. Liability on purchase money indebtedness or risk of loss in the event of the devaluation of the property was seen by the Supreme Court in *Lyon* as a factor favoring treatment of the nominal lessor as the tax owner of the property. The Tax Court in *Illinois Power Co. v. Commissioner*,[15] viewed the fixed rate of return to one of the parties to be that of a lender and therefore indicative that the risk of loss fell on the other party to the transaction.

g. Legal Title. Passage of legal title to the property is a factor considered by the Tax Court in *Torres* and *Regents Park* to be relevant in determining tax ownership of property.

h. Payments Apply to Equity. Where a portion of the payments under the agreement are made specifically applicable to an equity interest to be acquired by the lessee, or legal title to the property passes under the agreement, treatment of the nominal lessee as the tax owner is favored.[16] Passage of legal title to the property was also a factor considered by the Tax Court in *Torres* and *Regents Park* to be relevant in determining tax ownership of property.

In addition to the foregoing, in analyzing the benefits and burdens of ownership with respect to leased property, the courts have also taken into account to varying degrees many of the factors that are considered relevant by the IRS as reflected in its revenue rulings and revenue procedures. These administrative authorities are discussed in greater detail below.

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[15] 87 T.C. 1417 (1986) (Illinois Power Co. ("IPC") created a subsidiary ("IPFC"), gave 50 percent of the stock of IPFC to a university, sold nuclear fuel to IPFC, which purchased the fuel through commercial paper the payment of which was guaranteed by IPC. IPFC simultaneously leased back the fuel to IPC. The Tax Court held that IPC could disavow the form of the sale-leaseback and treat the transaction as a financing).

[16] *See also* Rev. Rul. 55-540, *supra*.

5. Rev. Rul. 55-540.

Rev. Rul. 55-540, 1955-2 C.B. 39, sets forth a number of factors that the IRS considers, in the context of an equipment lease, in determining whether a transaction is treated as a lease or a financing arrangement for federal income tax purposes. The ruling provides that the "intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed," governs the determination of whether an agreement is a lease or a conditional sales contract. As noted above, there have been developments in case law subsequent to the release of Rev. Rul. 55-540, and the ruling must be read in light of those developments. Nonetheless, Rev. Rul. 55-540 still provides helpful guidance to the extent that it offers insight into the factors considered by the IRS in making such tax ownership determinations and is frequently cited by the IRS in its rulings.[17]

Rev. Rul. 55-540 provides that, although no single fact is controlling, the following conditions (in addition to certain of the factors listed above) are helpful in determining the tax ownership of property in a sale-leaseback transaction:

a. Rentals Disproportionate. When the total amount to be paid by the lessee for a relatively short period of use is an inordinately large portion of the total required to be paid to secure transfer of title, treatment of the nominal lessee as the tax owner is favored.

b. Rentals Exceed Fair Market Value. Treatment of the nominal lessee as tax owner is favored when the agreed rental payments materially exceed the current fair rental value of the leased property, indicating an element other than compensation for the use of property.

c. Bargain Option to Purchase. The existence of an option to acquire the leased property for a price that is nominal in relation to its value at the time of the exercise of the purchase option indicates that the nominal lessee is the owner of the property for federal income tax purposes.[18]

d. Designation of Portion of Payments as Interest. The designation of some portion of the rental payments as interest is indicative of ownership by the nominal lessee.

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[17] *See, e.g.,* Priv. Ltr. Rul. 93-13-001 (Apr. 7, 1992) (leases for the use of automobiles by retail customers were true leases).

[18] *See also* Rev. Proc. 75-21, 1975-1 C.B. 715.

e. Rental Payments Based on Use. The existence of rental payments at an hourly, daily or weekly rate, or based on production, use, mileage or a similar measure and not directly related to the normal purchase price, is a factor indicating tax ownership by the nominal lessor, provided that, if there is an option to purchase, the option price reasonably approximates the fair market value of the property on the option date.

f. Rental Payments not Required throughout Lease Term. Where the sum of specified rentals over a relatively short part of the expected useful life of the property approximates the price at which the property could have been purchased, plus interest and/or carrying charges, and the lessee may continue to use the equipment for an additional period approximating its remaining estimated useful life for relatively nominal or token amounts, the nominal lessee is favored as tax owner.

g. Payments Approximate Purchase Price. Where the sum of the rentals payable under an agreement, plus the exercise prices of any options to purchase the property, approximate the purchase price of the property plus a stated return, the agreement more closely resembles a financing than a lease. In such case, the nominal lessee would appropriately be treated as the owner of the underlying property.

6. Rev. Proc. 75-21.

In Rev. Proc. 75-21, 1975-1 C.B. 715, the IRS set forth guidelines that it will use for advance ruling purposes in determining whether certain transactions ("leveraged leases") are leases rather than financing arrangements. Although the guidelines were intended to clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued, the IRS stated in Section 3 of Rev. Proc. 75-21 that it would consider ruling in cases where the guidelines are not satisfied, based on all the facts and circumstances. The ruling guidelines established in Rev. Proc. 75-21 have been applied by the IRS in recent years in the context of private rulings.[19] Certain of the facts and circumstances set forth in Rev. Proc. 75-21 that the IRS considers relevant in establishing that the lessor in a leveraged lease is the owner of the property for federal income tax purposes have been discussed *infra*. The following additional facts and circumstances are identified in Rev. Proc. 75-21:[20]

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[19]*See, e.g.*, Priv. Ltr. Rul. 91-45-008 (Aug. 12, 1991) (sale-leaseback of paper-mill equipment was determined to be a true lease); Priv. Ltr. Rul. 91-44-001 (May 14, 1991) (lease for use of an airplane and related facilities was determined to be a true lease); Priv. Ltr. Rul. 89-51-002 (Sept. 13, 1989) (Partnership that leased automobiles to third parties was not the owner of the automobiles for depreciation purposes).

[20]Like Rev. Proc. 55-540, Rev. Proc. 75-21 provides guidelines for determining whether a transaction may be treated as a lease for federal income tax purposes in the context of an equipment lease. However, like Rev. Rul. 55-540, Rev. Proc. 75-21 is helpful to the extent that it offers insight into the guidelines applied by the IRS in making tax

a. Minimum Unconditional "At Risk" Investment. When the property is first placed in service or use by the lessee, the minimum investment made by the lessor in the property must be 20 percent of the cost of the property. The lessor must maintain the minimum investment of 20 percent throughout the term of the lease and must demonstrate that an amount equal to 20 percent of the cost of the property is a reasonable estimate of the market value of the property at the end of the lease term.

b. Lessor Cannot Force Purchase by Lessee. When the property is first placed in service or use by the lessee, the lessor may not have a contractual right to cause any party to purchase the property.

c. No Investment by Lessee. No part of the cost of the property may be furnished by the lessee. No portion of the cost of improvements or additions to the property, except for improvements or additions that are owned by the lessee and are readily removable without causing material damage to the property, may be paid by the lessee.

d. No Lessee Loans or Guarantees. The lessee may not lend any of the funds necessary to acquire the property to the lessor and may not guarantee any indebtedness created in connection with the acquisition of the property by the lessor.

B. Analysis of the Lease.

In analyzing the effect of the Lease on tax ownership of the Building, it is important to note that the parties to the Lease have clearly indicated their intent in Section 3.02(b) of the Lease that, for all purposes other than accounting and regulatory purposes, including for bankruptcy and tax purposes, the Lease is to be treated as a financing transaction. Thus, the express, stated intent of the parties to the Lease is that the transaction be treated as a secured loan for all but limited accounting and regulatory purposes.[21] Accordingly, for state law enforceability purposes and all purposes other than accounting and regulatory purposes, assuming that the expressed intent of the parties is

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ownership determinations.

[21]Because the taxpayer chooses the form of the transaction, the courts have imposed restrictions on the ability of taxpayers to submit evidence of the substance of a transaction when seeking to disavow its form. The Third Circuit, in *Commissioner v. Danielson*, 378 F. 2d 771 (3d Cir. 1967), imposed a stringent burden of proof requirement that allows a taxpayer to challenge the tax consequences of a transaction's form only by a showing of mistake, undue influence, fraud or duress or any other ground that in an action between the transacting parties would be sufficient to set aside an agreement or to alter its construction. With regard to the transactions contemplated in the Lease, the treatment of the transaction as a financing for federal income tax purposes is fully consistent with the intent of the parties as evidenced by Section 3.02(b) of the Lease. Accordingly, the IRS will not face conflicting taxpayer characterizations of the Lease such that the *Danielson* rule would prevent the parties to the Lease from treating the Lease in conformity with the stated intent and substance of the Lease rather than its label.

respected, the Lease should be treated as a mortgage lien or security interest in the Building in favor of Brazos.[22]

State law defines the rights of the parties to a transaction and the legal consequences of the transaction; it is from that point that an analysis of the federal income tax consequences of the transaction may proceed.[23] The starting point for analyzing the Lease should therefore be a determination that the form of the Lease, as intended by the parties, is a financing, despite the labels placed on the operative documents. In continuing the analysis with respect to the Lease, as noted above it is necessary to determine whether the Lease has sufficient economic substance to be recognized for federal income tax purposes, and then to consider whether the Lease confers sufficient benefits and burdens of ownership on OPI for it to be considered the owner of the Building for federal income tax purposes (prior to the Assignment).

1. Economic Substance.

The factors enumerated above as indicating economic substance can be applied to the arrangement evidenced by the Lease as follows:

a. Parties. It has been represented that neither Enron nor OPI has any ownership interest in Brazos; thus, Brazos and OPI are not related parties. Further, it has been represented that the marginal federal income tax rates of OPI and the partners of Brazos are substantially identical. The independence of the parties and the relative tax rates of the parties support treatment of the Lease in accordance with its form.

b. Business Purpose. The existence of a business purpose for the Lease, long-term financing of the Building, supports treatment of the Lease in accordance with its form.

c. Profit Expectation. OPI will be able to capture the benefits of any appreciation in the value of the Building as a result of OPI's option to purchase the Building for the Acquisition Cost after the third anniversary of the Lease Term.

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[22]Reference is made to our opinion letter dated April 14, 1997, which sets forth our opinion that the Lease and the Memorandum of Lease are sufficient to create a valid mortgage lien or security interest in favor of Brazos encumbering the Building and that the Lease is a legal, valid and binding obligation of OPI, subject to the qualification that our opinion should not be construed as meaning the Lease would be enforced as a lease. Our opinion states that it is predicated upon our conclusion that for state law purposes the transaction under the Lease and related documents would be characterized as a loan in keeping with the parties' expressed intent.

[23]*See Comm'r v. Crichton*, 122 F. 2d 181 (5th Cir. 1941) (mineral rights were real property under Louisiana law and, as real property, were of a like kind with improved city real estate); Rev. Rul. 55-749, 1955-2 C.B. 295 (where applicable state law considers water rights to be real property rights, the exchange of perpetual water rights for a fee interest in land constituted a nontaxable exchange of property of like kind).

Rental payments under the Lease are computed based on a formula that provides a specified return to Brazos after the payment of debt service on the Building pursuant to the Credit Agreement. The profit expectation of Brazos is therefore that of a lender, rather than an owner of the Building. The Acquisition Cost of the Building is $284,500,000, regardless of the fair market value of the Building at the time of the exercise of the option. This factor supports treatment of the Lease in accordance with its form.

The above-described factors support a determination that the Lease transaction has economic substance and that, accordingly, the Lease transaction should be recognized for federal income tax purposes in accordance with its form. As discussed above, the parties' intention that the Lease transaction be a financing for all purposes other than accounting and regulatory purposes, including lien enforceability purposes, should be respected as the form of the transaction for federal income tax purposes. Having crossed the economic substance threshold, it is appropriate to address the benefits and burdens of ownership factors.

2. <u>Benefits and Burdens of Ownership</u>.

An application of the factors enumerated above indicating benefits and burdens of ownership follows:

a. <u>Possession</u>. So long as the Lease is in effect, OPI will have possession of the Building. However, a lessor is not normally vested with the right of possession during the term of a lease. The relevant inquiry, therefore, is whether the useful life of the Building extends beyond the term of the Lease. The parties have represented that the remaining economic useful life of the Building as of April 14, 1997 is at least 50 years. The Initial Term of the Lease, plus all Renewal Terms, is 40 years. Accordingly, the useful life of the Building extends well beyond the term of the Lease. This factor therefore favors Brazos as tax owner of the Building.

b. <u>Property Taxes</u>. The Lease requires OPI to pay property taxes. As indicated by the Tax Court's decision in *Torres*, this factor is less relevant in the context of a commercial lease; however, the payment of property taxes by OPI favors OPI as tax owner of the Building.

c. <u>Risk of Casualty Loss</u>. The Lease requires OPI to maintain insurance on the Building. As indicated by the Tax Court's decision in *Torres*, this factor, like property taxes, is less relevant in the context of a commercial lease; however, OPI's responsibility for risk of casualty loss is a factor supporting OPI as tax owner of the Building.

d. Likelihood of Exercise of Renewal Option. OPI has no option to renew the Lease for a nominal rental amount. However, if OPI chooses not to renew the Lease. Section 11.03(b) of the Lease requires OPI to (a) purchase the Building for cash at the Acquisition Cost or (b) arrange for the property to be sold for cash pursuant to Section 11.04 of the Lease. The lack of a nominal renewal amount does not literally support OPI as tax owner of the Building, but a consideration of the consequences to OPI of non-renewal supports the likelihood of OPI renewing the Lease until the end of the Lease term.

e. Treatment of Parties for Accounting and Other Purposes. Brazos will be treated as the owner of the Building for financial accounting purposes pursuant to Section 3.02(a) of the Lease. Although the Supreme Court in *Frank Lyon Co.* recognized that this factor is not dispositive, federal income tax treatment consistent with that of financial accounting would indicate that Brazos should be treated as tax owner of the Building. For all other purposes, including bankruptcy and real estate lien enforceability purposes, the parties' express their intent in Section 3.02(b) of the Lease that OPI be treated as the owner of the Building and that the Lease be treated as the repayment and security provisions of a loan. Since accounting treatment is not dispositive and since the parties intend to treat the Lease as a financing for all other purposes, this factor appears to favor OPI as tax owner of the Building.

f. Benefit of Appreciation/Risk of Depreciation. Through its option to purchase the Building for the Acquisition Cost, OPI can effectively enjoy all of the benefit of appreciation in the value of the Building during the Lease. On any renewal date, if OPI chooses not to exercise its option to renew the Lease, OPI must either purchase the Building for cash at the Acquisition Cost or arrange for its sale to a third party pursuant to Section 11.04 of the Lease. Further, if OPI chooses to renew the Lease and Brazos is unable to obtain financing and equity contributions on terms acceptable to Brazos, its limited partners and OPI, Section 11.03(b) of the Lease requires OPI to either purchase the Building for an amount of cash equal to the Acquisition Cost or arrange for its sale to a third party. To the extent that proceeds of a sale of the Building to a third party exceed the Acquisition Cost, OPI receives such excess proceeds. In the event of a sale to a third party at a price less than the Acquisition Cost, the risk of depreciation loss depends on the sale price obtained. If the sale proceeds are 25 percent or more of the Acquisition Cost, OPI must pay Brazos the difference between the sale proceeds and the Acquisition Cost. If the sale proceeds are less than 25 percent of the Acquisition Cost, OPI is obligated to pay Brazos 75 percent of the Acquisition Cost plus an amount that Brazos determines in good faith to be the amount that the residual value of the Building was reduced in excess of that attributable to normal wear and tear, plus an amount that Brazos determines in good faith to be the amount the sale proceeds have been reduced due to certain Liens attaching to the Building that arise out of OPI's acts or failure to act. If OPI elects to renew the Lease but the Building depreciates significantly, Brazos will be unable to obtain nonrecourse financing for the Building on terms identical to those under the Credit Agreement or otherwise acceptable to Brazos. In such case, the economic effect of the Lease provisions is to place the risk of depreciation loss on OPI. Thus, through the last renewal date of the Lease, OPI bears most of the risk of depreciation on the Building. Because Brazos has financed the Building with nonrecourse debt, in the event that the Building were significantly depreciated at the end of the final Renewal Term and Brazos and the Banks had not identified the depreciation prior to such time, permitting Brazos to invoke the Lease provision requiring OPI to purchase or arrange for the purchase of the Building if acceptable financing were not available, the Banks would bear the risk of the depreciation. On balance, this factor favors OPI as tax owner of the Building, because OPI enjoys all of the benefits of any appreciation of the Building and substantially all of the risk of depreciation of the Building.

g. Legal Title. Legal title to the Building is vested in Brazos during the term of the Lease. This factor favors Brazos as tax owner of the Building.

h. Acquisition of Title or Equity Interest. OPI does not acquire title to the Building or a stated equity interest in the Building merely upon payment of a specified amount of rentals, a factor favoring Brazos as tax owner of the Building.

i. Rental Payments Not Disproportionate. Rental payments under the Lease are based solely on the cost of borrowing and a return on equity for Brazos. Accordingly, rental payments will remain relatively level throughout the term of the Lease, except for adjustments based on interest rate changes. Therefore, the total amount to be paid by OPI for a relatively short period of use is not an inordinately large portion of the total required to be paid to secure transfer of title. This factor favors Brazos as tax owner of the Building.

j. Rentals Relation to Fair Market Value. Rental payments under the Lease are based on the cost of borrowing and return on equity for Brazos, not on the fair market value rental for the Building. The fact that rental payments are based on the cost of funds supports treatment of OPI as tax owner of the Building to the extent that the determination of rental amounts are made without regard to fair rental value. On the other hand, to the extent that the agreed rental payments do not materially exceed the current fair rental value, reduced weight should be accorded to this factor.

k. Bargain Purchase Option. OPI has an option to purchase the Building at the Acquisition Cost or arrange for a third party to purchase the Building under Section 11.04 of the Lease. OPI's option to purchase functions as a bargain purchase option to the extent it confers on OPI all of the benefits of appreciation of the Building.

Although OPI's purchase option will not necessarily result in a bargain or nominal price purchase, because the option exercise price does not take into account appreciation of the Building, this factor provides support for the treatment of OPI as tax owner of the Building.

l. Designation of Payments as Interest. Base Rent under the Lease contains a component, Basic Rent (Debt), that is based on the cost of funds to Brazos. In addition, Section 3.02(b) of the Lease indicates that for all but limited accounting and regulatory purposes, including for bankruptcy and tax purposes, the Lease is intended to be treated as a loan and all payments of Basic Rent, Additional Rent, proceeds of sale and other amounts payable under the Lease be treated as principal, interest and other amounts owing with respect to such loan. This factor favors OPI as tax owner of the Building.

m. Rental Payments Measured Based on Passage of Time, Not Purchase Price. Rental payments under the Lease are based on (a) the cost of funds related to the debt incurred by Brazos to purchase the Building and (b) a specified return on the equity contributed by Brazos to purchase the Building. Rental payments are therefore based on the purchase price of the Building. The rental payment structure favors OPI as tax owner of the Building.

n. Rental Payments Required Throughout Lease Term. Rental payments based on the carrying cost of the Building to Brazos are required throughout the Lease Term. The Lease does not permit OPI to use the Building for relatively nominal amounts after a certain amount of rental payments have been made. This factor supports Brazos as tax owner of the Building.

o. Minimum Unconditional At Risk Investment. Brazos has a stated equity interest in the Building of 3 percent of the Acquisition Cost of the Building. Brazos does not meet the requirement of Rev. Proc. 75-21 that the minimum initial investment of the lessor be 20 percent of the cost of the property and that the minimum initial investment remain at 20 percent at all times throughout the term of the lease. The comparatively small magnitude of the unconditional at risk investment on the part of Brazos is a factor favoring OPI as tax owner of the Building.

p. Payments Approximate Purchase Price. Under the Lease, the sum of the rentals payable by OPI, plus the Acquisition Cost of the Building, approximates the purchase price of the Building plus debt service and a stated return to Brazos. The structure of the Lease payments is consistent with that of a financing transaction, the form intended for the Lease transaction by the parties.

q. Lessor Can Force Purchase. Under Section 11.02 of the Lease, Brazos can force OPI to purchase the Building or find a third party to purchase the Building in certain circumstances described in Section 11.02(b) of the Lease. Further, if OPI elects to renew the Lease but Brazos is unable to obtain financing on terms identical to the Credit Agreement or terms otherwise acceptable to Brazos, Brazos may force OPI to purchase the Building or find a third party to purchase the Building. This factor favors OPI as tax owner of the Building.

r. Investment by Lessee. The cost of any additions and improvements to the Building are to be paid by OPI, pursuant to Section 8.04 of the Lease, so long as there is no Event of Default. OPI is permitted under the Lease to make additions and alterations subject to a requirement to notify (not obtain the consent of) Brazos if the cost of such additions and alterations exceeds $5,000,000. This factor favors OPI as tax owner of the Building.

s. Lessee Loans or Guarantees. Enron, OPI's parent, has guaranteed the payments by OPI under the Lease. OPI has indemnified Enron for any payments Enron is required to make under the Guaranty. Neither OPI nor Enron has guaranteed the payments to be made by Brazos under the Credit Agreement. This factor favors Brazos as tax owner of the Building.

On balance, an examination of the factors listed above indicates that the Lease should be treated as a financing for federal income tax purposes and that OPI should be treated as the tax owner of the Building. The principal factors that support the treatment of OPI as the tax owner of the Building are (i) the intent of the parties, expressed in the Lease, that for all purposes other than accounting and regulatory purposes the Lease is to be treated as a financing transaction, (ii) the option of OPI to purchase the Building at the Acquisition Cost, (iii) the ability of Brazos under certain circumstances to force OPI to purchase the Building at the Acquisition Cost or arrange for the purchase of the Building by a third party pursuant to Section 11.04 of the Lease, (iv) the fact that rental payments are based on the cost of funds plus a specified return to Brazos, and (v) the fact that OPI bears most of the risk of financial loss and enjoys the benefits of any appreciation in the value of the Building.

Based on this analysis, prior to the Assignment OPI should be treated as the owner of the Building for federal income tax purposes. As noted above, pursuant to the Assignment OPI assigned all of its rights under the Lease to Leasing Partners, and Leasing Partners assumed all of OPI's obligations under the Lease. Accordingly, following the Assignment Leasing Partners should be treated as the owner of the Building for federal income tax purposes.

C. Analysis of the Sublease.

Following the Assignment, Leasing Partners subleased the Building to Enron pursuant to the Sublease. Accordingly, it is necessary to analyze the Sublease in order to conclude that Leasing Partners should continue to be treated as the owner of the Building following the Sublease.

As with the Lease, it is appropriate to bifurcate the tax ownership analysis of the Sublease into two parts: economic substance and benefits and burdens of ownership. The factors enumerated above can be applied to the arrangement evidenced by the Sublease as follows:

1. Economic Substance.

a. Parties. Enron controls Leasing Partners through its wholly-owned subsidiary, OPI. Enron also guarantees the payments to Brazos under the Lease; however, OPI, the 97 percent limited partner of Leasing Partners, has indemnified Enron for any payments Enron is required to make under the Guaranty. This factor supports Leasing Partners as tax owner of the Building.

b. Business purpose. Leasing Partners is receiving fair market value rental for the Building, while Enron is receiving the use of the Building. These valid business purposes for the Sublease support treatment of Leasing Partners as tax owner of the Building in accordance with the form of the transaction.

c. Profit Expectation. Rental payments under the Sublease are expected to exceed debt service payable by Leasing Partners to Brazos. Leasing Partners therefore has the expectation of profit from the lease arrangement, a factor supporting treatment of Leasing Partners as tax owner of the Building in accordance with the form of the transaction.

Unlike the Lease, the Sublease does not evidence an intent by the parties that it be treated as a financing transaction or anything other than a sublease for all purposes. Thus, application of the factors indicating economic substance support treating the Sublease as a true lease in accordance with its form and, accordingly, treating Leasing Partners as remaining the tax owner of the Building following the Sublease. Having crossed the economic substance threshold, it is appropriate to address the benefits and burdens of ownership factors.

2. Benefits and Burdens of Ownership.

a. Possession. So long as the Sublease is in effect, Enron will have possession of the Building. However, a lessor is not normally vested with the right of possession during the term of a lease. The relevant inquiry, therefore, is whether the useful life of the Building extends beyond the term of the Sublease. The parties have represented that remaining economic useful life of the Building as of April 14, 1997 is at least 50 years. The Initial Term of the Sublease, plus all Renewal Terms, is 20 years. Accordingly, the useful life of the Building extends well beyond the term of the Sublease. This factor therefore favors Leasing Partners as tax owner of the Building.

b. Property Taxes. The Sublease requires Enron to pay property taxes. As indicated by the Tax Court's decision in *Torres*, this factor is less relevant in the context of a commercial lease; however, the payment of property taxes by Enron favors Enron as tax owner of the Building.

c. Risk of Casualty Loss. The Sublease requires Enron to maintain insurance on the Building. As indicated by the Tax Court's decision in *Torres*, this factor, like property taxes, is less relevant in the context of a commercial lease; however, Enron's responsibility for risk of casualty loss is a factor supporting Enron as tax owner of the Building.

d. Likelihood of Exercise of Renewal Option. Enron has no option to renew the Sublease for a bargain rental amount, a factor that favors recognition of Leasing Partners as tax owner of the Building.

e. Treatment of Parties for Accounting and Other Purposes. The Sublease is silent with respect to the financial accounting treatment of the Sublease by the parties. Leasing Partners and Enron have represented that they will treat the Sublease as a true lease for accounting and other purposes. Although the Supreme Court in *Frank Lyon Co.* recognized that this factor is not dispositive, federal income tax treatment consistent with that of financial accounting would indicate that Leasing Partners should be treated as tax owner of the Building.

f. Benefit of Appreciation/Risk of Depreciation. At the end of five years, pursuant to the terms of the Lease, if Enron does not exercise its right to make the Cancellation Payment and cancel the Sublease, Leasing Partners can terminate the Lease. To terminate the Lease, Leasing Partners will be required to purchase the Building from Brazos at the Acquisition Cost or to arrange for the sale of the Building to a third party pursuant to Section 11.04 of the Lease. Under Section 11.04 of the Lease, if the purchase price of the Building does not equal or exceed the Acquisition Cost, Leasing Partners is at risk to pay Brazos all or at least a substantial portion of the shortfall. Accordingly, Leasing Partners bears the risk of loss if the Sublease is not renewed at the end of the Initial Term, a factor indicative of tax ownership by Leasing Partners. Enron has the right to purchase the Building only at its then-appraised fair market value at the end of the Sublease. Thus, as between Leasing Partners and Enron, Leasing Partners will enjoy the benefit of any appreciation of the Building. This factor favors Leasing Partners as tax owner of the Building.

g. Legal Title. Legal title to the Building is vested in Brazos during the term of the Lease. This factor does not clearly favor either Enron or Leasing Partners as tax owner of the Building.

h. Payments Applicable to Equity. Enron does not acquire an equity interest in or title to the Building through payment of rents, a factor favoring Leasing Partners as tax owner of the Building.

i. Rental Payments Not Disproportionate. Rental payments under the Sublease are level throughout the term of the Sublease, except for adjustments based on the Consumer Price Index. Enron has no option to acquire the Building at other than fair market value. Therefore, the total amount to be paid by Enron for a relatively short period of use is not an inordinately large portion of the total required to be paid to secure transfer of title. This factor favors Leasing Partners as tax owner of the Building.

j. Rentals Do Not Exceed Fair Market Value. Rental payments under the Sublease do not exceed fair market value. Enron and Leasing Partners have represented that the rental payments required under the Sublease approximate fair market value rental for the Building. Fair market value rental payments support Leasing Partners as tax owner of the Building.

k. Bargain Purchase Option. Enron has an option to purchase the Building at a price equal to fair market value at the end of the Initial Term and both Renewal Terms of the Sublease. The lack of a bargain purchase option on the part of Enron favors treating Leasing Partners as tax owner of the Building.

l. Designation of Portion of Payments as Interest. No portion of the rental payments under the Sublease are designated as interest, a factor favoring Leasing Partners as tax owner of the Building.

m. Rental Payments Based on Use. Rental payments under the Sublease are required monthly and are based on the amount of space rented. Rental payments are not based on the normal purchase price of the Building. Except for annual adjustments based on the Consumer Price Index, rental payments under the Sublease are level throughout the Initial Term and both Renewal Terms. The rental payment structure favors Leasing Partners as tax owner of the Building.

n. Rental Payments Required throughout Lease Term. Rental payments are required under the Sublease throughout the Initial Term and both Renewal Terms. This factor supports Leasing Partners as tax owner of the Building.

o. Minimum Unconditional At Risk Investment. Leasing Partners does not meet the requirement of Rev. Proc. 75-21 that the minimum initial investment of the lessor be 20 percent of the cost of the property and that the minimum initial investment remain at 20 percent at all times throughout the term of the lease. Lack of a 20 percent minimum unconditional at risk investment on the part of Leasing Partners is a factor favoring Enron as tax owner of the Building.

p. Payments do not Approximate Purchase Price. Enron has an option to purchase the Building only at the end of the Initial Term and both Renewal Terms for the Building's then-appraised fair market value. Thus, the sum of the rentals payable by Enron under the Sublease, plus the exercise price of the option to purchase the Building, far exceed the purchase price of the Building plus a stated return. Accordingly, the form of the Sublease should be respected as a sublease.

q. Lessor Cannot Force Purchase. Under the Sublease, Leasing Partners has no right to force Enron or any other party to purchase the Building. This factor favors Leasing Partners as tax owner of the Building.

r. Investment by Lessee. The cost of any additions and improvements to the Building are to be paid by Enron. This factor favors Enron as tax owner of the Building.

s. Lessee Loans or Guarantees. Enron has guaranteed the payments by Leasing Partners under the Lease with Brazos. This factor favors Enron as tax owner of the Building.

On balance, an examination of the factors listed above indicates that the Sublease should be treated as a true lease for federal income tax purposes and that Leasing Partners should be treated as the tax owner of the Building. The lack of a bargain purchase option by Enron, the lack of an equity accumulation from the rental payments by Enron and the fact that Leasing Partners bears the risk of financial loss and enjoys any appreciation from a change in the value of the Building are facts and circumstances that support Leasing Partners as tax owner of the Building for federal income tax purposes.

CONCLUSION

Based upon the facts, representations, law and analysis set forth above, in our opinion (i) prior to the Assignment OPI should be treated as the owner of the Building for federal income tax purposes, (ii) following the Assignment Leasing Partners should be treated as the owner of the Building for federal income tax purposes, and (iii) the Sublease should be treated as a sublease and accordingly Leasing Partners should continue to be treated as the owner of the Building for federal income tax purposes following the Sublease.

The opinions expressed herein are as of the date hereof, and we assume no obligation to update or supplement such opinions to reflect any facts or circumstances that may hereafter come to our attention or any changes in law that may hereafter occur or become effective.

This opinion is given to you by us solely for your use and is not to be quoted or otherwise referred to or furnished to any governmental agency (other than the Internal Revenue Service in connection with an examination of the transactions contemplated by the Lease, the Assignment and the Sublease) or to other persons without our prior written consent.

Very truly yours,

Vinson & Elkins L.L.P.

VINSON & ELKINS L.L.P.

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November 16, 1999

Mr. R. Davis Maxey
Vice President -- Tax Planning
Enron Corp.
1400 Smith Street
Houston, TX 77002-7361

Redetermination of Earnings and Profits of Enron Liquids Holding Corporation

This letter sets forth our views concerning the redetermination of the earnings and profits ("E&P") of Enron Liquids Holding Corp. ("ELHC") following the contribution of Enron Pipeline Company ("EPC") to Enron Operations Corp. ("EOC").

FACTS

In reaching the conclusions stated herein, we have made certain assumptions based on the facts Alicia Goodrow, Jim Holman and you have presented to us orally and in writing. Any changes to the facts or invalidity of these assumptions may affect the conclusions stated herein. We have made no independent determination regarding such facts and circumstances.

ELHC has issued both preferred and common stock. The preferred stock is held 80.20% by Enron Leasing Partners, LP (limited partnership for federal income tax purposes); 10.45% by EPC; and 9.35% by Enron. The common stock is held 80% by Enron and 20% by Organizational Partner, Inc., a deconsolidated subsidiary of Enron. ELHC joins in the filing of Enron's consolidated federal income tax return.[1] The Enron consolidated group files its returns on a calendar year basis.

ELHC has redeemed a portion of both its preferred and common stock quarterly since March 1998. For federal income tax purposes, you have indicated that these redemptions will be treated as distributions with respect to stock (e.g., dividends) by reason of Section 302(d). The

[1] We understand that the preferred stock is described under Section 1504(a)(4) and accordingly is excluded from the 80% vote and value test under Section 1504(a)(2) because it is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock, and is not convertible into another class of stock.

following schedule illustrates both the redemptions and dividends either made or expected to be made during the 1999 calendar year:

	Redemptions			Cash Dividends on Preferred Stock		
Date	Preferred Stock	Common Stock	Total	ELHC	EOC	Total
3/31/99	29,575,240	16,551,145	46,126,385	12,745,518		12,745,518
6/30/99	21,675,000	12,345,936	34,020,936	10,865,906		10,865,906
9/30/99	29,950,000	17,357,858	47,307,858	11,138,075		11,138,075
12/31/99	29,600,000	16,692,687	46,292,687	11,063,319	17,446,358	28,509,677
	110,800,240	62,947,625	173,747,865	45,812,818	17,446,358	63,259,176

As of December 31, 1998, ELHC has accumulated E&P of approximately $19,980,151. (See attached schedule for all numerical references.) ELHC is expected to generate approximately $37,072,554 of current E&P for the taxable year ended December 31, 1999. ELHC's E&P has been adjusted for the E&P derived by EOC, Enron Gas Liquids, Inc. ("EGLI"), Enron Louisiana Transportation Company ("ELTC"), Enron Products Pipeline, Inc. ("EPPI"), and EOTT Energy Corporation ("EOTT"), wholly owned subsidiaries of ELHC.

EPC is a wholly owned subsidiary of Enron with accumulated E&P of $968,753,074 at December 31, 1998. EPC is expected to generate approximately $184,616,953 of current E&P for the December 31, 1999 year.

TRANSACTION

The following transaction has been proposed:

- EPC will sell its 10.45% preferred stock interest in ELHC to Enron in exchange for an interest bearing note of equal value.
- Following the sale of EPC's preferred stock interest in ELHC, Enron will contribute 100% of the common stock of EPC to EOC in exchange for 1,000 shares non-voting, perpetual preferred stock with a stated dividend rate of 7% per annum of equal value.
- Incident to the transaction, in an attempt to reorganize along business lines, EGLI; ELTC; EPPI; and EOTT will be disposed of through intercompany sales or liquidations.

ISSUE

Upon the contribution of the stock of EPC to EOC, to what extent will EPC's current and accumulated E&P be replicated under Reg. §1.1502-33(f)(2) to the E&P of EOC and ELHC?

DISCUSSION AND ANALYSIS

Federal Income Tax Treatment of Distributions with Respect to Stock

Sections 301(a) and (c) provide, in part, that: (1) the portion of a distribution of property made by a corporation to a shareholder with respect to its stock which is a dividend shall be included in the shareholder's gross income; (2) the portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock; and (3) the portion of which is not a dividend to the extent that it exceeds the adjusted basis of the stock shall be treated as gain from the sale or exchange of property.

The term "dividend" means any distribution of property made by a corporation to its shareholders out of its E&P accumulated after February 28, 1913, or out of its E&P of the taxable year, without regard to the amount of E&P at the time the distribution was made.[2] Included as dividends are certain distributions in redemption of stock.[3]

Reg. §1.316-2(a) provides that a distribution with respect to stock is made, first, from the distributing corporation's E&P for the taxable year during which the distribution occurs. The determination of current E&P is made as of the end of the taxable year, without adjustment for any distributions made during the year and without regard to the amount of E&P on hand at the beginning of the taxable year or at the time of distribution.[4] If the total distributions made during the taxable year exceed the current E&P of that year, the excess amount is considered a taxable dividend to the extent of the distributing corporation's E&P accumulated after February 28, 1913.[5]

Consolidated Return Provisions

The consolidated return regulations provide a system for tiering up the E&P of the members of a consolidated group to each of the higher tier members and ultimately to the common parent. Each owning member adjusts its own E&P for its share of the E&P of its subsidiaries, using the principles applied to adjust the basis of a subsidiary's stock under Reg. §1.1502-32.[6] E&P

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[2] Section 316(a).

[3] Section 302(d).

[4] Section 316(a)(2); Reg. §1.316-2(b); Rev. Rul. 74-164, 1974-1 C.B. 74.

[5] Reg. §1.316-2(a) and (b).

[6] Reg. §1.1502-33(b).

adjustments are made as of the close of each consolidated return year, and as of any other time if a determination at that time is necessary to determine the earnings and profits of any person.[7]

The consolidated return regulations also contain special rules for determining the E&P of a member upon a restructuring of the consolidated group. Reg. §1.1502-33(f)(2) requires that if a member's location within a group changes, appropriate adjustments must be made to the E&P of the members to prevent E&P from being eliminated. Although the scope of this rule is not entirely clear, two examples are given to illustrate its meaning: if *P* transfers all of *S*'s stock to another member in a transaction to which Section 351 and Reg. §1.1502-13 apply, the transferee's E&P is adjusted immediately after the transfer to reflect *S*'s E&P immediately before the transfer from consolidated return years. On the other hand, if the transferee purchases *S*'s stock from *P*, the transferee's E&P is not adjusted.

Based on rule set forth in Reg. §1.1502-33(f)(2), it appears that both EOC and ELHC's E&P should be adjusted for EPC's current year E&P following the contribution of 100% of EPC's stock to EOC by Enron. Reg. §1.1502-33(f)(2) does not specify the *manner* in which EPC's E&P is replicated to EOC and to ELHC. Presumably, the replication occurs as if the stock of EPC had always been owned by EOC, and EPC's E&P is tiered up under the normal consolidated return E&P system under Reg. §1.1502-33(b).[8] Although not free from doubt, due to the issuance of the preferred stock by EOC to Enron, it appears that some portion of EPC's E&P which is replicated to EOC should be allocated to the preferred stock held by Enron. Because the preferred stock was not outstanding prior to the contribution of the stock of EPC to

[7] Reg. §1.1502-33(b)(1). Because the Enron group's consolidated return year does not close as a result of the transaction, and EPC's individual year likewise does not close, Reg. §1.1502-33 should not operate to convert EPC's current E&P generated before the date of the proposed transaction to accumulated E&P.

[8] Note that Reg. §1.1502-33(f)(2) makes no distinction between current and accumulated E&P. Under Reg. §1.1502-33(f)(1), if there is a group structure change as defined in that section, the E&P of the new common parent is adjusted to reflect the E&P of the old common parent. Reg. §1.1502-33(f)(1) specifically states that this adjustment is made as if the new corporate parent succeeds to the E&P of the old common parent in a Section 381(a) transaction. In general, Section 381(c)(2) requires an acquiring corporation, in a transaction to which Section 381(a) applies, to succeed to, and take into account, the E&P of the target corporation as of the close of the date of distribution or transfer. Reg. §1.381(c)(2)-1(a)(1). Although the acquiring corporation inherits the target corporation's E&P on the date of the transaction under Section 381(c)(2), this E&P will be treated as accumulated E&P rather than current E&P of the acquiring corporation. Reg. §1.381(c)(2)-1(a)(2) and -1(a)(7), Example 1. Because Reg. §1.1502-33(f)(2) does not state that the E&P replication is deemed to occur in a deemed Section 381(a) transaction as does Reg. §1.1502-33(f)(1), there does not appear to be a specific provision that requires EPC's E&P to be treated as accumulated in EOC's and ELHC's hands. Thus, it appears that EPC's E&P would retain its character as current and accumulated, as the case may be, in EOC's and ELHC's hands.

EOC, no allocation of EPC's replicated E&P to the EOC preferred stock appears to be necessary prior to the date the contribution occurs.[9]

It is estimated that EPC will generate approximately $184,616,953 of current E&P for the taxable year ended December 31, 1999. Assuming that the contribution of EPC stock to EOC occurs on December 1, 1999, approximately $1,076,932 ($184,616,953 x 7% x 1/12) should be allocated to the preferred stock interest owned by Enron following the tier up to EOC. The remaining current year E&P of $183,540,021 ($184,616,953 less $1,076,932 allocated to the preferred interest) generated by EPC should be allocated to the common stock interest owned by ELHC following the tier up to EOC. This amount, $183,540,021 should likewise be tiered up to ELHC as of the date of the contribution.

Availability of EPC's E&P

As previously discussed, Reg. §1.316-2(a) dictates that any corporate distribution comes, first, from the corporation's E&P for the taxable year during which the distribution occurs. The taxpayer makes the determination of current E&P as of the end of the taxable year, without adjustment for any distributions made during the year and without regard to the amount of E&P on hand at the beginning of the taxable year or at the time of distribution.[10] As such, at the end of the year, ELHC will have current year E&P of approximately $220,612,574 ($183,540,021 generated by EPC plus $37,072,554 generated by ELHC and subsidiaries) without taking into consideration any distributions throughout the year.

The priority-sequencing of corporate distributions need only occur where the aggregate amount of the distributions exceeds current E&P for the taxable year. Moreover, where such excess exists, IRS regulations render inconsequential the order of priority of distributions for purposes of applying current E&P. Under Reg. §1.316-2(b), the year's E&P is apportioned to all distributions on a pro rata basis, regardless of when they occurred during the year. The excess is deemed to come from post-February 28, 1913 E&P on hand as of the date of the particular distribution.[11] Because EPC's E&P presumably is not replicated under Reg. §1.1502-33(f)(2) until the date of the contribution of the EPC stock to EOC, only the current E&P (i.e., during calendar 1999) generated by EPC is available to offset the distributions occurring in March, June, and September, 1999. According to the distribution schedule above, total distributions for the year will exceed ELHC's current E&P. Thus, priority-sequencing must be performed.

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[9] Note that Reg. §1.1502-33(f)(2) provides, by way of illustration, that the adjustment to the higher tier members' E&P occurs *immediately after* the transaction.

[10] Rev. Rul. 74-164, 1974-1 C.B. 74.

[11] Section 316(a)(1); Reg. §§1.316-2(b) and (c).

Neither the parenthetical language of Section 316(a)(2) nor the regulations which require pro rata apportionment of the year's current E&P reflect any distinction between distributions made with respect to the same or different classes of stock. The IRS, nonetheless, takes the position that in determining the extent to which distributions made during the year with respect to different classes of stock come from current E&P, the taxpayer should consider any preferential rights of a particular class. Distributions made with respect to stock of the preferred class take priority over other distributions coming from current E&P.[12]

Based on the distribution schedule above, $174,059,416 of the total distributions relates to preferred stockholders. In completing the priority-sequencing, this amount should be treated as coming out of the current year E&P of $220,612,574. The remaining current year E&P of approximately $46,553,158 should then be apportioned to all remaining distributions on a pro-rata basis, regardless of when they occurred during the year. As such, approximately $11,638,290 ($46,553,158 divided by 4) of each distribution would be allocated to current year E&P. The excess would be deemed to come from post-February 28, 1913 accumulated E&P on hand as of the date of the particular distribution. Because EPC's E&P presumably does not replicate until the date of contribution of the EPC stock to EOC (which is currently scheduled to be December 1, 1999), only the $19,980,151 of accumulated E&P attributable to ELHC as of the beginning of the year should be allocable to the distributions occurring in March, June, and September, 1999. However, EPC's accumulated E&P of $968,753,074 should be available for any distribution subsequent to the contribution of the EPC stock to EOC.

CONCLUSION

Upon the contribution of the stock of EPC to EOC, it is more likely than not that EPC's current and accumulated E&P will be replicated under Reg. §1.1502-33(f)(2) to the E&P of EOC and ELHC. As described in detail above, a portion of EPC's current year E&P, upon tiering up to EOC, would be allocated to the preferred stock interest owned by Enron with the remainder being allocated to ELHC's common stock interest.

Therefore, ELHC should have sufficient E&P to treat the preferred dividends and preferred and common stock redemptions made for the tax year ended December 31, 1999, totaling $237,007,041, as dividends for purposes of Section 301.

Our comments, as stated above, are based upon the analysis of the Code, the Regulations thereunder, current case law, and published rulings. The foregoing are subject to change, and such change may be retroactively effective. If so, our views, as set forth above, may be affected and may not be relied upon. Further, any variation or differences in the facts as orally represented to us and recited herein, for any reason, might affect our conclusions, perhaps in an

[12] Rev. Rul. 69-440, 1969-2 C.B. 46.

adverse manner, and make them inapplicable. In addition, we have undertaken no obligation to update this letter for changes in facts or law occurring subsequent to the date thereof.

This letter represents our views as to the interpretation of existing law and, accordingly, no assurance can be given that the Service or courts will agree with the above analysis. Furthermore, we have not undertaken any analysis of foreign, state, or local tax consequences in the above.

This letter is addressed to your particular inquires and is not intended to be distributed to, or used by, third parties without our prior knowledge.

Thank you for the opportunity to work with you on this project. If you have any questions or would like to like to discuss this letter further, please call me at 713/750-8366 or Witland LeBlanc at 713/750-5947.

Very truly yours,

Kevin A. Duvall
Partner

VI. TAX OPINION LETTERS RELATING TO PROJECT TOMAS

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November 23, 1998

Enron Corp.
1400 Smith Street
P.O. Box 1188
Houston, Texas 77251

Ladies and Gentlemen:

You have requested our opinion as to certain federal income tax consequences of the transaction summarized in this paragraph (the ***"Transaction"***) in which (i) certain subsidiaries of Bankers Trust Corporation, a New York corporation (***"BT Corp."***), namely BT Leasing Corp., a New York corporation (***"BT Leasing"***), and EN-BT Delaware, Inc., a Delaware corporation (***"EN-BT Delaware,"*** and, together with BT Leasing, the ***"BT Partners"***), and (ii) Portland General Holdings, Inc., an Oregon corporation (***"PGH"***), a wholly owned subsidiary of Enron Corp., a Delaware corporation (***"Enron"***), contributed certain assets to Seneca Leasing Partners, L.P. (the ***"Partnership"***), a newly formed Delaware limited partnership that will elect to be classified as a partnership for federal income tax purposes, in exchange for all of the partnership interests of the Partnership. Our opinion represents our best judgment as to the likely outcome of the issues discussed if presented to a court of law. Our opinion is not binding on the Internal Revenue Service (the ***"Service"***) or a court. Thus, no assurance can be given that a court would agree with our opinion.

In preparing our opinion, we have examined such documents related to the Transaction as we deemed necessary and have assumed 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 and assumptions set forth herein and that such factual matters and assumptions are correct for purposes of rendering this opinion. In the event that the factual matters and assumptions 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. BACKGROUND

(1) Prior to the Transaction, PGH was the owner of 100% of two Oregon corporations, Columbia Willamette Leasing, Inc. ("*CWL*"), and Oneida Leasing, Inc. ("*Oneida*"), formerly known as PLC Kalamazoo, Inc.

(2) Prior to the Transaction, CWL owned certain items of personal property leased to third parties unrelated to Enron and its affiliates[1] as well as 100% of the stock of another Oregon corporation, Rail Leasing, Inc. ("***Rail Leasing***"). The assets of Rail Leasing consisted of a number of railcars under lease to GE Capital Railcar Associates, Inc. as more specifically described in the Subscription and Contribution Agreement dated September 15, 1998 (the "***Contribution Agreement***") by and between PGH and the Partnership. In the aggregate, the 17 leased assets held directly or indirectly by CWL had a gross fair market value of $279,678,051. Each of the assets was subject to non-recourse debt (the "***Nonrecourse Debt***"), totaling $169,555,556. The tax basis of the assets totaled approximately $8,000,000.

(3) Prior to the Transaction, Oneida held only a few assets. Oneida had been formed by PGH in 1990 to engage in a joint venture in the oil and gas industry. While the business never materialized, PGH was able to deduct the losses from the joint venture. As required pursuant to a tax sharing agreement between PGH and Oneida, PGH was indebted to Oneida with respect to the use of such losses. Such indebtedness was continuously reflected on the balance sheets of Oneida and PGH such that Oneida's balance sheet showed an account receivable from PGH worth $600,000. Oneida also held other nominal assets. Other than as described in this paragraph, Oneida has not engaged in any business transactions for four years. On September 14, 1998, all of the assets of Oneida other than the Enron Note (as defined below), were distributed from Oneida to PGH.[2]

B. THE TRANSACTION

The Transaction involves the formation of the Partnership by BT Leasing, EN-BT Delaware and PGH. It is anticipated that the Partnership will engage directly and indirectly in the business of owning and operating a portfolio of leased equipment and investing in other permitted investments.

[1] The assets generally consisted of airplanes, railcars, a Mack Truck facility, ships and certain other equipment, and are more specifically described in the Contribution Agreement (hereinafter defined).

[2] On September 14, 1998, Oneida adopted a resolution to pay a dividend to PGH, thereby clearing from its accounts any cash contributed by PGH in satisfaction of its indebtedness as well as any other Oneida assets.

(1) *Borrowing of Funds and Capitalization of Oneida*

All of the following occurred on July 17, 1998:

(a) PGH borrowed $250 million from Toronto Dominion (Texas), Inc. ("***Toronto Dominion***") on a recourse basis (the ***"Recourse Debt"***). The terms of the Recourse Debt require PGH to repay the principal and interest accrued thereon, on or before October 30, 1998. The interest rate on the Recourse Debt was set at LIBOR (as defined in the terms of the Recourse Debt) plus 35 basis points (.35) on a per annum basis. The Recourse Debt was not secured.

(b) Pursuant to a Guarantee issued by Enron on July 17, 1998 (the ***"Enron Guarantee"***), Enron guaranteed the Recourse Debt.

(c) Pursuant to a Contribution and Subscription Agreement dated July 17, 1998, between PGH and Oneida, PGH contributed $250 million cash to Oneida.

(d) Oneida loaned $250 million to Enron in exchange for a demand promissory note dated July 17, 1998 (the "***Enron Note***"), in which Enron agreed to pay the principal amount upon the earlier of demand or July 31, 2003, with an annual interest rate equal to LIBOR (as defined in the terms of the Enron Note) plus thirty-five basis points (.35).

(2) *Merger of PGH and its Subsidiaries*

(a) On September 4, 1998, CWL merged with and into its parent corporation, PGH, pursuant to a plan of merger adopted on September 3, 1998. Immediately after such merger, PGH held all of CWL's leased assets as well as 100% of the stock of Rail Leasing.

(b) On September 10, 1998, Rail Leasing merged with and into PGH pursuant to a plan of merger adopted on September 9, 1998. As a result of such merger, PGH held Rail Leasing's only leased asset plus the 16 leased assets formerly held by CWL.

(3) *The Formation and Funding of the Partnership*

(a) On September 9, 1998, PGH, BT Leasing, and EN-BT Delaware (referred to collectively herein as "***the Partners***") formed the Partnership as a Delaware limited partnership, by filing a Certificate of Limited Partnership with the Secretary of State of the State of Delaware and entering into a partnership agreement. Pursuant thereto, BT Leasing and EN-BT were admitted to the

Partnership as general partners, with 4% and 1% general partnership interests, respectively, and PGH was admitted to the Partnership as a limited partner with a 95% limited partnership interest.

(b) On September 15, 1998, PGH, BT Leasing and EN-BT Delaware entered into the First Amended and Restated Limited Partnership Agreement (the "***Partnership Agreement***"). On the same date, pursuant to the Contribution Agreement, PGH transferred 16 of its 17 leased assets and obligated itself to contribute the Mack Truck Facility or an amount of cash equal to the net fair market value of the Mack Truck Facility (collectively, the "***Contributed Equipment***") to the Partnership, as well as 100% of the stock of Oneida. The gross fair market value of the Contributed Equipment at the time of the transfer was $279,678,051, and each item of the Contributed Equipment was transferred to the Partnership subject to the Nonrecourse Debt totaling $169,555,556. The aggregate fair market value of the Contributed Equipment above includes PGH's obligation to contribute the Mack Truck Facility or cash equal to the net fair value of such asset. The fair market value of the Oneida stock at the time of the transfer was $252,521,946.

(c) On September 15, 1998, the Partnership assumed the Recourse Debt pursuant to, and as contemplated by, the Contribution Agreement. The Partnership, and in turn, BT Leasing and EN-BT Delaware, as general partners in the Partnership, became primarily liable on the Recourse Debt, although Enron remained liable as a guarantor until such debt was repaid two days later on September 17, 1998, as described below. However, in the event that Enron would have been required to make payments on the Recourse Debt as a guarantor, Enron would have had the right to collect from the Partnership such amounts paid under the Enron Guarantee.

(d) In exchange for its contribution of the Contributed Equipment and the Oneida stock to the Partnership, PGH received a 95% limited partnership interest with a fair market value of $110,122,495, a floating preferred return (the "***Preferred Return***") on $68,013,558 of its partnership interest, and the Retirement Right (as defined below).

(e) In exchange for its contribution of $8,972,646 cash, BT Leasing received a 4% general partnership interest, and in exchange for its contribution of $2,243,161 cash, EN-BT Delaware received a 1% general partnership interest.

(f) On September 30, 1998, PGH transferred the Mack Truck Facility to the Partnership in satisfaction of its obligation under the Contribution Agreement and the Partnership Agreement to contribute either the Mack Truck Facility or cash in an equivalent amount.

(4) *Operations, Allocations and Distributions of the Partnership*

(a) It is anticipated that the Partnership will invest the cash capital contributions from BT Leasing and EN-BT Delaware in certain permitted investments described in the Partnership Agreement.[3]

(b) Under the Partnership Agreement, Profits and Losses (as such terms are defined in the Partnership Agreement) are allocated in accordance with the Partners' relative percentage ownership interests (the "***Percentage Interests***"). However, if PGH's capital account is reduced to $68,013,558, then the Profit and Loss allocations change such that BT Leasing and EN-BT Delaware will be allocated 99% of the Partnership Profits and Losses (allocated between them in accordance with their proportionate interests) and PGH will be allocated 1% of the Partnership Profits and Losses.

(c) The Partnership Agreement provides that distributions shall be made to the extent of cumulative retained earnings of the Partnership, (i) first, to the extent of Net Cash Flow (as such term is defined in the Partnership Agreement), to the extent of the excess of the Preferred Return over the sum of certain prior distributions and (ii) second, to the partners in proportion to their Percentage Interests.

(d) Section 5.4 of the Partnership Agreement provides that BT Leasing and EN-BT Delaware (hereinafter sometimes referred to as the "***General Partners***") are to pay all ordinary and customary expenses of the Partnership incurred in the ordinary course of business in exchange for a management fee of $300,000 per year. However, for the year ending December 31, 1998, the General Partners will receive a prorated management fee of $87,500.

(e) Pursuant to a Service Agreement dated September 15, 1998, between BT Leasing and Oneida, Oneida will pay BT Leasing $300,000 per annum to act as its agent to engage in the business of owning and operating a portfolio of leased equipment.

[3] The permitted investments are described in section 5.6 of the Partnership Agreement.

(5) *The Guaranty and Indemnification Agreements*

(a) BT Corp. entered into a Guaranty and Indemnification Agreement (the "***BT Guaranty and Indemnification Agreement***") on September 15, 1998, in favor of PGH, guaranteeing the due and punctual performance by each General Partner of its respective material obligations and covenants as general partner under the Partnership Agreement, and indemnifying PGH for any damages arising from any misstatements or omissions by a General Partner of any material fact under the Partnership Agreement or any of the contribution agreements between a General Partner and the Partnership.

(b) Enron entered into a Guaranty and Indemnification Agreement on September 15, 1998, in favor of BT Leasing and EN-BT Delaware, guaranteeing the due and punctual performance by PGH of all of its material obligations and covenants under the Contribution Agreement between PGH and the Partnership, and indemnifying BT Leasing and EN-BT Delaware against any damages arising from any misstatements or omissions by PGH of any material fact under the Contribution Agreement or the Partnership Agreement between PGH and the Partnership.

(6) *The Formation of and Contribution to PGH Leasing, LLC*

(a) On September 14, 1998, PGH formed PGH Leasing, LLC ("***PGH LLC***"), by filing a Certificate of Formation with the Secretary of State of the State of Delaware, and by entering into a limited liability company agreement on that date. Pursuant to certain representations to be made by PGH, PGH LLC will elect to be treated as an entity which is disregarded for federal income tax purposes.

(b) On September 16, 1998, PGH contributed its limited partnership interest in the Partnership to PGH LLC, pursuant to the Contribution Agreement (the "***PGH LLC Contribution Agreement***") on that same date. BT Leasing and EN-BT Delaware acknowledged and agreed to accept PGH LLC as a substituted limited partner of the Partnership by signing the PGH LLC Contribution Agreement.[4]

[4] Under section 10.6(f) of the Partnership Agreement, the partners consent to the transfer of PGH's limited partnership interest in the Partnership to PGH LLC and to its admission to the Partnership as a substituted limited partner.

(7) *Refinancing of the Recourse Debt*

(a) On September 15, 1998, and prior to the contribution of the Oneida stock to the Partnership, Enron transferred cash in the amount of $252,521,946 to Oneida in satisfaction of the Enron Note.

(b) On the same date, Oneida lent to BT Corp. $252,521,946 on a recourse basis in exchange for a demand promissory note from BT Corp. (the "***Oneida Demand Note***"). Under the terms of the Oneida Demand Note, Oneida could demand payment of all or any part of the principal amount due at any time and from time to time. Interest on such note will accrue at a per annum rate equal to LIBOR (as defined under the terms of the Oneida Demand Note) plus 35 basis points (.35).

(c) On the same date, BT Corp. lent $252,521,946 cash to the Partnership on a recourse basis in exchange for a note of the Partnership (the "***BT Note***"). The terms of the BT Note require the Partnership to repay the principal, including accrued interest on such BT Note on December 31, 2003 or earlier, by acceleration or otherwise. The interest rate on the BT Note was set at LIBOR (as defined under the terms of the BT Note) plus 35 basis points (.35) on a per annum basis.

(d) On September 17, 1998, the Partnership paid $252,606,236.46 cash to Toronto Dominion in full satisfaction of the Recourse Debt.

C. Purposes of the Transaction

PGH has undertaken the transaction for a variety of business reasons, certain of which are set forth below. First, PGH has gained the expertise of BT Corp. in managing and expanding its leased asset portfolio. PGH has incentivized BT Corp. to achieve the best results from the management of the portfolio by causing the BT Partners to acquire a 5% economic interest in the Partnership and by including allocations in the Partnership Agreement that allocate to the BT Partners 99% of the losses after a decline in asset value below a particular level. In addition, the Partnership Agreement provides PGH with wide flexibility with respect to the continuation of the Partnership. PGH expects to receive a reasonable commercial return on the value of its investment in the Partnership, noting that the return is, in significant part, a function of the changing values of the assets included in the Partnership. Finally, PGH expects certain financial accounting benefits to be recognized on the consolidated GAAP financial statements in which it is included. For example, under GAAP, notwithstanding the tax treatment of the transaction, Enron may report gain for GAAP purposes arising from the Transaction because it has shifted a material amount of the risk of decline in the value of the Contributed Equipment to the BT Partners as a result of the allocations in the Partnership Agreement.

The BT Partners also expect a reasonable commercial return on their investment in the Partnership, although, again, it should be noted that the level of return is, in significant part, a function of the changing values of the assets of the Partnership.

D. Potential Future Events

At any time after two years from September 30, 1998,[5] PGH LLC, as the transferee of PGH's Limited Partnership interest, may exercise its right to compel the Partnership to liquidate its Partnership interest in exchange for assets of the Partnership (the "***Retirement Right***").[6] Upon exercise of its Retirement Right, under Section 10.8 of the Partnership Agreement, the Gross Asset Values (as defined in the Partnership Agreement) of the Partnership assets will be increased or decreased, to their fair market values, which adjustments will be reflected in the partners' capital accounts. PGH LLC will receive distributions in an amount equal to the positive balance in its capital account, plus the amount of Nonrecourse Debt or the BT Note assumed by it. Absent agreement to the contrary, the value of each leased asset will be based on the bids received in an open bidding process which will occur prior to the liquidation.[7] The composition of such assets as well as the amount of debt to be assumed by PGH will be solely at the discretion of PGH.

Additionally, in the future, the Partnership may decide to change the state of incorporation of Oneida from Oregon to Delaware through a redomestication process.

No contracts, agreements, understandings or arrangements exist with respect to such future events apart from the provisions of the Partnership Agreement relating to the Retirement Rights and the redomestication of Oneida.

II. TAX REPRESENTATIONS RELIED UPON

A. BT CORP. REPRESENTATIONS

BT Corp. has made the following representations to Akin, Gump, Strauss, Hauer & Feld, L.L.P. in connection with the Transaction for the purpose of providing a basis for the Firm's

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[5] Such date reflects the date on which the Mack Truck Facility was contributed to the Partnership by PGH.

[6] The Retirement Right is described under section 10.8 of the Partnership Agreement. In addition to its right to retire after September 30, 2000, PGH LLC also has the option to exercise its Retirement Right under certain limited circumstances set forth in section 10.8 of the Partnership Agreement.

[7] The bidding process is more fully described in section 10.8(c) and Exhibit A of the Partnership Agreement.

rendering of tax advice to its respective clients, with respect to Transaction including the formation, capitalization and operations of the Partnership by PGH and BT Partners.

(1) BT Corp. has caused the BT Partners to enter into the Transaction for substantial business purposes, including, an opportunity to collect management fees, an opportunity to expand its relationship with a customer, and to benefit financially from the potential profits resulting from leasing equipment.

(2) The Transaction documents were negotiated between the BT Partners and PGH at arm's length including the valuation of the assets contributed to the Partnership. All future transactions affecting the relative rights of the BT Partners and PGH will likewise be undertaken at arm's length.

(3) The BT Partners will file returns, reports and other statements consistent with and act in accordance with the terms of the Transaction documents.

(4) Each BT Partner expects a reasonable commercial positive pre-tax economic return from its investment in an interest in the Partnership after consideration of fees and expenses incurred by such BT Partner (and its affiliates) in connection with the Transaction.

(5) The Partnership will file tax returns consistent with its status as a partnership.

(6) The BT Partners believe that the value of the assets of the Partnership may vary over time and the composition of the assets held indirectly by the Partnership is likely to significantly change. In particular, it is the intent of the BT Partners to cause Oneida to acquire a substantial portfolio of leased equipment that will further diversify the Partnership's portfolio of equipment.

(7) Neither of the BT Partners nor any person who is a related person (within the meaning of Treas. Reg. § 1.752-4(b)(1)) with respect to the BT Partners or the Partnership was the lender with respect to, or has an interest in, any of the Nonrecourse Debt.

(8) For the two-year period following the Effective Date (as such term is defined in the Partnership Agreement), PGH will receive no distributions from the Partnership other than distributions of "operating cash flow" or "reasonable preferred returns" (within the meaning of Treas. Reg. §§ 1.707-4(b)(2) and 1.707-4(a), respectively).

(9) The Partnership will make a timely election, in the manner prescribed in Section 754, to adjust the basis of its property, that would be effective should PGH exercise its retirement right.

(10) BT Corp. expects the Partnership to continue in business for a prolonged period of time, holding the Contributed Equipment, any newly leased assets, and any other Permitted Investments.

(11) Prior to the retirement of PGH's interest in the Partnership, the Partnership will make no contributions to the capital of Oneida.

B. PGH TAX REPRESENTATIONS

The following representations have been made by PGH in connection with the Transaction for the purpose of providing a basis for the Firm's rendering of tax advice to its respective clients, with respect to the Transaction including the formation, capitalization and operations of the Partnership by PGH and BT Partners.

(1) PGH has entered into the Transaction for substantial business purposes. PGH's purposes include (i) gaining the expertise of BT Corp. in managing and expanding its leasing portfolio, while (ii) placing with BT Corp. an economic interest in the portfolio, including a disproportionate share of the downside, and (iii) preserving the opportunity to reevaluate BT Corp. 's performance.

(2) The Transaction documents were negotiated between the BT Partners and PGH at arm's length including the valuation of the assets contributed to the Partnership. All future transactions affecting the relative rights of the Partners will likewise be undertaken at arm's length.

(3) PGH will file returns, reports and other statements consistent with and act in accordance with the terms of the Transaction documents.

(4) PGH expects a reasonable commercial positive pre-tax economic return from its investment in the Partnership after consideration of fees and expenses incurred in connection with the Transactions.

(5) The Partnership will file tax returns consistent with its status as a partnership.

(6) PGH believes that the value of the assets of the Partnership may vary over time and the composition of the assets held indirectly by the Partnership is likely to significantly change. In particular, it is the intent of PGH that Oneida acquire a substantial portfolio of leased equipment that will further diversify the Partnership's portfolio of equipment. Oneida intends to acquire such assets using proceeds of calls upon the Oneida Demand Note.

(7) On July 17, 1998, the $250,000,000 of proceeds of the Recourse Debt were advanced by Toronto Dominion directly to Oneida at the request of PGH.

(8) Each component of the Nonrecourse Debt was originally incurred by CWL or Rail Leasing, as the case may be, solely for the purpose of financing the acquisition of the Contributed Equipment secured thereby, and all of the proceeds of such debt were used to pay the purchase price of such Contributed Equipment.

(9) Each component of the Nonrecourse Debt has encumbered the related Contributed Equipment for more than two years prior to the date of the Transactions.

(10) The Recourse Debt is not secured by any property.

(11) Oneida was formed by PGH for valid non-tax business reasons more than two years prior to the beginning of discussions of the Transaction. PGH has held 100% of the stock of Oneida for the two years prior to the date of the Transaction. Oneida's existence for state law and federal income tax purposes has been continued and has been respected during that time.

(12) PGH LLC will be wholly-owned by PGH and will elect to be treated as an entity disregarded for federal income tax purposes.

(13) The leases to which the Contributed Equipment contributed by PGH to the Partnership are subject are considered "true leases" for federal income tax purposes.

(14) Neither of the BT Partners, nor any person who is a related person (within the meaning of Treas. Reg. § 1.752-4(b)(1)) with respect to the BT Partners or the Partnership was the lender with respect to, or has an interest in, any of the Nonrecourse Debt.

(15) The Nonrecourse Debt assumed by the Partnership in connection with PGH's contribution to the Partnership of the Contributed Equipment represents nonrecourse liabilities within the meaning of Treasury Regulation Section 1.752-1(a)(2).

(16) PGH expects the Partnership to continue in business for a prolonged period of time, holding the Contributed Equipment, any newly leased assets, and any other Permitted Investments.

III. OPINION

Based upon the facts set forth above, the representations given to Akin Gump by BT Corp. and PGH and the existing law:

(1) We believe that the merger of CWL with and into PGH and the merger of Rail Leasing with and into PGH should each constitute a liquidation of CWL and Rail Leasing, respectively, within the meaning of Section 332 of the Code.

(2) We believe that the Partnership should be treated as a "partnership" and not as an association taxable as a corporation for federal income tax purposes.

(3) We believe that the transfers of (i) the Contributed Equipment (subject to the Nonrecourse Debt) and (ii) the stock of Oneida to the Partnership should constitute transfers governed by Section 721(a) of the Code.

(4) We believe that neither the Partnership's receipt of the Contributed Equipment subject to the Nonrecourse Debt transferred by PGH, nor the Partnership's assumption of the Recourse Debt should be treated as consideration received by PGH subject to Section 707 of the Code (relating to "disguised sales").

(5) We believe that at the time of its contribution of Contributed Equipment subject to the Nonrecourse Debt to the Partnership, PGH should be allocated the Nonrecourse Debt of the Partnership as follows: (i) first, to the extent of PGH's share of Partnership minimum gain, if any, (ii) second, to the extent of the amount of any taxable gain that would be allocated to PGH pursuant to Section 704(c) of the Code with respect to the Contributed Equipment if the Partnership disposed of such Contributed Equipment in a taxable transaction in full satisfaction of the Nonrecourse Debt and for no other consideration and (iii) third, the balance of any remaining Nonrecourse Debt, to PGH in accordance with its share of Partnership profits (95%).

(6) We believe that PGH LLC will be treated as an entity that is disregarded for federal income tax purposes and that the contribution from PGH of its interest in the Partnership to PGH LLC will be treated as a non-event for federal income tax purposes.

(7) In the event that PGH LLC exercises the Retirement Right and receives distributions consisting solely of cash, Contributed Equipment and stock of Oneida, we believe that, except to the extent of cash distributed or deemed distributed to PGH LLC in excess of PGH LLC's basis in its interest in the Partnership, no gain should be recognized upon the exercise of and distribution pursuant to the Retirement Right of PGH LLC. In particular, we believe that if such a distribution to PGH LLC consists of stock of Oneida and/or all or a portion of the Contributed Equipment, the exceptions in sections 737(d)(1), 751(b)(2)(A) and 731(c)(3)(A)(i) should be applicable to such distribution.

(8) We believe that the opinions expressed in Paragraphs 1 through 8 above should not be subject to change under the business purpose doctrine, section 269 of the Code, the substance-over-form doctrine, or the partnership anti-abuse regulations promulgated under section 701 of the Code.

Our opinion is based on the Code as 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. In particular, note that opinion number 8 above relates to possible future transactions analyzed under existing law. Relevant intervening changes in the Code, Treasury regulations or interpretations thereof could change our opinion on such issues.

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.

IV. ANALYSIS

A. LIQUIDATION OF CWL AND RAIL LEASING

Generally, when a wholly owned subsidiary merges with and into its parent corporation, such merger is treated as a subsidiary liquidation under Code section 332. Under Treasury Regulation section 1.332-2(d), "[i]f a transaction constitutes a distribution in complete liquidation within the meaning of the Internal Revenue Code of 1954 and satisfies the requirements of section 332, it is not material that it is otherwise described under the local law." Further, section 332(b)(2) explicitly provides that a shareholder's resolution authorizing the distribution of all the corporation's assets in complete cancellation or redemption of all the stock "shall be considered an adoption of a plan of liquidation."

Section 332(a) provides that "[n]o gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation."

Section 332(b) provides that section 332(a) shall be applicable where the recipient of the distribution is a corporation holding at least 80% by vote and value of the stock of the liquidating corporation at all times on and after the date of the adoption of the plan of liquidation.[8]

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[8] The complete text of section 332 is as follows:

(a) General rule.

No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

(b) Liquidations to which section applies.

For purposes of subsection (a), a distribution shall be considered to be in complete liquidation only if—

(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) meeting the requirements of section 1504(a)(2); and either

In Rev. Rul. 75-521, 1975-2 C.B. 120, the Service held that the 80% control requirement of section 332(b) was met where a corporate shareholder that owned 50% of the stock of a corporation purchased all the remaining stock from individual shareholders and immediately thereafter adopted a plan of complete liquidation of the corporation. There appears to be no reason this result would be changed as a consequence of a corporation acquiring 100% of the stock of the corporation rather than 50% immediately before a liquidation is adopted. As described immediately below, the treatment of liquidations as good liquidations under 332 immediately following a qualified stock purchase (as that term is used in section 338) reinforces this conclusion.

Section 338 was added to the Code in 1982. Pursuant to the applicable legislative history, section 338 is "intended to replace any nonstatutory treatment of a stock purchase [followed by a liquidation] as an asset purchase under the *Kimbell Diamond* doctrine." *See* House-Senate Conference Committee Report, S. Rept. No. 97-530, 97th Cong., 2nd Sess. At 536 (Aug. 17, 1982) 1982-2 C.B. 600, 632. Rev. Rul. 90-95, 1990-2 C.B. 67, affirms that a "qualified stock purchase" of target stock by a corporation followed by a liquidation of the target into the acquirer will not be subject to the application of the step-transaction doctrine. The ruling states:

> [t]he step-transaction doctrine does not apply . . . Asset purchase treatment turns on whether a section 338 election is made (or is deemed made) following a qualified stock purchase. A qualified stock purchase of the target stock has independent significance from a subsequent liquidation of the target into the acquirer regardless of whether section 338 election is made or deemed made.

1990-2 C.B. at 68-69. *See also*, Treasury Regulation section 1.338-2(c)(1).

The Service has ruled privately that successive liquidations of pre-existing corporate subsidiaries satisfy the requirements of section 332(b) of the Code. In Private Letter Ruling 9029030 (April 20, 1990), Parent was a mutual life insurance company which owned 100% of

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(2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(3) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

the stock of Sub 1, a holding company, which in turn owned 100% of the stock of Sub 2. Sub 2 owned stock in several subsidiaries, including 100% of the stock of certain subsidiaries (*"Sub 3"*). In order to streamline Parent's corporate structure and achieve operating efficiencies, and pursuant to successive plans of liquidation to be adopted by Parent and Sub 1, then Parent and Sub 2, and then Parent and Sub 3, each of Sub 1, Sub 2, and Sub 3 would be liquidated. With respect to each liquidation, a representation was made that Parent, on the date of the adoption of the plan of liquidation, and at all times until receipt of the property of the liquidating subsidiary, would be the owner of 100% of the total combined voting power of all classes of stock of such subsidiary entitled to vote. The Service concluded that each liquidation would be treated as a complete liquidation under section 332(a) of the Code.

Similarly, in Private Letter Ruling 9103028 (October 23, 1990), P was the parent corporation and owned 100% of the stock of S1, which in turn owned 100% of the stock of FC1, a foreign corporation. FC1 owned 100% of the stock of FC2, which, in turn owned 100% of S2. In order to achieve an integration of business operations, and pursuant to plans of dissolution, FC2 would be liquidated and, thereafter, pursuant to a separate plan of liquidation, FC1 would be liquidated. As a result of such steps, S1 would become the sole shareholder of S2, formerly held by FC2. Each of FC1 and S1 represented that on the date of the respective plans of liquidation and at all times thereafter until the receipt of property, FC1 and S1, respectively, owned 100% of the voting power and value of the stock of FC2 and FC1, respectively. Again, the Service concluded that each of the proposed liquidations would be treated as a complete liquidation within the meaning of section 332 of the Code.

The steps of the liquidations of CWL and Rail Leasing were consistent with the requirements of section 332(b). In particular the plan of merger of CWL with and into PGH was adopted on September 3, 1998, with the merger becoming effective on September 4, 1998. The plan of merger of Rail Leasing with and into PGH was adopted on September 9, five days after PGH had acquired 100% of the stock of Rail Leasing. Each plan of merger was agreed to by the shareholder of the liquidating corporation and the liquidating corporation itself. In addition, each plan of merger sets forth that it is intended to be a merger for state law purposes and a liquidation within the meaning of Code section 332 for federal income tax purposes. Thus, the mechanics set forth under Code section 332(b) appear to be satisfied both with respect to the merger of CWL with and into PGH and the subsequent merger of Rail Leasing with and into PGH.

Based on the foregoing, we believe that the merger of CWL with and into PGH and the merger of Rail Leasing with and into PGH should each constitute a liquidation of CWL and Rail Leasing, respectively, within the meaning of section 332 of the Code.

B. PARTNERSHIP STATUS OF SENECA LEASING PARTNERS, L.P.

The discussion in this section analyzes whether the Partnership should be treated as a partnership rather than as an association taxable as a corporation for federal income tax purposes. A partnership, for federal income tax purposes, is a business entity that has elected, or defaulted to, partnership classification under the entity classification regulations. *See* Treas. Reg. sections 301.7701-1 through 3 (hereinafter referred to as the "***Check-The-Box Regulations***"). To be eligible to elect classification as a partnership for tax purposes, a particular arrangement must:

(1) qualify as a "separate entity" for federal tax purposes;
(2) be a "business entity" as opposed to a trust;
(3) be an "eligible entity" as opposed to a corporation *per se;*
(4) be composed of two or more members; and
(5) not have elected to be treated as an association taxable as a corporation.

Accordingly, under the Check-The-Box Regulations, a business entity is eligible to elect classification as a partnership for federal income tax purposes if it has two or more members and if it is not mandatory that it be classified as a corporation.

1. SEPARATE ENTITY STATUS

The Check-The-Box Regulations only apply to those organizations which are determined to be separate entities for federal income tax purposes.[9] The determination as to whether an organization is a separate entity for federal tax purposes is a matter of federal tax law, and "does not depend on whether the organization is recognized as an entity under local law." Treas. Regs. section 301.7701-1(a). For this purpose, Treasury Regulation section 301.7701-1(a)(2) defines a separate entity as a joint venture or other contractual arrangement that is entered into, where "the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity for tax purposes exists where co-owners of an apartment building lease space and provide services to the occupants either directly or through an agent." However, where two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes, rather, they have engaged in a joint undertaking merely to share expenses.[10] Treas. Reg. section 301.7701-1(a)(2).

Courts interpreting whether associations or other contractual arrangements constitute separate entities for tax purposes focus on the intentions of the parties involved and the purpose or purposes for the affiliation or other arrangement. For example, a partnership will generally be considered an entity separate from its partners for tax purposes if the partners, in good faith and

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[9] In certain situations, organizations which constitute separate entities for tax purposes are not eligible to make a classification election, such as those that require special treatment under the Code and those taxed as trusts under subchapter J. *See* Treas. Reg. section 301.7701-1(b).

[10] Several types of entities are not recognized as separate entities for federal income tax purposes, including: (1) certain qualified cost sharing arrangements described in Treas. Reg. section 1.482-7; (2) certain local law entities, such as organizations wholly owned by a State if they are an integral part of the State; and (3) certain incorporated tribes. *See* Treas. Reg. section 301.7701-1(a)(3). In addition, organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners. *See* Treas. Reg. sections 301.7701-3.

acting with a business purpose, intend to join together in the present conduct of an enterprise.[11] *See Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949); *ASA Investerings Partnership, AlliedSignal Inc., Tax Matters Partner v. Commissioner*, 76 T.C.M. (CCH) 325 (Aug. 20, 1998); *Cusick v. Commissioner*, 76 T.C.M. (CCH) 241 (Aug. 5, 1998). The standard used to determine whether such an intent exists was articulated by the United States Supreme Court in *Culbertson*, 337 U.S. at 742. The court concluded in that case that a partnership exists for federal income tax purposes only when

> considering all the facts – the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent – the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. *Culbertson*, 337 U.S. at 742.

An association between two corporations was held not to be a valid partnership when considering all of the facts, the parties did not intend to join together in the present conduct of an enterprise. *See ASA Investerings Partnership*, 76 T.C.M. (CCH) 325. In 1991, AlliedSignal expected to realize a $446.7 million capital gain by selling a subsidiary. A member of AlliedSignal's board suggested a tax proposal developed by Merrill Lynch to create an offsetting capital loss to shelter the anticipated gain. The plan involved forming a partnership, ASA Investerings Partnership ("***ASA***"), with a foreign partner, capitalized largely by the foreign partner. The partnership would purchase high-grade, floating-rate private placement notes ("***PPNs***"), and sell them for cash and LIBOR-indexed installment notes. The partnership would report the sale of the PPNs using the installment method, with the foreign majority partner recognizing most of the gain. AlliedSignal would then buy a portion of the foreign partner's interest, with AlliedSignal becoming the majority partner, and the partnership would distribute the LIBOR notes to AlliedSignal. AlliedSignal could then sell the LIBOR notes for a loss which could be used to offset its capital gain.

The court concluded that the parties to the partnership agreement did not join together for the common purpose of investing in interest-bearing instruments and sharing profits and losses. This conclusion was based on the findings that AlliedSignal and its purported partner, Algemene Bank Netherlands, N.V. ("***ABN***")[12], had different business goals, with AlliedSignal entering into the venture to generate capital losses and ABN desiring a specified return with no intention to share profits and losses. The court also found that the partners did not follow partnership formalities; for example, the agreement called for a sharing of losses, but ABN did not want, and did not share in, ASA's losses. The court further found that ABN bore minimal risk of loss on

[11] A corporation may be disregarded as a separate entity for federal income tax purposes if it holds no assets and it lacks a business purpose or any business activity. *See Moline Properties, Inc. v. CIR*, 319 U.S. 436, 438-439 (1943).
[12] Although several other corporations had formed the partnership with AlliedSignal, the court found that the relevant parties were AlliedSignal and ABN. *See ASA Investerings Partnership*, 76 T.C.M. (CCH) 325.

the PPNs and LIBOR notes, and that AlliedSignal approved the plan before it even knew the identity of the foreign partner. AlliedSignal was obligated to pay all expenses, and it made all critical management decisions. Thus, the court concluded that, rather than creating a partnership, AlliedSignal and ABN had created a debtor-creditor relationship, with AlliedSignal as the borrower and ABN as the creditor. Accordingly, ASA was not treated as an entity separate from AlliedSignal and ABN for federal income tax purposes.

In another case, an association between two parties constituted a valid partnership, and therefore, a separate taxable entity, even though no formal partnership agreement was entered into, because, considering all the facts, the parties intended to join together in the present conduct of an enterprise. *See Cusick*, 76 T.C.M. (CCH) 241. Between 1987 and 1991, two parties, an individual and a married couple, purchased property as tenants in common. Each party contributed half of the capital, and they agreed to share profits and losses equally. In addition, they each handled management at various times, by maintaining books and records, collecting rent, and repairing various maintenance tasks. When they sold one property on an installment basis, they split the proceeds equally. Based on these facts, the court concluded that the arrangement between the two parties constituted a joint venture carrying on a "business, financial operation, or venture" and therefore that it fell within the statutory definition of a partnership. As such, the partnership was treated as a separate entity for federal tax purposes.

When forming the Partnership, PGH, BT Leasing, and EN-BT Delaware entered into the Partnership Agreement and each contributed assets or cash proportionate to their respective interests. Furthermore, they agreed to divide Profits and Losses in accordance with the Partners' relative percentage ownership interests, unless PGH's capital account should drop below $68,013,558, in which case the Partners' interests in the allocation of Profits and Losses would flip.[13] Moreover, under section 5 of the Partnership Agreement, the Partners agreed that the General Partners will manage and control the business of the Partnership and the Limited Partner will compensate them for their expenses and services by means of a management fee. The Partners have represented that the Transaction documents were negotiated at arm's length including the valuation of the assets contributed to the Partnership, and that all future transactions affecting the relative rights of the Partners will be undertaken at arm's length. The Partners have further represented that they expect a reasonable commercial positive economic return from their investment in the Partnership after consideration of fees and expenses in connection with the Transaction. All allocations and distributions are based on the fair market value of the Partnership's assets, which are, for the most part, expected to be leased assets and leased personal property, which values will fluctuate and should be distinguished from financial assets such as those in *ASA Investerings*, which were less likely to fluctuate. Thus, unlike in *ASA Investerings*, this relationship reflects the sharing of profits and losses. The Partners' business intentions and expectations regarding the formation of the Partnership are discussed further in the Business Purpose section.

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[13] Under the terms of the Partnership Agreement, if PGH's capital account drops below $68,013,558, PGH will be allocated 1% of the Profits and Losses, and the General Partners will be allocated 99% of the Profits and Losses.

Based on the foregoing discussion, we believe that the Partnership should be treated as an entity separate from its partners for federal tax purposes.

2. "BUSINESS ENTITY" STATUS

Only "business entities" are eligible to elect treatment as partnerships. *See* Treas. Reg. section 301.7701-2. A "business entity" is an entity that is not a trust, as such term is defined by Treas. Reg. section 301.7701-4.

The Partnership does not fall into the definition of a trust under Treasury Regulations section 301.7701-4. The Partners formed the Partnership to actively participate in a number of business activities identified in Section 1.3 of the Partnership Agreement, including leasing activities related to the Contributed Equipment and newly acquired leased assets. The Partnership was not created by will or by an inter vivos declaration, nor was the Partnership formed for the purpose of "the protection and conservation of property for beneficiaries." Thus, the Partnership should qualify as a "business entity."

3. "ELIGIBLE ENTITY" STATUS

Business entities are divided into two categories: (i) those that are treated as corporations *per se*, and (ii) "eligible entities." *See* Treas. Reg. 301.7701-3(a). An "eligible entity" is a business entity that is not classified as a corporation *per se*. Corporations *per se* include business entities "organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic" and any business entity "organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association." Treas. Reg. sections 301.7701-2(b)(1) and (3). In addition, the *per se* category of corporations includes certain business entities conducting banking activities, entities taxable as insurance companies, entities wholly owned by a State or any political subdivision thereof, those entities that are taxable as corporations under a provision of the Code other than section 7701(a)(3), and certain foreign entities listed in the Treasury Regulations. Treas. Reg. sections 301.7701-2(b)(4)-(8).

The Partnership does not fall into any of the categories defining a *per se* corporation and, therefore, should be considered an "eligible entity."

4. TWO OR MORE MEMBERS

A domestic eligible entity established after December 31, 1996, with two or more members will be treated, by default, as a partnership for federal income tax purposes. *See* Treas. Reg. section 301.7701-3(b)(1)(i).

Single owner entities may not elect to be classified as a partnership for federal income tax purposes. In fact, absent an election, an eligible entity with a single owner will not be treated as an entity separate from its owner. However, such entities can elect to be classified as an association taxable as a corporation. *See* Treas. Reg. sections 301.7701-1(a)(4), -3(a), -3(b)(ii).

The Partnership is composed of three partners, and was established after December 31, 1996. Thus, the Partnership should be considered a partnership for federal income tax purposes by default.

5. ELECTION TO BE TREATED AS AN ASSOCIATION TAXABLE AS A CORPORATION

The default classification may be overridden by an affirmative election. Thus, eligible entities that are not satisfied with their default classification may elect the other classification. *See* Treas. Reg. section 301.7701-3(c)(1)(i).[14] No such election has been made for the Partnership.

For the foregoing reasons, we believe that the Partnership should be treated as a partnership for federal income tax purposes.

C. TAX-FREE CONTRIBUTION OF PROPERTY UNDER CODE SECTION 721

Section 721(a) provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." Thus, as the Contributed Equipment and Oneida stock are clearly "property," no gain or loss should be recognized by PGH on its contribution of the Contributed Equipment and Oneida stock to the Partnership except to the extent that an exception applies.[15]

Section 721(b) provides that "[s]ubsection (a) shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated." Section 351(e) and the Treasury regulations thereunder provide that a corporation is an "investment company" at any particular time if more than 80% of its assets consist of certain defined categories of investment assets at such time (taking into account plans in existence at that time). Treas. Reg. sections 1.351-1(c)(1) and (2). Because at the time of PGH's contributions to the Partnership, the Contributed Equipment constituted more than 20% of the assets of the Partnership and the

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[14] An entity may not elect to change its classification more than once every five years without permission from the Internal Revenue Service. *See* Treas. Reg. section 301.7701-3(c)(1)(iv). However, this rule does not apply to eligible entities that existed on the day the Check-The-Box Regulations were finalized. *See* Treas. Reg. section 301.7701-3(b)(3).

[15] Such exceptions and their applicability to the Transaction are discussed in sections ______ herein.

Contributed Equipment does not fall into any of the categories of investment assets listed in section 351(e)(1) (taking into account plans in existence at that time), the Partnership should not be an "investment company" and section 721(b) should be inapplicable.

Based on the foregoing analysis, we believe that the transfers of (i) the Contributed Equipment (subject to the Nonrecourse Debt) and (ii) the stock of Oneida to the Partnership should constitute transfers governed by section 721(a) of the Code.

D. ANALYSIS OF DISGUISED SALES

Section 707, relating to "disguised sales," can also apply (as an exception to nonrecognition under section 721(a)) to certain transactions that, in form, are contributions of property to a partnership that otherwise are governed by section 721.[16] Generally, under section 707, if the partnership that receives a contribution of property from a partner also tenders consideration other than a partnership interest ("*other property*") to the partner in return for such contribution, the part of the property contributed to the partnership by the partner for the other property will be treated as sold by the partner to the partnership in a taxable transaction. Treas. Reg. section 1.707-3(a)(1).[17]

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[16] section 707 (a) provides as follows: Partner not acting in capacity as partner.

(1) In general. -- If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(2) Treatment of payments to partners for property or services. -- Under regulations prescribed by the Secretary --

(A) Treatment of certain services and transfers of property. If --

(i) a partner performs services for a partnership or transfers property to a partnership,

(ii) there is a related direct or indirect allocation and distribution to such partner, and

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in paragraph (1).

(B) Treatment of certain property transfers. If --

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

[17] Treas. Reg. section 1.707-3(a) provides as follows:

In particular, with respect to PGH's contributions to the Partnership pursuant to the Transaction, the Partnership's assumption of the Recourse Debt or the Partnership's taking subject to Nonrecourse Debt may be considered to be, in whole or part, other property received by PGH unless the Nonrecourse Debt and Recourse Debt are "qualified liabilities" within the meaning of Treasury Regulation section 1.707-5. Treasury Regulation section 1.707-5(a)(1) provides the general rule regarding the assumption of the liabilities of a partner in connection with a capital contribution of property to a partnership:

> [I]f a partnership assumes or takes property subject to a qualified liability of a partner, the partnership is treated as transferring consideration to the partner only to the extent provided in paragraph (a)(5) of this section. By contrast, if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability [referred to hereinafter as a "nonqualified excess liability or "NEL"], as provided in paragraphs (a)(2), (3) and (4)...

Because no portion of the Recourse Debt assumed by the Partnership should be allocable to PGH, if the Recourse Debt is not a qualified liability, 100% of the amount of the Recourse Debt could be treated as paid to PGH in a disguised sale from some part of the Leased Equipment or the Oneida stock.

With respect to nonrecourse liabilities that are not qualified liabilities, paragraph (a)(2)(ii) provides:

> *Nonrecourse liability*. A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the

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(1) *In general.* Except as otherwise provided in this section, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in paragraph (b)(1) of this section, the transfers are treated as a sale of property, in whole or in part, to the partnership.

(2) *Definition and timing of sale.* For purposes of §§1.707-3 through 1.707-5, the use of the term sale (or any variation of that word) to refer to a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to a partner means a sale or exchange of that property, in whole or in part, to the partnership by the partner acting in a capacity other than as a member of the partnership, rather than a contribution and distribution to which sections 721 and 731, respectively, apply. A transfer that is treated as a sale under paragraph (a)(1) of this section is treated as a sale for all purposes of the Code (e.g., sections 453, 483, 1001, 1012, 1031 and 1274). The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered the owner of the property. If the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership, the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration.

> partner's share of the excess nonrecourse liability under §1.752-3(a)(3) [i.e., the residual profit sharing percentages]. A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under §1.752-1(a)(2)[18] or would be a nonrecourse liability of the partnership under §1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section.

Applying these rules, and subject to the limitations addressed below, if the Nonrecourse Debt were not a qualified liability, approximately 5% of the Nonrecourse Debt (i.e., $8.5 million) would be an NEL treated as consideration paid for a portion of the Equipment in a taxable transaction.

In the event that the Nonrecourse Debt is not a qualified liability, the Treasury Regulations potentially provide that an even greater percentage of the Nonrecourse Debt would be treated as part of the disguised sale transaction. Treasury Regulation section 1.707-5(a)(3) provides:

> For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if –
>
> (i) At the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and
>
> (ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a sale under § 1.707-3.

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[18] The Nonrecourse Debt will be a "nonrecourse liability" under Treasury Regulation section 1.752-1(a)(2) "to the extent that no partner or related person bears the economic risk of loss for that liability under §1.752-2." Under Treasury Regulation section 1.752-2(b), "a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner." Thus, in short, the Nonrecourse Debt will be a "nonrecourse liability" only to the extent that no partner or a related person bears any risk of loss with respect to the Nonrecourse Debt. PGH has represented that the Nonrecourse Debt is a "nonrecourse liability" within the meaning of Treasury Regulation section 1.752-1(a)(2). PGH has also represented that none of BT Leasing, EN-BT Delaware, PGH or their affiliates is liable for such debt (other than through the loss of the Contributed Equipment pursuant to a foreclosure), and that none of such persons is the lender with respect to any portion or all of the Nonrecourse Debt. Finally, there is no explicit restoration obligation by a Partner or the Partnership with respect to the Nonrecourse Debt in the Partnership Agreement.

Thus, under section 707, the ability of PGH to pick and choose which assets to take upon exercise of its Retirement Right could be treated as a provision that results in the anticipated reduction of the allocation of the Nonrecourse Debt to PGH. In this event, if the Nonrecourse Debt were not a qualified liability, then $169 million of the contributed property (i.e., the Contributed Equipment, and perhaps the Oneida stock) might be treated as sold pursuant to a disguised sale upon contribution (generating significant taxable gain to PGH). This test is subjective and will be applied in hindsight. Consequently, the Nonrecourse Debt and the Recourse Debt must be qualified liabilities in order to avoid gain recognition under the disguised sale rules.[19]

Qualified Liabilities. Treasury Regulation section 1.707-5(a)(6) defines the term "qualified liability" for purposes of the contribution of property by a partner to a partnership as follows:

> (6) *Qualified liability of a partner defined.* A liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is a qualified liability of the partner only to the extent –
>
> (i) The liability is –
>
> (A) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;
>
> (B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a property transfer or of a written agreement to transfer);

[19] The 5% (i.e., $8.5 million) portion of the Nonrecourse Debt represents the difference between the amount of the Nonrecourse Debt and PGH's share of the Partnership nonrecourse liabilities. As noted above, PGH's share of the Partnership Profits and Losses is 95%, unless and until its capital account drops below approximately $68 million. At such time, PGH's share of the Partnership Profits and Losses is reduced to 1%. Under Treasury Regulation section 1.752-3(a)(3), a "partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners." Thus, if the Nonrecourse Debt is not a qualified liability under Treas. Reg. section 1.707-5, PGH's percentage share of the excess nonrecourse liabilities may actually be less than 95%, thereby decreasing its share of the Nonrecourse Debt and increasing the amount of gain recognized by PGH.

(C) A liability that is allocable under the rules of §1.163-8T to capital expenditures with respect to the property; or

(D) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; and

(ii) If the liability is a recourse liability, the amount of the liability does not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraph (a)(6)(i)(C) or (D) of this section) at the time of the transfer.

Application to Nonrecourse Debt. Each of (i)(A) – (D) is analyzed below to determine if the Nonrecourse Debt meets the definition of a "qualified liability." Neither (A) nor (B) would literally apply to the Nonrecourse Debt because the Contributed Equipment was transferred subject to the Nonrecourse Debt from Rail Leasing and CWL in section 332 liquidations prior to the Transaction. In particular, "(A)" is not literally applicable because PGH did not itself incur the Nonrecourse Debt more than two years prior to its contribution of the Contributed Equipment to the Partnership, but rather took the Contributed Equipment subject to such Nonrecourse Debt pursuant to the merger of CWL into PGH and the merger of Rail Leasing into PGH. The provisions under "(B)" also may not be literally applicable under the argument that PGH incurred the Nonrecourse Debt in anticipation of its contribution of the Contributed Equipment subject to the Nonrecourse Debt to the Partnership.[20] It is also not clear that "(D)" would be applicable and further factual information would be needed to make such determination. However, if the Nonrecourse Debt would be a "qualified liability" in the hands of either Rail Leasing or CWL were either of them to participate in the Transaction directly, then paragraph (C), which invokes the tracing rules of Treasury Regulation section 1.163-8T, should be applicable. PGH has represented that CWL and Rail Leasing originally incurred the Nonrecourse Debt on their respective items of Contributed Equipment and that all of the proceeds of the Nonrecourse Debt were used to pay the purchase price on their respective items of Contributed Equipment. Furthermore, PGH has represented that each component of the Nonrecourse Debt has encumbered the related Contributed Equipment for more than two years prior to the date of the Transaction.

Treas. Reg. section 1.163-8T(c)(1) provides the general rule for the allocation of debt proceeds to various expenditures:

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[20] In the case of either "(A)" or "(B)", however, a court may well find the acquisition of the Contribution Equipment in transactions governed by section 381 to include the history of the predecessors.

> *Allocation in accordance with use of proceeds.* Debt is allocated to expenditures in accordance with the use of the debt proceeds and, except as provided in paragraph (m) of this section, interest expense accruing on a debt during any period is allocated to expenditures in the same manner as the debt is allocated from time to time during such period. Except as provided in paragraph (m) of this section, debt proceeds and related interest expense are allocated solely by reference to the use of such proceeds, and the allocation is not affected by the use of an interest in any property to secure the repayment of such debt or interest.

Also relevant is Treas. Reg. section 1.163-8T(c)(3)(ii):

> (ii) *Debt assumptions not involving cash disbursements.* If a taxpayer incurs or assumes a debt in consideration for the sale or use of property, for services, or for any other purpose, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated for purposes of this section as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property, services, or other purpose.

Thus, under the debt proceeds tracing rules, since PGH acquired the Contributed Equipment from CWL or Rail Leasing subject to the Nonrecourse Debt (and the Nonrecourse Debt is otherwise a qualified liability with respect to CWL or Rail Leasing, whichever is applicable), then the Nonrecourse Debt should be treated as a qualified liability for purposes of the Transaction. Moreover, under section 8.3(a) of the Partnership Agreement, PGH LLC (as successor to PGH) has the right to direct the Partnership to allocate liabilities of the Partnership for purposes of Treasury Regulations section 1.163-8T. Thus, the Nonrecourse Debt should remain a qualified liability.

Application to Recourse Debt. The analysis of the treatment of the Recourse Debt as a qualified liability is similar to the analysis of the status of the Nonrecourse Debt as a qualified liability. The proceeds of the Recourse Debt, which was originally incurred by PGH, were directly paid by Toronto Dominion into Oneida at the direction of PGH. Thus, the proceeds should be treated as directly traceable as a capital expenditure with respect to the stock of Oneida under the rules of Treasury Regulation section 1.163-8T.

Based on the foregoing analysis, we believe that neither the Partnership's receipt of the Contributed Equipment subject to the Nonrecourse Debt transferred by PGH, nor the Partnership's assumption of the Recourse Debt should be treated as consideration received by PGH subject to the disguised sale rules of section 707 of the Code.

The balance of this Opinion assumes that the Recourse Debt and the Nonrecourse Debt are qualified liabilities for purposes of the contributions to the Partnership by PGH in the Transaction.[21]

E. ALLOCATION OF LIABILITIES UNDER SECTION 752

1. ALLOCATION OF NONRECOURSE DEBT

With respect to the Nonrecourse Debt, under section 752(b) and (c), upon contribution of the Contributed Equipment subject to the Nonrecourse Debt, the Partnership is treated as making a cash distribution to PGH equal to the $170 million amount of the Nonrecourse Debt to which the Contributed Equipment is subject (so long as the amount of the Nonrecourse Debt does not exceed the value of the Contributed Equipment). Under section 752(a), any increase in PGH's allocable share of Partnership liabilities attributable to the Partnership taking the Contributed Equipment subject to the $170 million of Nonrecourse Debt will be treated as a contribution of cash by PGH to the Partnership. In the context of a single transaction, the increases and decreases to basis under section 752 are netted. Treas. Reg. section 1.752-1(f). Thus, to determine whether there has been a net cash distribution to PGH pursuant to the Transaction, as a result of the Partnership's assumption of the Nonrecourse Debt, the amount of the Nonrecourse Debt allocable to PGH under section 752(a) must be determined.

Assuming the Nonrecourse Debt is a "nonrecourse liability" within the meaning of the Treasury Regulations under section 752[22], the $170 million of Nonrecourse Debt will be allocated among the three Partners of the Partnership pursuant to Treasury Regulation section 1.752-3(a) in the following order:

> In general. A partner's share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows --
>
> (1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder ("Tier (1)");
>
> (2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities

[21] Disclosure of the assumption of a liability by a partnership is required in certain circumstances under Treasury Regulations section 1.707-5(a)(7)(ii) if the liability is not subject to tracing under Treasury Regulation section 1.163-8T. It would be expected that the assumption of the Recourse Debt and the Nonrecourse Debt by the Partnership would not be subject to this requirement as the proceeds will be directly traceable to the stock of Oneida and the Contributed Equipment.

[22] PGH has represented that the Nonrecourse Debt constitutes a "nonrecourse liability" under Code section 752.

of the partnership in full satisfaction of the liabilities and for no other consideration ("Tier (2)"); and

(3) The partner's share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits ("Tier (3)").

With respect to Tier (1), partnership minimum gain is the excess, if any, of the amount of the nonrecourse indebtedness that is secured by partnership property over the section 704(b) book value ("book value") of the property. Initially, the Partnership will have zero partnership minimum gain because the initial book value of the Contributed Equipment will be \$280 million, which is in excess of the \$170 million of Nonrecourse Debt. Thus, none of the Nonrecourse Debt should initially be allocated pursuant to Tier (1).

With respect to Tier (2), the amount of potential section 704(c) gain to PGH is approximately \$272 million (i.e., the excess of the \$280 million book value of the Contributed Equipment over its tax basis of approximately \$8 million). The minimum section 704(c) gain described in Tier (2) is \$162 million (or \$170 million of Nonrecourse Debt less the tax basis of approximately \$8 million). Thus, under Tier (2), approximately \$162 million of the \$170 million of Nonrecourse Debt would be allocated to PGH at the time of its contributions to the Partnership.

The remaining \$8 million of basis would be allocated in proportion to the Tier (3) residual sharing ratios, which is agreed in section 3 of the Partnership Agreement to be 95%.

Under the netting rule, the net impact of the contribution of the Nonrecourse Debt by PGH pursuant to the Transaction is certainly less than \$8 million, and thus no deemed distribution or contribution in excess of basis results from the operation of section 752.

Based on the foregoing, we believe that at the time of its contribution of Contributed Equipment subject to the Nonrecourse Debt to the Partnership, PGH should be allocated the Nonrecourse Debt of the Partnership as follows: (i) first, to the extent of PGH's share of Partnership minimum gain, if any, (ii) second, to the extent of the amount of any taxable gain that would be allocated to PGH pursuant to section 704(c) of the Code with respect to the Contributed Equipment if the Partnership disposed of such Contributed Equipment in a taxable transaction in full satisfaction of the Nonrecourse Debt and for no other consideration, and (iii) third, the balance of any remaining Nonrecourse Debt, to PGH in accordance with its share of Partnership profits (95%).

2. ALLOCATION OF RECOURSE DEBT

With respect to the Recourse Debt which will be assumed by the Partnership, because PGH is a limited partner in the Partnership, the BT Partners (in the aggregate) will be allocated the entire amount of the Recourse Debt. Underlying this conclusion is the assumption that the Recourse Debt is "assumed" for purposes of the Code. Under section 752(a) an increase in a partner's individual liabilities by reason of the assumption of partnership liabilities by the partner is treated as a contribution of money by the assuming partner. Treasury Regulation section 1.752-1(d) states that a person is considered to have assumed a liability only if--

(1) The assuming person is personally obligated to pay the liability; and

(2) If a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner would bear the economic risk of loss for the liability immediately after the assumption.

Prior to the adoption of these Regulations, the Service's position was that a partner did not "assume" a debt for purposes of section 752 unless there was a "novation" with respect to the original obligor. *See* Priv. Ltr. Rul. 8404012 (where the IRS ruled that a partner had not "assumed" partnership debt, for purposes of section 752 and section 465, as long as the partnership remained liable on such debt under state law irrespective of the partnership's right to proceed against the assuming partner for the payment of the liability). The Tax Court, however, has consistently ruled that an "assumption" under section 752 does not require a "novation" with respect to the original obligor so long as the assuming partner has "*ultimate liability*" with respect to the liability assumed, whether by contract or otherwise. *See, Smith v. Commissioner*, 84 T.C. 889, Tax Ct. Rep. (CCH) 42,096 (1985), affirmed 805 F.2d 1073 (1986); *Abramson v. Commissioner*, 86 T.C. 360, Tax Ct. Rep. (CCCH) 42,919 (1986) and *Gefen v. Commissioner*, 87 T.C. 1471, Tax Ct. Rep. (CCH) 43,600 (1986). *See also, Peters v. Commissioner*, 89 T.C. 423, Tax Ct. rep. (CCH) 44,173 (1987) (holding that a limited partner had not "assumed" a debt for purposes of section 465 where he was not "ultimately liable" for the repayment of the debt under state law).

By analogy to these specific requirements for a partner's assumption of a liability, the Partnership's assumption of the Recourse Debt has been structured so that the Partnership is ultimately liable for the amount assumed even though there is no "novation" with respect to PGH. In the Transaction, pursuant to the Contribution Agreement, the Partnership assumed the Recourse Debt. Until the Recourse Debt was satisfied, Enron remained a guarantor on such Recourse Debt. However, in the event that Enron would have been required to make a payment under the guaranty, upon full satisfaction of the Recourse Debt, Enron would have had the right to claim reimbursement from the Partnership.

The assumption by the Partnership of the Recourse Debt pursuant to the Transaction with no allocation of such liability to PGH will result in a deemed distribution to PGH of the amount of the Recourse Debt. Such deemed distribution will reduced PGH's basis in its Partnership interest by $250 million.

An assertion that the Partnership does not have sufficient assets to satisfy any obligation to reimburse Enron should be disregarded, because pursuant to section 12.3 of the Partnership Agreement, the BT Partners are obligated to restore any negative capital account balances which may result from reimbursing Enron. Furthermore, if for some reason the BT Partners are unable to fulfill this obligation, BT Corp. is obligated to restore any negative capital account balances pursuant to the BT Guaranty and Indemnification Agreement. Pursuant to Treasury Regulation section 1.752-2(b)(6), "[f]or purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation." In the present situation, the facts and circumstances indicate that the Partnership did not intend to circumvent or avoid any of its obligations. On the contrary, not only did the Partnership contain valuable leased assets, as well as other Permitted Investments which it could have sold to fulfill its obligations, there are also the obligations of the General Partners and the guaranty of BT Corp. to perform if the Partnership is unable to do so. These facts demonstrate an intent not to circumvent or avoid satisfying any such obligations. Therefore, it should be presumed that the Partnership will be able to fulfill any obligation it has to reimburse Enron.

Based on the foregoing analysis, at the time of the assumption of the Recourse Debt by the Partnership, the BT Partners should be allocated the Recourse Debt.

F. TAX TREATMENT OF PGH LLC

Immediately after the Transaction, PGH's interest in the Partnership was transferred to PGH LLC, a wholly owned limited liability company.

Treasury Regulation section 1.7701-3 provides as follows:

(c) Other business entities. For federal tax purposes—

(1) The term partnership means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.

(2) Wholly owned entities. (i) In general. A business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.

PGH has represented that it wholly owns PGH LLC and that it has opted to treat PGH LLC as an entity that is disregarded for federal income tax purposes. Thus, for federal income tax purposes, PGH LLC will be disregarded as an entity separate from PGH. Accordingly, the tax analysis is the same as if PGH had continued to hold the limited partnership interest in the Partnership.

Based on the foregoing analysis, we believe that PGH LLC will be treated as an entity that is disregarded for federal income tax purposes and that the contribution from PGH of its interest in the Partnership to PGH LLC will be treated as a non-event for federal income tax purposes.

G. TAX CONSEQUENCES OF A DISTRIBUTION OF PARTNERSHIP ASSETS

1. GENERAL RULES

In the event that PGH exercises the Retirement Right, it would be treated as receiving a distribution from the Partnership in liquidation of its interest in an amount equal to its allocable share of the Partnership liabilities (under section 752) from which it is relieved, *net of* any liabilities assumed by PGH in connection with the liquidation of its interest.[23] Second, PGH would be treated as receiving a distribution of any Partnership assets actually distributed.[24] Under section 731(a)(1) of the Code, "gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution." Thus, PGH would recognize gain under section 731(a)(1) only to the extent that the net reduction in PGH's share of liabilities that result from the liquidation of its interest through exercise of its Retirement Right (which net reduction amount is treated as a distribution of money) exceeds the tax basis of PGH in its interest in the Partnership immediately before the liquidation of its interest in the Partnership. Since PGH's tax basis would have been increased under section 752 by the prior allocation to it of precisely the liabilities from which it would be relieved under section 752 by virtue of the exercise of its Retirement Right, PGH should not be treated as having been relieved of liabilities in excess of its tax basis (which excess, if any, would constitute recognized gain under section 731). The one case in which gain could arise under section 731 will be if PGH has been allocated losses from the Partnership.

PGH's initial tax basis in the Partnership after the Transaction should be approximately equal to its aggregate tax basis in the contributed property (the Oneida Stock and Leased Equipment), except that such aggregate tax basis must be (i) decreased by the amount of the Recourse Debt, (ii) decreased by the amount of the Nonrecourse Debt, and (iii) increased by the

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23 Under the netting rule of Treasury Regulation section 1.752-1(f), the decrease in PGH's allocable liabilities under section 752 and the assumption by PGH of any Partnership liabilities are netted to determine a net deemed distribution (or contribution).

24 Section 10.8 of the Partnership Agreement gives PGH the right to select which assets should be distributed to it upon exercise of its Retirement Right.

portion of the Nonrecourse Debt allocated to PGH under section 752. Inasmuch as adjustment (i) should roughly offset PGH's tax basis in Oneida stock and adjustment (ii) should roughly offset adjustment (iii), the initial basis of PGH in its Partnership interest will be approximately equal to its pre-contribution tax basis in the Leased Equipment. If, as a result of the exercise of its Retirement Right, PGH receives no property subject to Nonrecouse Debt and assumes none of the Recourse Debt, then the decrease in its share of the $169 million Nonrecourse Debt would result in a deemed cash distribution to PGH, which in turn would result in taxable gain to PGH if such deemed cash distribution exceeded PGH's basis in its Partnership interest. If PGH either received Leased Equipment subject to Nonrecourse Debt or assumed a portion of the Recourse Debt, then under the netting rule of Reg. section 1.752-1(f) then any such taxable gain would be reduced or eliminated.

Also as a result of the exercise of its Retirement Right, under section 732(b)[25], PGH would take a basis in the assets distributed to it equal to its basis in its interest in the Partnership immediately before the liquidation of its interest decreased (but not below zero) by the net liability reduction resulting from the transaction, or increased by the net liability increase.

Several technical rules (including exceptions to these general rules) are analyzed below to determine whether they change the result described above.

2. SECTION 737

The general rule of section 737 provides:

> (a) General rule.--In the case of any distribution by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of --
>
> > (1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of such partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or
> >
> > (2) the net precontribution gain of the partner.
>
> Gain recognized under the preceding sentence shall be in addition to any gain recognized under section 731. The character of such gain shall be

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[25] Section 732(b) reads:

(b) *Distributions in liquidation.* The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

determined by reference to the proportionate character of the net precontribution gain.

Section 737(a)(1) is generally applicable to protect the flip side of section 704(c) (*i.e.*, while section 704(c) triggers gain to a partner that contributed appreciated property to a partnership on the distribution of such contributed property to a noncontributing partner, section 737 triggers gain on the distribution of non-contributed property to such contributing partner). Thus, subject to certain limitations discussed below, section 737(a)(1) causes gain to be recognized to a contributing partner who has contributed appreciated property to a partnership if other property (other than money) is distributed to the contributing partner within seven years of the contribution of the appreciated property to the partnership.

Section 737(d)(1) provides as follows:

> If any portion of the property distributed consists of property which had been contributed by a distributee partner to the partnership, such property shall not be taken into account under subsection (a)(1) and shall not be taken into account in determining the amount of the net precontribution gain. If the property distributed consists of an interest in an entity, the preceding sentence shall not apply to the extent that the value of such interest is attributable to property contributed to such entity after such interest had been contributed to the partnership.

Accordingly, pursuant to the literal terms of section 737(d)(1), any distribution of contributed property back to the contributing partner is exempt from the application of section 737(a)(1).[26]

The legislative history to section 737 expressly affirms the exception provided in section 737(d)(1) and contains an example of previously contributed property in the form of stock in a corporation. The example assumes that A and B form a partnership to which A contributes appreciated property X and B contributes appreciated property Y. In addition, A contributes the stock of C, a corporation with no substantial assets. Subsequent to the contributions, the partnership contributes property Y to C and then distributes the stock of C back to A. Technically, the distribution of the C stock is a distribution of property contributed by the distributee partner. Under the second sentence of section 737(d)(1), however, the exception in section 737(d) will not apply to the extent that the value of the C stock is attributable to property contributed to C after the interest in C was contributed to the partnership. The example provides that upon the distribution of the stock of C to A, A must include in income its gain with respect to property X to the extent that the value of the C stock (taking into account

[26] For this reason, it is important that the contributions made by PGH qualify as a contribution and not (even in part) as a disguised sale. Contribution status also is important for purposes of the exceptions to section 751(b) and section 731(c) as discussed *infra*.

the value of property Y) exceeds A's basis in its partnership interest. The example clearly contemplates that the distributed C stock triggers section 737(a)(1) only to the extent of the value of the C stock that is attributable to the Y property. Clearly missing from this example is any indication that the distribution of the C stock triggers gain under section 737(a)(1) in the absence of the prior contribution of the Y property to C. By negative inference, this example therefore confirms the plain language of the statute.

The Treasury Regulations promulgated under section 737 provide an even more specific example of the exception under section 737(d)(1). Example 2 of Treasury Regulation section 1.737-2(e) provides that A, B, and C form a partnership to which (i) A contributes property A with a value of $10,000 and a tax basis of $5,000, along with all the stock of corporation X with a value and tax basis of $500; (ii) B contributes $500 cash and property B with a value and tax basis of $10,000; and (iii) C contributes $10,500 cash. After formation, the partnership contributes property B to corporation X in a nonrecognition transaction under section 351. Subsequently, all the stock of X is distributed to A in complete liquidation of A's interest in the partnership.

The example concludes that the stock of X is treated as previously contributed property with respect to A only to the extent of the $500 fair market value of the X stock (*i.e.*, as determined without regard to the contribution to X of property Y). Since the actual value of the X stock distributed equals $10,500 ($500 original value plus $10,000 from the property B contribution), $10,000 of the value of the X stock distributed is taken into account for purposes of section 737(a)(1), resulting in A's recognition of its entire $5,000 gain on property A.

This example clearly contemplates that the portion of the X stock value that does not relate to the partnership's contribution of assets to X is not taken into account for purposes of section 737(a)(1). *See also*, Treas. Reg. section 1.737-2(d)(2) (making clear that the adverse rule for contributions by the partnership to X does not apply if the contributed asset previously had been contributed to the partnership by A, the distributee partner).

Therefore, the distribution of assets to PGH in an amount equal to the value of PGH's capital account should not trigger gain to PGH under section 737(a)(1) to the extent that the distributed assets are assets previously contributed to the Partnership by PGH. Pursuant to the plain language of section 737(d), to the extent the distributed assets consist of stock of Oneida, an entity previously contributed by PGH, the distribution would not trigger gain under section 737(a)(1) if the value of the interest in Oneida is not attributable to assets contributed to Oneida after PGH's contribution of the stock of Oneida to the Partnership. Pursuant to section 6.4 of the Partnership Agreement, the Partnership may not make any contributions to Oneida without the express consent of PGH. Thus, upon exercise of its Retirement Right, distributions to PGH should come within the provisions of section 737(d)(1).

Treasury Regulation section 1.737-4 is a broadly worded anti-abuse Regulation granting the Commissioner authority to "recast the transaction" where "a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 737." Each of the examples deals with distributions to a partner of property other than property that was contributed by that partner. The Treasury Regulations contain no inference that they are intended to override the express prohibition on the application of section 737(a)(1) that is found in section 737(d).

3. SECTION 751

Section 751(b)(1)[27] is intended to impose tax in the case of a distribution that results in an effective exchange by a partner of a portion of its interest in "hot assets" (i.e., substantially appreciated inventory or unrealized receivables, which, of particular significance with respect to the Contributed Equipment or any future purchased leased assets (hereinafter together referred to as ***"Leased Assets"***), includes potential section 1245 recapture amounts). If the property selected by PGH to be distributed to it pursuant to its Retirement Right is the stock of Oneida, such distribution would result in the receipt by PGH of two properties from the Partnership – the stock of Oneida and a deemed distribution of money under section 752(b) as a result of an elimination of the allocation to PGH of its share of the debts of the Partnership. In addition, exercise of the Retirement Right could result in the elimination of the interest of PGH in the Leased Assets if it does not select such assets. Thus, unless section 751(b)(1) is not otherwise inapplicable to such a distribution upon exercise of the Retirement Right, PGH may be treated as realizing ordinary income equal to part or all of the potential depreciation recapture in the Leased Assets as a result of its disposition of its interest in the Leased Assets upon its withdrawal from the Partnership.

Section 751(b)(2)(A) provides an exception to the income recognition mandated by section 751(b)(1) as follows:

> (2) Exceptions.
> Paragraph (1) shall not apply to (A) a distribution of property which the distributee contributed to the partnership...

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[27] (1) General rule.

To the extent a partner receives in a distribution --

(A) partnership property which is --

(i) unrealized receivables, or

(ii) inventory items which have appreciated substantially in value, in exchange for all or a part of his interest in other partnership property (including money), or

(B) **partnership property (including money)** other than property described in subparagraph (A)(i) or (ii) in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii), such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

This exception is on its face applicable to the distribution of the stock of Oneida and the Contributed Equipment to PGH because PGH contributed such assets to the Partnership in a transaction governed by section 721. This exception would also appear to be equally applicable to the deemed distribution of money to PGH under section 752(b) because the money deemed distributed upon reallocation of the Nonrecourse Debt to the BT Partners upon a distribution pursuant to the exercise of PGH's Retirement Right reasonably is treated as the same money deemed contributed by PGH to the Partnership under section 752(a) upon the initial allocation of the Nonrecourse Debt to PGH at the time of the Transaction. Section 752(a) and (b) read as follows:

> (a) Increase in partner's liabilities.
> **Any increase in a partner's share of the liabilities of a partnership**, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, **shall be considered as a contribution of money by such partner to the partnership.**
>
> (b) Decrease in partner's liabilities.
> **Any decrease in a partner's share of the liabilities of a partnership**, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, **shall be considered as a distribution of money to the partner by the partnership.**

(Emphasis added). If the exception of section 751(b)(2)(A) is applicable to all of the properties distributed or deemed distributed by the Partnership to PGH, then ordinary income will not be recognized by PGH upon its receipt of distributions and its withdrawal pursuant to the exercise of its Retirement Right.

A Revenue Ruling issued in 1984, however, indicates that the Service may not consider the deemed cash distribution pursuant to PGH's exercise of its Retirement Right to be subject to the exception under section 751(b)(2)(A). If such an argument were successful, it would result in part or all of the potential depreciation recapture with respect to the Leased Assets being recognized by PGH as a result of the exercise of its Retirement Right.

In Revenue Ruling 84-102, 1984-2 C.B. 119, a three person cash basis professional partnership admitted a fourth equal partner. The partnership had $100 of liabilities and the admission of the fourth partner caused a decrease in each original partner's share of the liabilities of $8.33 (from $33.33 to $25). In addition, the partnership also had $40 of unrealized receivables, and the interest therein of each of the original three partners was decreased as a result of the admission of the fourth partner by $3.33 (from $13.33 to $10). The ruling holds that the original three partners are subject to taxation under section 751(b) as a result of the combination of (i) the deemed distribution of $8.33 in cash and (ii) the $3.33 decrease in the interest of each such partner in the unrealized receivables of the partnership.

Revenue Ruling 84-102 does not appear to have been applied by any court or the Service. Applying the logic of Revenue Ruling 84-102 to the distributions pursuant to PGH's exercise of its Retirement Right, the deemed distribution of cash to PGH under section 752(b) would result in recognition of part or all of the unrealized receivable represented by depreciation recapture. However, Revenue Ruling 84-102 has been criticized by commentators due to its failure to apply the deemed contribution fiction of section 752(a) *in tandem with* the deemed distribution fiction of section 752(b). *See*, *Partner Can Avoid Recognition of Phantom Gain when Partnership Liabilities are Reduced*, 15 Tax'n for Lawyers 112 (1986). Carman, *Revenue Ruling 84-102--An Erroneous Conclusion?*, 15 J. Partnership Tax'n 1371, 372-73 (1986). In particular, the commentators point out that for purposes of applying the section 751(b)(2)(A) exception to section 751(b)(1), section 752(a) should be afforded no less respect than section 752(b).

In the case of the Partnership, for example, the deemed contribution of cash upon the allocation of the Nonrecourse Debt to PGH under section 752(a) should be taken into account in applying the exception of section 751(b)(2)(A), i.e., the deemed distribution should be viewed as a return of the same hypothetical cash that was contributed as a result of the allocation of the Nonrecourse Debt. Upon exercise of its Retirement Right, PGH will be required to take the position that the rationale of Revenue Ruling 84-102 does not cause PGH to recognize gain under section 751(b)(1) by reason of the deemed cash distribution.

As stated above, the cornerstone of the position that Revenue Ruling 84-102 and section 751(b) do not apply to the deemed cash distribution that could result pursuant to PGH's exercise of its Retirement Right is that PGH should be treated as having contributed cash to the Partnership by reference to the same liabilities it is relieved of pursuant to its Retirement Right. Treasury Regulation section 1.752-1(f) raises a question, however, as to whether PGH should indeed be treated as contributing cash in the amount of its share of such debt, despite the plain language of section 752 to such effect. Treasury Regulation section 1.752-1(f) provides as follows:

> (f) Netting of increases and decreases in liabilities resulting from same transaction. If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and **only the net increase is treated as a contribution of money to the partnership**. **Generally, the contribution to** or distribution from **a partnership of property subject to a liability** or the termination of the partnership under section 708(b) **will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution** or received a distribution as a result of the transaction. (Emphasis added).

The netting rule was added to the originally proposed (and temporary) Treasury Regulations under section 752 by amendment in late 1989. The preamble to the amendment stated:

> This document amends the temporary section 752 regulations **to clarify** that an increase in a partner's share of partnership liabilities (or the partner's individual liabilities) and a decrease in a partner's share of partnership liabilities (or the partner's individual liabilities) that result from the same transaction **may be offset against each other prior to** determining the amount of any constructive contribution or distribution or money under section 752 and the regulations thereunder.

T.D. 8274, 1989-2 C.B. 101, 103. (Emphasis added). The language proposed in 1989 was subsequently modified to its current state although with no substantive difference.

The netting rule represents the adoption of a position of the Service under section 752 previously announced in Revenue Ruling 79-205, 1979-2 C.B. 255. That Ruling involved the distribution of property by a Partnership that was subject to debt, part of which had been previously allocable under section 752 to the distributee partner. The Analysis and Holding of the Service in that Ruling was as follows:

> ANALYSIS & HOLDING
> In general, partnership distributions are taxable under section 731(a)(1) of the Code only to the extent that the amount of money distributed exceeds the distributee partner's basis for the partner's partnership interest. This rule reflects the Congressional intent to limit narrowly the area in which gain or loss is recognized upon a distribution so as to remove deterrents to property being moved in and out of partnerships as business reasons dictate. *See* S. Rep. No. 1622, 83rd Cong., 2nd Sess., page 96 (1954). Here, since partner liabilities are both increasing and decreasing in the same transaction offsetting the increases and decreases tends to limit recognition of gain, thereby giving effect to the Congressional intent. Consequently, in a distribution of encumbered property, **the resulting liability adjustments will be treated as occurring simultaneously, rather than occurring in a particular order.** Therefore, on a distribution of encumbered property, the amount of money considered distributed to a partner for purposes of section 731(a) (1) is the amount (if any) by which the decrease in the partner's share of the liabilities of the partnership under section 752(b) exceeds the increase in the partner's individual liabilities under section 752(a). The amount of money considered contributed by a partner for purposes of section 722 is the amount (if any) by which the increase in the partner's individual liabilities under section 752(a) exceeds the decrease in the partner's share of the liabilities of the partnership under section 752(b). The increase in the partner's individual liabilities occurs by reason of the assumption by the partner of

> partnership liabilities, or by reason of a distribution of property subject to a liability, to the extent of the fair market value of such property.
>
> Because the distribution was part of a single transaction, the two properties are treated as having been distributed simultaneously to A and B. Therefore, all resulting liability adjustments relating to the distribution of the two properties will be **treated as occurring simultaneously, rather than occurring in a particular order.**
>
> TREATMENT OF PARTNER A
> A will be deemed to have received a **net** distribution of 600x dollars in money, that is, **the amount by which the amount of money considered distributed to A** (2,200x dollars) **exceeds the amount of money considered contributed by A** (1,600x dollars). Since 600x dollars does not exceed A's basis for A's interest in M immediately before the distribution (1,000x dollars), no gain is recognized to A.

Thus, to the extent the netting rule of Treasury Regulation section 1.752-1(f) is interpreted consistently with the netting principle of Revenue Ruling 79-205, PGH would be treated at the time of its contributions to the Partnership as having received a distribution from the Partnership under section 752(b) of the amount of the Nonrecourse Debt and as having made a contribution of its allocable share of the Nonrecourse Debt. This interpretation of the netting approach is consistent with giving effect to the plain language of section 752(a) and section 752(b).

In a subsequent Ruling, Rev. Rul. 87-120, 1987-2 C.B. 161, the Service again interpreted the provisions of section 752(a) and section 752(b) as being simultaneously applied, stating:

> Rev. Rul. 79-205, 1979-2 C.B. 255, considers increases and decreases in partners' individual liabilities resulting from a transaction involving nonliquidating distributions of encumbered partnership properties. That ruling holds that these increases and decreases are treated as occurring simultaneously for purposes of determining the amount of money considered distributed or contributed. The ruling also holds that, for purposes of applying sections 732(a) and 733 to a distributee of encumbered property, the basis adjustments triggered by the distribution are treated as occurring first, and the distribution itself as occurring second...
>
> In the present situation, each partner's individual liability is increased by $9x as a result of that partner's assumption of the mortgage that encumbered the property that was distributed to that partner in liquidation of the partnership interest. Under section 752(a) of the Code, this increase in liabilities is considered a contribution of money by the partner to the partnership. In addition, each partner's share of partnership liabilities is decreased by $9x, representing each

> partner's $3x share of the mortgage that encumbered each of the distributed parcels. Under section 752(b), this reduction in liabilities is considered a distribution of money to the partner by the partnership. Because the nonrecognition provision of section 731(a)(1) is limited to the amount of the distributee partner's adjusted basis, **the tax consequences** for X, Y, and Z **depend on the order in which the money is deemed distributed to, or contributed** by, each of them.
>
> In a liquidating distribution of encumbered property, the liability adjustments--and thus **the resulting deemed distributions and contributions under sections 752(a) and (b)--are all treated as occurring simultaneously.** *See* Rev. Rul. 79-205. Since the amount of the increase in each partner's individual liabilities equals the decrease in each partner's share of the partnership liabilities, **the deemed contribution of money under section 752(a) and the deemed distribution of money under section 752(b) for each partner are exactly offsetting amounts.** Therefore, no gain or loss to X, Y, or Z results from the section 752 liability adjustments. Moreover, after taking into account such liability adjustments, each partner's interest has a remaining basis of $6x ($6x + $9x - $3x - $3x - $3x). The determination of a partner's basis in the distributed property is made after the partner's basis in his partnership interest is adjusted to reflect any net increase or decrease in liabilities. *See* Rev. Rul. 79-205. (Emphasis added).

Thus, the position of the Service prior to the netting rule of Treasury Regulation section 1.752-1(f) was clearly that both section 752(a) and section 752(b) were to be given full effect on a simultaneous basis when a single transaction resulted in decreases and increases in a partner's share of partnership liabilities. The Preamble to the netting rule stated only that the netting rule was to "clarify" that the amount of any increases or decreases in a single transaction may be offset against each other and did not indicate the intention to provide a rule inconsistent with sections 752(a) and 752(b), or to change by Treasury Regulations the meaning of those sections as they had been interpreted in Revenue Ruling 79-205 and Revenue Ruling 87-120.

Additionally, the adverse interpretation of the netting rule would be at odds with the fundamental workings of section 752. Under the plain language of that section, every incurrence and reduction of a liability by a partnership results in a change of a partner's share in the partnership liabilities and is either a deemed distribution or contribution under section 752. It is the assumption of the Nonrecourse Debt and the resulting deemed distribution to PGH that is the currency used by the Partnership to acquire the Contributed Equipment from PGH. Thus, the application of the netting rule in a fashion that would ignore the component adjustments under section 752(a) and section 752(b) is contrary to the plain language of the statute, inconsistent with the framework of handling liabilities under the statute, and a departure from (rather than a "clarification" of) the established interpretations of section 752(a) and section 752(b).

Finally, with respect to Revenue Ruling 84-102, an interpretation of the Code making section 751(b) applicable to PGH's exercise of its Retirement Right is inconsistent with section 707(a)(2)(B) of the Code, which provides:

> Under regulations prescribed by the Secretary -- If --
> (i) **there is a** direct or indirect **transfer of money** or other property **by a partner to a partnership,**
> (ii) **there is a related** direct or indirect **transfer of money** or other property **by the partnership to** such partner (or **another partner**), and
> (iii) **the transfers** described in clauses (i) and (ii), **when viewed together, are properly characterized as a sale or exchange of property**,
> **such transfers shall be treated** either as a transaction described in paragraph (1) or **as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.** (Emphasis added).

Section 707(a)(2)(B) gives the Service the authority to treat PGH's exercise of its Retirement Right as a disguised sale of an interest in the Partnership from PGH to the BT Partners, because the BT Partners will be deemed to have contributed cash to the Partnership and PGH will be deemed to have received a cash distribution from the Partnership. If a disguised sale were to occur, then section 751(a), and not section 751(b) would be potentially applicable to PGH's withdrawal. In light of the clear Congressional sanction to this treatment of PGH's exercise of its Retirement Right pursuant to section 707 and section 751(a), a less clear treatment under section 752(b) seems inappropriate, i.e., one transaction should not be deemed taxable under both section 751(a) and section 751(b). The Service has currently only reserved with respect to the issuance of Treasury Regulations implementing the disguised sale provisions as they relate to transactions among partners.

4. SECTION 731(c)

Section 731(c) provides that distributions of marketable securities shall be treated as the equivalent of cash distributions for purposes of determining whether gain is recognized by a partner under section 731(a) as the result of a distribution to the partner of cash in excess of the partner's basis in its interest in the partnership. If any of the property distributed by the Partnership to PGH pursuant to PGH's exercise of its Retirement Right consists of marketable securities, the resulting deemed cash received by PGH is likely to result in gain being recognized by PGH.

Generally, the Leased Assets will not fall within the definition of a marketable security. Therefore, generally, the Leased Assets could be distributed to PGH pursuant to the exercise of its Retirement Right without implicating section 731(c). However, section 731(c)(2)(B) includes as a marketable security "(ii) any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities..."

Thus, Leased Assets that are subject to contracts to sell, may be marketable securities and should not be distributed to PGH.

With respect to the possible distribution to PGH of the stock of Oneida, section 731(c)(2)(B) includes as a marketable security "(v) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both..." Thus, under this rule the stock of Oneida could be treated as a marketable security depending upon the composition of its assets.

The Treasury Regulations contain more guidance, providing that if the underlying assets of an entity are (i) 90% or more marketable securities, all the interests in the entity shall be treated as a marketable security, (ii) between 20% and up to 90% marketable securities, a proportionate part of the interests in the entity shall be treated as marketable securities, and (iii) less than 20% marketable securities, none of the interests of the entity shall be treated as marketable securities. Treas. Reg. section 1.731-2(c)(3). However, section 731(c)(3)(A)(i) provides that the rule treating marketable securities as money for purposes of section 731 (and section 737) "shall not apply to the distribution from a partnership of a marketable security to a partner if . . . the security was contributed to the partnership by such partner, except to the extent that the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) to the entity to which the distributed security relates . . ." Thus, because the stock of Oneida was "contributed" to the Partnership by PGH, it should not be viewed as a marketable security vis a vis PGH regardless of the composition of its assets, so long as no additional contributions of assets are made to Oneida by the Partnership. Any such contributions must be explicitly approved by PGH under section 6.4 of the Partnership Agreement.

Treasury Regulation section 1.731-2(h) does contain an anti-abuse rule. However, this rule is focused on situations involving the disguised distribution of marketable securities to a partner. The rule does not purport to override the clear exception to the application of section 731(c) for the return of previously contributed property.

5. SECTION 707 Application

An assumption to the application of the foregoing exceptions to sections 731, 737 and 751 is that the stock of Oneida is treated as having been "contributed" to the Partnership by PGH. The stock of Oneida was transferred to the Partnership along with the Leased Equipment pursuant to the Contribution Agreement. The Partnership also assumed the Recourse Debt and took the Leased Equipment subject to the Nonrecourse Debt. The Recourse Debt, while traceable to the stock of Oneida pursuant to Treasury Regulation section 1.163-8T, was not secured by the stock of Oneida nor the Leased Equipment. Inasmuch as the stock of Oneida is beneficially owned by the Partnership and, as such, the partners of the Partnership will share in the appreciation and depreciation of the value of such stock consistently with their normal sharing ratios, the stock of Oneida should be treated as having been transferred to the Partnership on the Effective Date. Further, there is no authority under section 721 that would suggest that, apart from section 707 where applicable, a single integrated contribution transaction should be viewed as in part a sale and in part a contribution. In fact, in the analogous context of contributions under section 351, the Service has ruled to the contrary. *See* G.C.M. 38873 (July 7, 1982); cited favorably by G.C.M. 39413 (September 25, 1985). *See also*, Rev. Rul. 95-74, 1995-2 C.B. 36 (contribution not bifurcated in section 351 transfer, even though transferor benefited from the assumption of certain contingent liabilities by transferee); Rev. Rul. 94-45, 1994-2 C.B. 39 (same); Tech. Adv. Mem. 9716001 (June 17, 1996). Thus, the form of the transaction and the analogous authorities applying section 351 to the form of similar transactions, support treating the stock of Oneida as having been "contributed" to the Partnership by PGH.

6. Conclusion

Based on the foregoing, we believe that if PGH LLC exercises the Retirement Right and receives distributions consisting solely of cash, Contributed Equipment and stock of Oneida, we believe that, except to the extent of cash distributed or deemed distributed to PGH LLC in excess of PGH LLC's basis in its interest in the Partnership, no gain should be recognized upon the exercise of and distribution pursuant to the Retirement Right of PGH LLC. In particular, we believe that if such a distribution to PGH LLC consists of stock of Oneida and/or all or a portion of the Contributed Equipment, the exceptions in sections 737(d)(1), 751(b)(2)(A) and 731(c)(3)(A)(i) should be applicable to such distribution.

H. SECTION 701 ANTI-ABUSE REGULATIONS AND BUSINESS PURPOSE DOCTRINE

1. SECTION 701 ANTI-ABUSE REGULATIONS

Assuming compliance with the technical provisions of the Code, application of the intended results to the Transaction will revolve around the less technical issues of Treasury Regulation section 1.701-2, the partnership anti-abuse regulation, and the business purpose doctrine generally. The partnership anti-abuse rule has not been applied in any case. Thus, the approach to its application by the courts is uncertain.

Treasury Regulation section 1.701-2 might fail to apply to the Transaction either because it is inapplicable under its terms or because it is invalid as applied to the Transaction. Given the lack of judicial interpretation, we cannot advise as to whether the regulation is invalid by its terms. The following discussion analyzes whether the regulation should be treated as inapplicable by its terms. Under the literal terms of Treas. Reg. section 1.701-2(a), it will be inapplicable by its terms if the following requirements are satisfied:

> (1) The partnership must be bona fide and each partnership transaction . . must be entered into for a substantial business purpose.

> (2) The form of each partnership transaction must be respected under substance over form principles.
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> (3) . . . [T]he tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, *proper reflection of income*). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision . . . .[28]

Treas. Reg. section 1.701-2(a).

Thus, at its core, if the requirements of paragraphs (a)(1) and (2) are satisfied, the issue under Treasury Regulation section 1.701-2 will be whether Congress clearly contemplated tax-free combinations of property in partnerships when it enacted the nonrecognition regime of section 721 and whether Congress clearly contemplated tax-free distributions when it enacted the nonrecognition regime of section 731. In particular, and assuming that the stock of Oneida or the Contributed Equipment is ultimately being distributed to PGH, the transaction relies on, (i) the

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[28] Accepted on its face, and as interpreted primarily through the illustrative fact patterns set forth in the regulatory examples, the partnership anti-abuse rule purports to establish three basic rules as are well summarized in the McKee treatise:

> 1. Using a partnership to avoid restrictions contained in non-Subchapter K Code provisions is generally permissible;
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> 2. Allocations which have some potential economic corollary and are valid under the § 704(b) Regulations are not subject to the abuse-of-Subchapter-K rule; and
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> 3. Transactions that are "tax planned" from the outset are vulnerable to attack, especially if the tax plan minimizes the economic risks and rewards to one or more partners. In contrast, transactions involving historic partnerships, partners, and partnership assets will generally be respected even if the transaction in question is highly tax charged. Although large tax benefits are not fatal per se, they weigh against a transaction and can be determinative in close cases.

McKee, Nelson, & Whitmore, *Federal Taxation of Partnerships and Partners* at section 1.05[1][a]. As applied to the instant case, the Transaction may be viewed as "tax planned" from the outset. Thus, it is important to ensure that the Transaction does not minimize the economic risks and rewards to PGH or the BT Partners.

applicability of section 721 and the inapplicability of section 707 for the tax-free capital contributions by PGH of the Contributed Equipment and the stock of Oneida, and (ii) the applicability of section 731(a)(1) and the applicability of the exceptions in sections 731(c)(3)(A)(i), 737(d), and 751(b)(2)(A) to the distribution of Oneida stock back to PGH. We will examine the validity of these assumptions below.

Paragraphs (a)(1) and (2) require that the partnership be "bona fide," that *each* partnership transaction have a "substantial business purpose," and that "each partnership transaction must be respected under substance over from principles." The preamble to Treasury Regulation section 1.701-2 states that "the final regulations confirm certain fundamental principles that must, in all cases, be satisfied in applying the provisions of subchapter K to partnership transactions." T.D. 8588, 1995-1 C.B. 109, 112. Thus, the partnership anti-abuse regulation should be applied based on traditional notions of "bona fide," "business purpose," and "substance over form." Examples 7, 8 and 11 of Treasury Regulation section 1.701-2 provide the best guidance as to when the Service believes these requirements are met.

Example 7. In Example 7, a new partnership is formed to effect a rent strip transaction, in which X (a foreign corporation) joins as a partner, is allocated substantially all the income generated from a sale of the rental income stream from the partnerships assets "shortly thereafter," and "thereafter" X receives a cash distribution in liquidation of its interest. The Example states that "[o]n these facts, [the partnership] is not bona fide . . . , and the transaction is not respected under applicable substance over form principles . . . , and does not properly reflect the income of" the domestic corporate partner that received the benefit of the high tax basis in the leased equipment.

Under the facts of Example 7, X became a partner and in short order was allocated the income from the rent strip and was removed as a partner. Thus, although the Example does not describe the appropriate adjustment under Treasury Regulation section 1.701-2, presumably X's admittance as a partner under state law would be deemed not to be bona fide for tax purposes, not to be respected under substance over form, and (for good measure) not to have a substantial business purpose. Based on the short time frame and apparent indifference of X as to the ultimate changes in value of the assets of the partnership, the Service may be able to justify this result under traditional notions of bona fide, business purpose, and substance over form. The Transaction is distinguishable from Example 7 because PGH and the BT Partners will be sharing profits and losses with respect to a significant number of assets over a substantial period of time. As a consequence, the BT Partners and PGH should be bona fide members of the Partnership.

Example 8. Example 8 involves the creation of a partnership that allows the duplication of tax basis. A owned land with a $100 basis and a $60 value that A wanted to sell to B. A formed a partnership with persons other than B and contributed the land to the partnership. The other partners contributed cash. The land was leased to B for three years, with B having an option to purchase after three years at fair market value at that time. In year 3, "at a time when the values of the partnership's assets have not materially changed," the interest of A was liquidated. As a consequence, A was able to recognize his $40 loss. Thereafter, the partnership sold the property to B and the remaining partners were allocated the partnership's $40 loss. The Example concludes that--

> any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes. Accordingly, the transaction lacks a substantial business purpose. In addition, the partnership was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with subchapter K. On these facts, the partnership is not bona fide and the transaction is not respected under applicable substance over form principles.

In this Example, presumably the other partners are not viewed as actual participants in the economics of the ownership of the land because of the arrangement with B to purchase the land and the fact that the "values of the partnership's assets had not materially changed." The Service may have had a basis for this conclusion under traditional notions of bona fide partnership and substance over form, although given the possibility of changes in the value of the partnership's assets it is difficult to see how the members of the partnership were not actually participating in a joint profit sharing venture. Once again, the Partnership is distinguishable from the Example because a key fact in the Example was the static value of the single asset, which had a built-in buyer at the formation of the partnership. The Partnership has been structured such that a change in the composition of the assets over time, in the Partnership and in Oneida, is both possible and intended. A functioning business with repositioning of the risks and rewards of multiple assets in the Partnership and Oneida should establish a bona fide intent to share profits and losses from the joint ownership of a changing portfolio of assets.

Example 11. In Example 11, a pre-existing partnership admitted a partner, X, who desired to acquire certain undeveloped land held by the partnership with a basis of $5 and a value of $95. X contributed $100 for its interest in the partnership. "Subsequently (at a time when the value of the partnership's assets [had] not materially changed), the partnership distribute[d] to X in liquidation of its interest in the partnership the land and another asset with a value and basis to the partnership of $5." The distribution of the additional asset allowed X to allocate $50 of basis to the other asset and thereafter sell the asset for a $45 loss, which in the view of the Example allowed X to "recover a substantial portion of the purchase price of the land almost immediately." The Example held that the proper reflection of income standard was not satisfied because "the ultimate tax consequences [to X] that would thereby result, were not clearly contemplated by that provision [section 732] of subchapter K." Interestingly, the Example does not hold that the partnership is not bona fide, that the transactions would fail to meet the substance over form test, or that the transactions lacked a substantial business purpose.

The Service gives no indication of how this transaction should be recharacterized and, apart from treatment under section 707 as a disguised sale which would impact both the partnership and X, the Service would apparently intend to merely ignore the plain meaning of section 732 and revert to pre-1954 basis allocation rules.

Again, the Partnership should be distinguishable from Example 11. In the facts of the Example, apparently the timing of the entrance and exit of X to and from the partnership was such that the value of the assets of the partnership had not materially changed. Like Examples 7 and 8, the facts in each case presuppose less than an active trade or business in the partnership. Accordingly, the Transaction is factually distinguishable from the partnership in Example 11 assuming BT Leasing will actively manage the affairs of the Partnership in Oneida by disposing of properties and by acquiring new properties.

With respect to the disposition of the land by the partnership for the cash contributed by X, Example 11 directly leaves open the possibility of the application of the section 707 disguised sale rules. Application of the disguised sale rules would impact both X, who would have a fair market value cost basis in each asset distributed to it in the disguised sale, and the original partners of the partnership. It is interesting (and helpful) that Example 11 does not appear to expand the reach of Treasury Regulation section 1.701-2 directly to broaden the override of section 721 nonrecognition by section 707.

If a transaction is found to have results that are inconsistent with the intent of the partnership anti-abuse regulations, the "Commissioner can recast the transaction for federal tax purposes." Treas. Reg. section 1.701-2(b). Presumably, although the examples in the Regulation are remarkably silent, the plain language of subchapter K will then be applied to the recast transaction. This approach would be consistent, although a substantial expansion, of the substance-over-form doctrine, which applies the language of the Code to transactions the forms of which have been recharacterized to reflect their substance. In the case of the Transaction, the Service will presumably assert that the Transaction should be recharacterized under one of two approaches. First, the Service might attempt to recast the contribution of the Contributed Equipment as a disguised sale under section 707-like principles (thus triggering gain on the Contributed Equipment as of the date contribution thereof).

Second, the Service might assert that the stock of Oneida was never an asset of the Partnership. Under that approach, the contribution of the stock of Oneida would not have increased the basis of PGH in its interest in the Partnership and the release of PGH from its allocation of the Nonrecourse Debt at the time of its exercise of the Retirement Right would result in additional gain at such time under section 731.

Active operations of Oneida and the Partnership and the ownership of assets that may significantly change in value make it difficult for the Service to successfully assert that either such recast of the Transaction is appropriate. With respect to the disguised sale rules, the regulations under section 707 find a sale where "a subsequent transfer [to a partner who contributed appreciated property] is not dependent upon the entrepreneurial risks of partnership operations." Treas. Reg. section 1.707-2(b)(1)(ii). Because PGH will retain a very substantial

(95%) share in the profit and loss on the portfolio of Contributed Equipment, the Service will be hard pressed to argue that the form of the transaction violates the spirit and purpose of the disguised sale Regulations.

With respect to the assertion that the stock of Oneida was never contributed to the Partnership, the active participation of Oneida in a leasing business in which the BT Partners share 5% of profits and up to 95% of losses is contrary to such an assertion. If the Service is unable to divorce Oneida from the Partnership, it will be difficult for the Service to argue that section 737(a) should result in gain to PGH at the time of its exercise of the Retirement Right in the face of the plain language of section 737(d).[29]

Finally, a good case can be made that the intended tax results under subchapter K are achieved in the Transaction. PGH's basis in the stock of Oneida, if that is the property distributed, would be zero (or thereabouts). Thus, PGH has not had an accession to an amount of basis that is inconsistent with the application of subchapter K. The Service may complain that the inside basis of the assets of Oneida is effectively available to PGH because of the application of section 332 of the Code, but (i) inherent in the subchapter C regime is a maintenance of unequal inside and outside basis absent a section 338 election, (ii) subchapter K is not concerned with the inside basis of a corporation in its assets (such that the inside asset basis results of a particular transaction should not be considered inconsistent with the intent of subchapter K), (iii) section 269 is devoted to such issues, and (iv) Congress has considered legislation designed to coordinate the operation of section 332 and subchapter K but has chosen not to revise the Code in such a fashion.[30]

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[29] We would be remiss, however, if we did not note that the Service may discern no limits to its authority under the partnership anti-abuse rules, having included the following language in Treasury Regulation section 1.701-2(b):

> Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K . . . [t]he claimed tax treatment should otherwise be adjusted or modified.

The Service may view this language as allowing it to override the provisions of the Code even if a transaction cannot be "recast . . . for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances." Treas. Reg. section 1.701-2(b).

[30] On April 8, 1997, the Joint Committee on Taxation (the "*JCT*") released a report that analyzed a variety of issues relating to the taxation of partnerships under subchapter K of the Code. The report stated:

> The proposal would provide that if stock of a corporation is distributed by a partnership to a corporate partner, and the corporate partner owns 80 percent or more (by vote and value), directly or indirectly, of the stock as a result of the partnership's distribution (whether solely as a result of the distribution, or as a result of the distribution combined with acquisitions of stock within one year before or after the distribution), then the corporation (whose stock was distributed) must reduce the basis of its assets. The amount of the reduction to asset basis would the amount by which the stock basis is reduced as a result of the distribution.

97 TNT 68-8 (footnotes omitted).

2. BUSINESS PURPOSE DOCTRINE AS APPLIED BY SERVICE

In a wide variety of circumstances, the Service has successfully asserted the lack of an underlying business purpose for a transaction as a reason to overcome the tax consequences that would otherwise govern the form of the transaction. This business purpose requirement is presumably the same requirement as needs to be satisfied under the partnership anti-abuse regulation discussed above. Thus, most of the comments that we made about each part of the Transaction having economic substance apply equally in the business purpose doctrine context.

In Revenue Ruling 74-87, 1974-1 C.B. 72, the Service ruled that a transfer by three shareholders of their stock in a corporation, aggregating 10 percent in value of the corporation's stock, to a partnership formed by them would be disregarded where the partnership was formed as part of a plan to have the corporation transfer appreciated real property to the partnership in complete redemption of its aggregate 10 percent interest. Accordingly, the transaction was treated as a redemption of each individual shareholder's stock followed by a contribution of the appreciated property to the partnership, resulting in the termination of the shareholders' interests in the corporation and the recognition of gain by the corporation. A tax avoidance purpose was at the core of the transfer of stock to the partnership because it was effected to qualify the succeeding redemption under section 311(d)(2)(A)[31] and thereby to avoid gain recognition. The Service concluded that even if no tax avoidance purpose was present, as would be the case if the redeeming corporation were not in any way connected with the partnership formation and subsequent transfer to it of the minority stock interests, the transaction would still be recast because of the transitory nature of the intermediary step.

In G.C.M. 38393 (May 30, 1980), the Service decided that the transfer of a corporation's stock by its shareholders to a partnership immediately prior to a plan of complete liquidation would be recognized for federal income tax purposes, instead of being disregarded and treated as a transfer of assets to the corporation's shareholders followed by the shareholder's transfer of those assets to the partnership. Even though the transfer was part of the overall plan of liquidation, the transfer of the corporation's stock to the partnership was respected because the transfer was for valid business reasons. This method of transferring the assets to the partnership was chosen, instead of distributing the assets to the shareholders after a liquidation and then

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If this proposal were subsequently enacted prior to the occurrence of the exercise of PGH's Retirement Right, the basis of Oneida in its assets may be materially reduced as a result of the exercise of PGH's Retirement Right. However, the proposal does indicate that the JCT does not consider the intended result of PGH's exercise of its Retirement Right as inconsistent with subchapter K, but rather as inconsistent with the proper taxation of a corporation subject to subchapter C.

[31] Repealed Code section 311(d)(2)(A) provided that the general rule requiring recognition of gain realized through the use of appreciated property to redeem stock did not apply to a distribution in complete redemption of all of the stock of a shareholder who, at all times within the 12-month period ending on the date of distribution, owned at least 10 percent in value of the outstanding stock of the distributing corporation.

contributing the assets to the partnership, in order to avoid the imposition of a state real property transfer tax on the asset contribution by the shareholders. The Service noted that, while the partnership's possession of the stock was transitory, its continued participation in the business formerly carried on by the corporation was not. The Service distinguished its decision G.C.M. 38393 from Revenue Ruling 74-87 by placing great emphasis on the significance of the business purpose of avoiding state real property transfer tax.

3. CASE LAW APPLYING THE BUSINESS PURPOSE DOCTRINE

In the context of tax-free reorganizations, it is well-established that a taxpayer must prove the existence of a non-tax business purpose, however, only *one* satisfactory purpose is generally required. *Laure v. Commissioner*, 653 F.2d 253, 259 (6th Cir. 1981). 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 inapplicable 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).

Although only one business purpose is required, it must be a bona fide business purpose. In a recent and widely publicized business purpose doctrine case, *ACM Partnership v. Commissioner*, No. 97-7527, 1998 WL 710617 (3rd Cir. Oct. 13, 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), the Third Circuit 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.

The Third Circuit affirmed the Tax Court's opinion except it found that ACM was entitled to deduct the portion of its loss that was not attributable to the installment sale accounting so that it reflected the actual economics of the transactions. The Third Circuit found that the Tax Court erroneously failed to recognize that ACM's ownership of the LIBOR notes had economic substance even if the contingent installment sale did not, and thus improperly disallowed deductions arising from its ownership of those notes, resulting in inconsistent tax treatment in light of ACM's reporting of the income generated by the notes. The court stated that, even where a transaction is not intended to serve business purposes, it may give rise to a deduction to the extent that it has separable objective economic consequences apart from tax benefits.

In another publicized business purpose doctrine case involving the same general structure as that in *ACM Partnership*, *ASA Investerings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998), the court held that AlliedSignal, an aerospace and automotive products manufacturing corporation, and a foreign bank failed to form a bona fide partnership in connection with an investment venture involving interest-bearing instruments. As a result, gains and losses relating to the sale of the instruments were not allocated to the bank.

AlliedSignal expected to realize a large capital gain with respect to the sale of certain assets, but an investment bank developed a tax proposal that could create capital losses to shelter this gain. A foreign bank, which was not subject to U.S. taxation, and AlliedSignal formed a partnership. The partnership was capitalized with cash contributions, primarily from the foreign partner, who would be the majority partner after the initial contributions. The partnership purchased high-grade, floating rate PPNs, which included put options, permitting the notes to be sold at par. The partnership sold the PPNs for consideration consisting of 80 percent cash and 20 percent indexed installment notes (LIBOR notes). The partnership reported the sale of the PPNs using the installment method under section 453 so that a small fraction of the PPNs' bases would be used to calculate the gain on the sale and the remaining basis would be allocated to the LIBOR notes. Thus, the PPN sale created a large capital gain and a future sale of the LIBOR notes would create a large capital loss. The gain was allocated according to each partner's partnership interest (i.e., the tax-exempt foreign bank recognized most of the gain). Thereafter, AlliedSignal bought a portion of the foreign bank's partnership interest and became the majority partner. The partnership distributed cash to the foreign bank and the LIBOR notes to AlliedSignal, who sold them and recognized a large capital loss.

The court noted that although a partnership agreement was executed, the bank did not have a profit expectation from the venture and did not intend partnership status. Furthermore, despite partnership agreement provisions to the contrary, the bank did not share in losses or expenses, nor did it play a significant management role. The relationship between the corporation and the bank was properly characterized as a debtor-creditor relationship. Evidence indicated that the corporation's only concerns were that the venture was financed by a reputable bank and that the conduct of the bank in assessing the credit risk in the transaction and maintenance of collateral was consistent with that of a lender. The court did not address whether the transaction had economic substance, as in *ACM Partnership*, because it found that there had been no partnership.

In another business purpose case, *Merryman v. Commissioner*, 89-1 U.S.T.C ¶ 9338 (5th Cir.), the court held that a partnership functioned merely as an instrument through which one of the partners could retain control of an oil rig while passing on various tax advantages to its partners. Therefore, the partnership was disregarded as a mere paper conduit of a related corporation and, as a result, losses and an investment tax credit were denied to its partners. The pattern of interconnected ownership and lack of obvious business purpose in the parties' dealings were considered evidence that the partnership's formation and activities lacked economic substance.

The corporation, its key employees and officers, and a family partnership formed the partnership. Under the partnership agreement, the corporation was the managing partner of the partnership and was given full and sole control over the partnership's affairs. The corporation sold the partnership an oil rig, which it had recently constructed, for the cost of construction and did not inform third parties of the change in ownership. The partnership waived all warranties and made no down payment, but rather issued an installment note for the purchase price. Also, the corporation and the partnership entered into a "Rig Management Agreement" which called for the corporation to manage all aspects of the operation of the oil rig. The corporation did not pay the accrued net operating profits to the partnership and the payments due on the partnership's promissory note to the corporation were not paid on time. The records indicated that the partnership had no office or employees, paid no salaries, and carried on no other business dealings. The corporation entered into an indemnity agreement with the partnership, in which it undertook to indemnify the partners for any and all possible liabilities.

The court found that, although the partnership held assets and operated for a profit, its formation and role served no other purpose except tax avoidance. All liabilities arising from the partnership's activities were assumed by the corporation. The sale by the managing partner, the corporation, on exceedingly favorable terms to the partnership raised doubts about the existence of an arms-length deal and provided evidence of a transaction lacking economic substance. Also, the individual partners did not invest any capital in the partnership, and no risks were associated with their partnership investment. The Service alternatively claimed that, if the partnership was not disregarded for tax purposes, the management agreement entered into by the corporation and the partnership should have been considered a lease with an indefinite term, which would invalidate the investment tax credit.

In *Duhon v. Commissioner*, 62 T.C.M (CCH) 382 (1991), the court held that another partner in the *Merryman* transaction was not entitled tax benefits because the partnership was disregarded for federal income tax purposes. The partner argued that the main consideration in establishing the partnership was retaining key employees. The court found that the key employees of the corporation theoretically stood to benefit from net profits of the partnership remaining after note payments had been made on the promissory note, but it dismissed this argument because the key employees also stood to benefit from the significant tax benefits to be realized if the partnership was recognized for tax purposes. The taxpayer argued that, under state law, the partners would be liable for their individual shares of the debt of the partnership and that the partnership still was liable for its own negligent acts, so the partnership acquired the benefits and burdens of ownership. The court disregarded any liability that the partnership might have under state law because of the indemnity agreement protecting the partners.

In *Hunt v. Commissioner*, 59 T.C.M. (CCH) 635 (1990), the court held that a partnership formed by the wholly owned subsidiary of a gold and silver exploration corporation and three limited partners was not a financing arrangement lacking in economic substance. The limited partners and the subsidiary entered into a formal partnership agreement that provided for the contribution of capital by both. The limited partners had debts related to their investments in silver and their motivation to enter into the partnership was to refinance these debts and avoid bankruptcy. They were also motivated to enter into the partnership with the subsidiary for the purpose of retaining their silver investments until silver increased in price. The subsidiary believed that the public thought that the limited partners controlled it, so it was concerned that a bankruptcy filing by the limited partners would adversely affect its business relationships and credit rating. The subsidiary also thought that silver investments contributed to the partnership by the limited partners had significant appreciation potential and that it would profit handsomely.

The court found that the limited partners' obligation in the partnership agreement to guarantee a return of 98% of the partnership's capital contribution was consistent with the status of the arrangement as a partnership, and their motivation to enter into a partnership arrangement in order to refinance their debts was a valid business purpose. The limited partners did not realize cancellation of indebtedness income upon the dissolution of the partnership and were entitled to deduct losses that flowed to them.

In *ASA Investerings Partnership*, AlliedSignal cited *Hunt* to support the contention that, even if the bank was entitled to a guaranteed return, that was not inconsistent with partnership treatment. The court distinguished *Hunt* in that the partnership agreement in *Hunt* provided for the guaranteed return, but in *ASA Investerings Partnership*, the bank's specified return was not provided in, and was contrary to, AlliedSignal and the bank's partnership agreement. Also, in *Hunt*, the partner receiving the guaranteed return was also eligible to receive partnership profits in excess of such partner's guaranteed return, but the bank was only entitled to its specified return and nothing more.

4. APPLICATION OF BUSINESS PURPOSE TEST

In the Transaction, PGH and the BT Partners have sound non-tax business reasons, as detailed above, for entering into the Transaction. From the perspective of PGH it has an intention to benefit economically, apart from tax savings and taking into account all transaction costs, as a result of the Transaction. In particular, as elaborated above in connection with the discussion of the partnership anti-abuse regulation, PGH by entering into the Transaction has enlisted the aid of the BT Partners in increasing the value of the Contributed Equipment and improving the profile of the portfolio of such Leased Assets through the active management of the portfolio both in the Partnership and in Oneida. PGH has shifted risk to the BT Partners. PGH has significant flexibility with respect to future Partnership operations. Likewise, the BT Partners have represented (through BT Corp.) that they intend to make a fair commercial return on the equity they have invested in the Partnership. Due to their profit and loss positions the BT Partners have an incentive to manage the portfolio of Leased Assets.

Moreover, the parties have represented that they expect the Partnership to continue in business for a prolonged period of time, holding the Contributed Equipment, any newly leased assets, and any other Permitted Investments. No exercise of the Retirement Right is permitted to occur for at least two years and the Transaction is not contingent on such exercise of the Retirement Right. Thus, the Partnership should not be considered a transitory entity for purposes of determining whether the business purpose requirement is satisfied.

5. SECTION 269

Section 269(a) provides, in relevant part:

> If any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation...and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance.

Thus, 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." Control may be "acquired" not only through a direct purchase of stock but also through tax-free acquisitions and indirect methods of acquiring control of a corporation. For example, acquisitions occur through the redemption of stock of other shareholders, the use of chains of controlled corporations, and possibly even the use of convertible debentures or options to acquire additional stock. *See, e.g., Swiss Colony, Inc. v. CIR*, 428 F.2d 49 (7th Cir. 1970) (control acquired through combination of repossession of previously sold stock and purchases from third parties); *Bobsee Corporation v. U.S.*, 411 F.2d 231, 235 (5th Cir. 1969) (creation of a corporation is the acquisition of it within the meaning of section 269(a)(1)). *But see Hermes Consol., Inc. v. US*, 14 Cl. Ct. 398, 1988-1 USTC 9220 (1988) (carefully structured acquisition to avoid crossing 50-percent-control line through use of voting power and value determination was successful); *The Challenger, Inc. v. Commissioner*, 23 T.C.M. (CCH) 2096, T.C. Memo 1964-338, T.C.Mem. (P-H) 640338 (1964) (the revival of dormant corporation is not a control acquisition under section 269).

a. Section 269 and the Revival of Oneida

The revival of a dormant corporation should not be treated as an "acquisition of control" under, section 269, because "control" is defined by the Code in terms of stock ownership, and a revival does not constitute the acquisition of ownership of stock. *See IRC*, section 269(a)(1); Treas. Reg. section 1.269; *Challenger, supra.*

In *Challenger, supra*, the United States Tax Court held that the revival of dormant corporations for use in entirely different circumstances with funds borrowed from related entities, was not the equivalent of the "acquisition" of the corporations under section 269 of the Code. An individual by the name of Graves owned a number of Idaho corporations, two of which are relevant to this discussion. One corporation, known as Saratoga, operated a small club with a restaurant, a bar and slot machines in Caldwell, Idaho. The second corporation, known as Waldorf, operated a cigar store with food, sporting goods, and slot machines in Nampa, Idaho. When slot machines were made illegal in Idaho during the early 1950s, each of these businesses were closed down.[32] The corporations sold most of their business assets, retaining only their slot machines and certain restaurant equipment. These assets were eventually moved to the State of Nevada.

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[32] It is unclear from the facts exactly when each of these two businesses were closed down, but at the very latest it was in 1953 when the Idaho State Supreme Court ruled that slot machines were illegal. *See State v. Village of Garden City*, 74 Ida. 513, 265 P.2d 328 (1953).

Saratoga and Waldorf remained dormant until February, 1954, when they purchased stock in a Nevada corporation. Thereafter, the corporations invested in other clubs, and leased slot machines in Nevada as their primary business activities.[33] Apparently both corporations received payments from another corporation owned by Graves. The IRS claimed, *inter alia*, that Saratoga and Waldorf should not be allowed surtax credits because they were revived for the sole purpose of utilizing their surtax credits, i.e. for the purpose of avoiding taxes under section 269 of the Code. The IRS' argued in its brief that, "...the revival of dormant corporations for use in entirely different circumstances with funds borrowed from related entities, as was done here, is the equivalent of the 'acquisition' of the corporations under section 269 of the Internal Revenue code of 1954." The court disagreed. It concluded that under section 269, "control" is defined in terms of stock ownership, and that "[t]he revival of a dormant corporation does not constitute the acquisition of ownership of stock." Thus, because Graves owned the requisite percentage of shares to constitute control before the corporations entered Nevada, and this control was not broken prior to the transfer of slot machines, there could not have been an acquisition of control when the corporations entered into the slot machine business.

The court noted further that there is no language in section 269 to support the IRS' position, and that even the cases cited to by the IRS did not support its argument, because they all involved transactions where those who revived the corporations did not have control of them prior to the revival.

PGH owned all the stock of Oneida both before and after its revival. Thus, based on the foregoing discussion, we believe that the revival of Oneida should not be treated as an "acquisition of control" under section 269(a)(1) of the Code.

b. Section 269 and the De Facto Dissolution Doctrine

Courts have applied the de facto liquidation doctrine to prevent corporations which exist as mere "shells" from utilizing unused excess profit tax credits, or from carrying back net operating losses in situations not intended by Congress. Under this doctrine, such corporations are deemed to have been dissolved in a de facto liquidation such that the tax attributes ceased to exist prior to such corporations' improper use. *See* Rev. Rul. 61-191, p. 253-254, 1961-2 CB 251. *See also, American Well & Prosp. Co. v Commissioner of Internal Revenue*, 232 F.2d 934, 49 AFTR 1030, 56-1 USTC P 9388 (3rd Cir. 1956), cert. den. 77 S.Ct. 61, 1 L.E.2d 57 (1956), (corporation's use of unused excess profits tax credits disallowed based on the court's conclusion that it had been dissolved de facto prior to engaging in new business); *Wier Long Leaf Lumber Company v. Commissioner of Internal Revenue*, 173 F.2d 549, 551-553, 37 AFTR 1164, 49-1 USTC P 5930 (5th Cir., 1949), affirming and reversing in part 9 T.C. 990 (1947), (excess profits credit carry-back properly denied where liquidating corporation dissolved de facto); *Winter & Company, Inc. v. Commissioner of Internal Revenue*, 13 T.C. 108 (1949) (once a corporation is

[33] Nothing in the facts indicates that Saratoga or Waldorf ever reorganized as Nevada corporations.

de facto liquidated, its unused excess profits credits terminate, and may not be used again; and net operating loss carryback properly denied where corporation dissolved de facto). A corporation will be considered dissolved de facto for purposes of such credits or carrybacks, if it has, "disposed of all or most of its operating assets, terminated its business activities, and become a mere shell, a corporation in name and semblance only, without real corporate substance, serving no real corporate purpose, and having no valid or compelling reason for continuing its existence, even though not formally dissolved." Rev. Rul. 61-191, p. 253-254, 1961-2 CB 251. *But see*, *Anbaco-Emig Corp. v. Commissioner of Internal Revenue*, 49 T.C. 100, 103, 107 (1967), acq. in result, 1968-2 C.B., acq. in result 1968-1 C.B. (corporation not de facto dissolved where it merely "discontinued one line of endeavor and after a relatively short period of time entered into another," for purposes of carrying over net operating losses). The de facto liquidation doctrine heretofore has not been applied by the courts to treat the revival of a dormant corporation as an "acquisition of control" within the meaning of section 269 of the Code.

A corporation that retained only intangible assets consisting of credits on the parent corporation's books in respect of transferred tangible assets, and of accounts receivable, was considered de facto dissolved, and therefore could not take advantage of excess profits credits and net operating loss carrybacks. *See Winter & Co., supra* at 120. *See also, American Well & Prosp. Co., supra* at 1034-1035 (corporation dissolved de facto when it had sold all of its assets and been dormant for two years before entering new business). The corporation in question, Winter & Co., was a subsidiary that assembled pianos for sale to the parent company's customers. Intercompany transactions were settled by bookkeeping entries of offsetting credits and debits. When it was determined that Winter & Co. should be liquidated, all tangible assets were transferred to the parent corporation, leaving only credit entries on the parent corporation's books, it ceased all operations, and had no earnings or business expenses. The court's conception of the purpose for provisions for the carry-over and carry-back of unused excess profits credits from a current tax year was to level the burden of excess-profits taxes over a period not exceeding five years of a going concern. It was inconceivable to the court that Congress would have intended for the excess profits credit to apply to nonoperating years. Thus, the court's conclusion that the corporation in *Winter & Co.* had been dissolved de facto, was based on the specific facts, as well as on the court's belief that Congress would not have intended for the carrybacks to be taken under such circumstances. *Id.* at 117.

In a case where the corporation in question was actually revived, and substantially the same shareholders sought to carryover losses from the prior business, the Tax Court was unwilling to apply the de facto dissolution doctrine, because it was "resistant" to reading "a limitation into the statute which [was] not there as an express limitation." [34] *Anbaco-Emig*,

[34] In refusing to apply the de facto dissolution doctrine to loss carryforwards, the *Anbaco-Emig* court stated, "We note that Congress adopted the [] theory of de facto liquidation in excess profits credits cases when it passed sec. 432(e) of the 1939 Code in 1949. Such section eliminated the excess profits credit in cases where the courts had previously found a de facto liquidation. That no such legislation has been adopted in the net operating loss area by

supra at 107. In *Anbaco-Emig*, a corporation engaged in the tool and die business, had sold all of its machinery, fixtures, and inventory, and, after remaining inactive for two years, was revived by the same shareholders to engage in an entirely different business, the renting of a loft building. *See id.* at 100-101. The court concluded that it was the same "taxpayer" for purposes of the net operating loss provisions, and that therefore, the "revived" corporation could take advantage of the net operating losses incurred in the tool and die business. *Id.* at 107. In reaching this conclusion, the court stated that, "courts have looked not only to the facts of each individual case, but also to the different provisions of the tax law under consideration and the underlying purpose of Congress in enacting the various provisions," to determine whether or not to apply the de facto dissolution doctrine to prevent a corporation from utilizing certain tax benefits. *See Anbaco-Emig, supra* at 105-106. Thus, because there was ample authority to support a corporation's use of net operating loss carryovers to offset profits in a wholly new activity, as long as the ownership of the corporation remained substantially unchanged,[35] and Congress had not modified the statute to disallow such use of loss carryovers, the court believed that Congress did not intend for the de facto dissolution doctrine to apply in such circumstances. *Id.* at 107.

In a case involving the merger of a successful partnership into a loss corporation owned by the partners, the court was unwilling to apply the de fact dissolution doctrine, despite the facts that the loss corporation's main business activity was servicing its debt, and the corporation engaged in an entirely different business activity after the merger. *See Wofac Corporation v. U.S.*, 1607, 269 F. Supp. 654, 19 AFTR 2d 1601, 67-2 USTC P 9532 (1967). In *Wofac*, four partners engaged in the management consulting business had organized a New York corporation, Warsaw Button Co., to engage in the woodworking business. The management consulting business flourished, and the woodworking business failed and accumulated losses. After a number of years, during which one of the partners had left and been bought out in both enterprises, the three remaining partners wished to reorganize their partnership as a corporation. They did so by transferring the partnership assets and business to the already-established, New York corporation, Warsaw Button Co. In the same transaction, the name of Warsaw Button Co. was changed to The Work-Factor Company, Inc. The corporation was subsequently redomesticated to Delaware, and its name was ultimately changed to Wofac Corporation ("***Wofac***").

One of the arguments made by the IRS was that the corporation should be treated as dissolved de facto because other than servicing its debt, it had engaged in no business activities for a period of four years, and that the corporate "shell" had been maintained by the shareholders for the sole purpose of preserving its net operating losses. Thus, the IRS claimed that section 269 should apply to disallow the loss deductions from the old business by the new business. The court rejected this argument with respect to the partnership transfer, stating that "unless there

Congress indicates recognition of the distinction between net operating loss deductions and excess profits tax credit deductions." *Anbaco-Emig*, 49 T.C. at 107, n.3.

[35] The court cites to Rev. Rul. 63-40, 1963-1 CB 46, to support this proposition.

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was in fact a dissolution of the loss corporation, the net operating losses were proper allowances..." *Id.* at 1611. The court proceeded to list the facts which would support a finding that the corporation continued as "an active, affirmatively functioning corporation." *Id.* It noted that the Warsaw Button Co. was not a mere "shell," for purposes of the de facto dissolution doctrine. It had sales of $1,120 between 1951-1953, and held assets worth approximately $45,000 between 1953-1957, the corporation continued to meet its mortgage and tax obligations, paid franchise fees, and filed tax returns.

Oneida is not attempting to take any excess profits credits or utilize net operating losses from its previous business activities. Moreover, there has been no change in the ownership of Oneida. Thus, based on the foregoing discussion, we believe that Oneida should not be treated as dissolved in a de facto liquidation, and, therefore, that the revival of Oneida for use in a new business activity should not constitute an acquisition of control within the meaning of section 269 of the Code.

c. Section 269 and the redomestication of Oneida

The redomestication of a corporation from one State to another (pursuant to section 368(a)(1)(F)) does not constitute an "acquisition of control" within the meaning of section 269(a)(1), as long as there has not been more than a minor change in stock ownership. *Wofac supra. See also, Southland Corp. v. Campbell*, 358 F.2d 333, 336, 17 AFTR.2d 673, 66-1 USTC P 9347 (5th Cir., 1966). Therefore, a redomesticated corporation should be treated as the same entity for federal income tax purposes. *See e.g., Wofac, supra* at 1607; *Newmarket Mfg. Co. v. U.S.*, 233 F.2d 493, 499, 49 AFTR 1254, 56-1 USTC P 9540 (1 Cir. 1956), cert. den. 353 U.S. 983 (1957) (after "F" reorganization, two corporate entities treated for substantive purposes in income tax as the same taxpayer); Rev. Rul. 96-29, 1996-1 CB 50; Rev. Rul. 87-110, 1987-2 CB 159 (a section 361 exchange of a partnership interest was not an "exchange" because in a section 368(a)(1)(F) reorganization, "there is virtually no change in the identity of the shareholders and their interests or in the assets involved"); Rev. Rul. 80-168, 1980-1 CB 178 (mere change in place of incorporation, qualifying under section 368(a)(1)(F), does not terminate corporation's election to be treated as possessions corporation under section 936); Rev. Rul. 73-526, 1973-2 CB (under section 1.381(b)-1(a)(2) of the regulations, acquiring corporation treated just as the transferor corporation would have been treated in the absence of a reorganization); Rev. Rul. 64-250, 1964-2 CB 333 ("F" reorganization did not cause termination of election under section 1372).

There was no "acquisition of control" under section 269 when taxpayers, who transferred assets and liabilities from a partnership to a previously-owned corporation, were the "sole owners of both the surviving corporation and the absorbed partnership." *See Wofac supra* at 1607. *See, also, Southland supra* at 336 (no "acquisition of control" within meaning of section 269, when merged subsidiaries owned by same shareholders); *Jackson Oldsmobile, Inc. v. United States*, 237 F.Supp. 779, 782, 15 AFTR.2d 35, 65-1 USTC P 9113 (1964), affirm., 371 F.2d 808 (5th Cir. 1967) (no "acquisition of control" within meaning of section 269 when corporation owned by same shareholders engaged in entirely different business activity). As discussed above, in *Wofac*, the three partners transferred the partnership assets and business to the already-established, New York corporation, Warsaw Button Co., and in the same transaction, changed the name of Warsaw Button Co. to The Work-Factor Company, Inc. They subsequently formed a new shell corporation in the State of Delaware, known as The Work-Factor Company, Inc., transferred the assets and liabilities of the New York corporation bearing the same name to the new Delaware corporation, and dissolved the New York corporation. The name of the Delaware corporation was ultimately changed to Wofac Corporation.

Wofac claimed it was entitled to carryover net operating losses sustained from its prior activities in the woodworking business pursuant to section 172 of the Code. The IRS argued that section 269 should apply to disallow the deductions, because the transfer of the partnership assets and business and subsequent reorganization was part of a plan to avoid income taxes. The court rejected the IRS' argument based on its conclusion that there had been no "acquisition of corporate control" under section 269, because "the stockholders were the sole owners of both the surviving corporation and the absorbed partnership." *Wofac, supra* at 1607. The court stated that the,

> "...acquisition of control of one corporation by another corporation cannot arise where, as in the instant case, the stockholders were the sole owners of both the surviving corporation and the absorbed partnership. At the time of the transfer of the profitable partnership business to the loss-experience corporation, the stockholder-partners owned both. So that the 'acquisition of control' element of section 269 was not met." *Wofac, supra* at 1607.

The court concluded further that the change of the New York corporation to the Delaware corporation, constituted "a mere change in domicile" and that such a change had "no greater tax significance than a like change of domicile by an individual taxpayer." *Wofac, supra* at 1612. *See also, Newmarket, supra* at 498 ("...taxation is an intensely practical matter, which ought to turn upon economic realities rather than upon technical differences of the corporate entity consequent upon the migration of a corporation from one state to another").

Additionally, LTR 8908030 indirectly supports the conclusion that after an "F" reorganization, the new corporation is the same entity for tax purposes. It held that the new corporation in an "F" reorganization should be treated the same as the absorbed corporation under the stapled stock rules of the Code. In that ruling, corporation O was merged into corporation N in an "F" reorganization. Corporation O's stock was stapled to corporation A. Part of the ruling held that corporation N and corporation A would be considered stapled entities under section 269B(a)(1). However, because corporation O and corporation A were stapled entities on June 30, 1983, pursuant to the legislative history of section 269B, corporation O and corporation A were exempt from the stapled stock rules. The ruling held that corporation A would continue to be exempt from the stapled stock rules of section 269B. The ruling further held that corporation N, as a successor to corporation O, and corporation A would be considered to have been stapled entities on June 30, 1983. The legislative history to section 269B states that those rules "do not apply to U.S. corporations stapled to Puerto Rican corporations on June 30, 1983." Therefore, the ruling held indirectly that corporation N was considered to be the same corporation as corporation O for tax purposes.

Oneida merely changed its domicile from Oregon to Delaware pursuant to section 368(a)(1)(F). Moreover, there was no change in stock ownership. Therefore, based on the foregoing discussion, we believe that the redomestication of Oneida in Delaware should not constitute an "acquisition of control" under section 269(a)(1).

d. Indirect Control Through Partnership

Should PGH reacquire the shares of Oneida in the future, a determination of whether PGH has "maintained" control or "acquired" control may be necessary. The legislative history of the predecessor of section 269 describes the scope of the "control" requirement in pertinent part as follows:

> If a controlled or affiliated group existed on October 8, 1940 [the effective date of the predecessor of current section 269], transfers thereafter within the group could not amount *to the acquisition of such control by the parent or its controlling interest. Control once acquired could not be again acquired, unless the group was in some way broken. A mere shift in the form of control--from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect--can not, therefore, amount to the acquisition of control within the meaning of section 115 of the bill.*

S. Rep. No. 627, 78th Cong., 1st Sess. 61 (1943), 1944 C.B. 973, 1016 (emphasis added).

The Treasury Regulations under section 269 faithfully implement the intent of Congress as confirmed in the above passage:

> For control to be "acquired on or after October 8, 1940," it is not necessary that all of such stock be acquired on or after October 8, 1940. Thus, if A, on October 7, 1940, and at all times thereafter, owns 40 percent of the stock of X Corporation and acquires on October 8, 1940, an additional 10 percent of such stock, an acquisition within the meaning of such phrase is made by A on October 8, 1940. Similarly, if B, on October 7, 1940, owns certain assets and transfers on October 8, 1940, such assets to a newly organized Y Corporation in exchange for all the stock of Y Corporation, an acquisition within the meaning of such phrase is made by B on October 8, 1940. *If, under the facts stated in the preceding sentence, B is a corporation, all of whose stock is owned by Z Corporation, then an acquisition within the meaning of such phrase is also made by Z Corporation, on October 8, 1940,*

> *as well as by the shareholders of Z Corporation taken as a group on such date, and by any of such shareholders if such shareholders as a group own 50 percent of the stock of Z on such date.*

Treas. Reg. section 1.269-1(c) (emphasis added).

The Tax Court recognized this fundamental aspect of section 269 in *Brick Milling Co. v. Commissioner*, 22 T.C.M. (CCH) 1603 (1963). Stating that the stock attribution rules of section 318 did not apply in the section 269 context,[36] the Tax Court carefully distinguished between *constructive* ownership under the attribution rules of section 318 and *indirect* ownership:

> The indirect control provision of section 269(a) requires that there be ownership *although it may be one or more steps removed, as in the case of a subsidiary of a directly owned parent corporation. See* S. Rept. No. 627, 78th Cong., 1st Sess., pp. 60-61 (1943), 1944 C.B. 973, 1016; sec. 1.269-1(c), Income Tax Regs. It has been held that when two brothers acquire ownership of in excess of 50 percent of a taxpayer's outstanding shares, no constructive ownership between brothers is dictated by . . . section 267 . . . . Also, the attribution rules of section 318 are inapplicable since they apply only to subchapter C of the 1954 Code . . . .

(Emphasis added).

The analysis in Revenue Ruling 80-46, 1980-1 C.B. 62, also is instructive on the indirect control issue. In that ruling, individual A owned 100 percent of the stock of M corporation and 10 percent of the stock of X corporation. M owned 45 percent of X's stock, and X itself owned all the stock of Y corporation and Z corporation. In the transaction, X merged into M Corporation for the proscribed principal purpose. By reason of the merger, M Corporation directly acquired all the stock of Y Corporation and Z Corporation.

The principal issue addressed by the ruling was "whether the X stock owned directly by A before the merger can be attributed to M so that M had control of X before the merger and therefore did not acquire it within the meaning of section 269(a)(1)." Implicit in this formulation of the issue (and explicit in the ruling's rationale) were that M indirectly owned 45 percent of the stock of Y and Z for purposes of the section 269 control analysis.

Relying on the Tax Court's *Brick Milling* opinion, the Service in Revenue Ruling 80-46 reasoned as follows:

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[36] The attribution rules contained in section 318 are not applicable for purposes of section 269 because those rules apply only to subchapter C of the Code, whereas section 269 is in subchapter B.

> In the present situation, M directly owned only 45 percent of X and thereby indirectly owned *only 45 percent of Y and Z* before the merger. The 10 percent interest in X held by A cannot be attributed to M because there are no rules of constructive ownership of stock expressly made applicable to section 269.

(Emphasis added). Had M directly owned 50 percent of X, M clearly would have been deemed to be in indirect control of Y and Z, so that the transaction there at issue, although undertaken for a bad purpose, would not have been within the scope of section 269(a)(1).[37]

Thus, to the extent that pursuant to the exercise of its Retirement Right, PGH selects for distribution the stock of Oneida, the distribution by the Partnership and acquisition by PGH of 100% of the stock of Oneida should not be considered an acquisition of "control" within the meaning of section 269(a). It must be remembered that the "directly or indirectly" language of section 269 only deems control to have continuously existed where the upstream/downstream relationship of the benefited parties is maintained. Accordingly, as the 95% partner (by profits and capital) of the Partnership, PGH should be treated as having indirect ownership of more than Oneida held by the Partnership. Since Oneida has been an "old and cold" subsidiary of PGH since prior to the contemplation of the Transaction, Oneida should be treated as continuously controlled by PGH, even after the contribution of its stock to the Partnership.

6. CONCLUSION

Based on the foregoing analysis, we believe that the opinions expressed in section A through H above should not be subject to change under the business purpose doctrine, section 269 of the Code, the substance-over-form doctrine, or the partnership anti-abuse regulations promulgated under section 701 of the Code.

Sincerely,

Akin Gump Strauss Hauer & Feld, LLP

AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.

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37 Nor would the transaction have been within the scope of section 269(a)(2), since the property--the stock of Y and Z--would have been acquired by M from a corporation--X--that M controlled (directly) immediately before the acquisition.

VII. TAX OPINION LETTERS

RELATING TO

PROJECT CONDOR

&

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First Draft: March 17, 2000

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Attorney-Client
Privileged Communication

EC2 000034132

Ladies and Gentlemen:

We have acted as counsel to Enron Corp. ("Enron") in connection with certain aspects of the transactions more fully described below (collectively, the "Transaction"). In connection therewith, you have requested our opinion as to certain U.S. federal income tax consequences associated with the Transaction under the Internal Revenue Code of 1986, as amended (the "Code").[1]

In rendering our opinions we have relied on the following documents (collectively, the "Transaction Documents"): (i) Assignment Agreement (Membership Interest in Kingfisher) dated as of November 10, 1999 between Enron Corp., Assignor and Houston Pipe Line Company, Assignee; (ii) Agreement of Limited Partnership of HPL Asset Holdings L.P. dated as of November 10, 1999 among Houston Pipe Line Company, as the General Partner and as a Limited Partner and Peregrine I LLC, as a Limited Partner; (iii) Assignment and Contribution Agreement (Bammel Storage Facility Reservoir) effective November 10, 1999 between Houston Pipe Line Company, Grantor, and HPL Asset Holdings L.P., Grantee; (iv) Assignment and Contribution Agreement (Bammel Storage Facility Equipment) effective November 10, 1999 between Houston Pipe Line Company, Grantor, and HPL Asset Holdings L.P., Grantee; (v) Assignment and Contribution Agreement (Houston Loop and Texas City Loop) effective November 10, 1999 between Houston Pipe Line Company, Grantor, and HPL Asset Holdings L.P., Grantee; (vi) Assignment Agreement (General Partnership Interest in HPL Asset Holdings L.P.) dated November 10, 1999 between Houston Pipe Line Company, Assignor, and Blue Heron I LLC, Assignee; (vii) Certificate of Amendment to the Certificate of Limited Partnership of HPL Asset Holdings L.P.; (viii) Letter Agreement dated as of November 10, 1999 between Whitewing Associates L.P. and Houston Pipe Line Company; (ix) Assignment Agreement (Membership Interest in Blue Heron I LLC and Limited Partnership Interest in HPL Asset Holdings L.P.) dated as of November 10, 1999 between Houston Pipe Line Company, Assignor, and Whitewing Associates L.P., Assignee; (x) First Amendment to Limited Partnership Agreement of Whitewing Associates L.P.; (xi) Assignment Agreement (Limited Partnership Interest in Whitewing Associates L.P.) dated as of November 10, 1999 between Houston Pipe Line Company, Assignor, and Kingfisher I LLC, Assignee; (xii) Lease Agreement between HPL Asset Holdings L.P., as Lessor and Houston Pipe Line Company, as Lessee effective as of November 10,

[1]All section references are to the Code or the Treasury regulations promulgated thereunder, unless otherwise notes.

1999; (xiii) Consent of The Bank of New York and Bank of America, N.A. to approve the form and substance of Assumption Agreement and Ratification of Guaranty; (xiv) Assumption Agreement dated as of November 10, 1999 between HPL Asset Holdings L.P. and Houston Pipe Line Company; (xv) Certificate of Formation of HPL Asset Holdings L.P.

I. FACTS

A. The Parties

Whitewing Associates L.P. ("Whitewing") is a Delaware limited partnership that was formerly known as Whitewing Associates L.L.C. Whitewing is owned by Whitewing Management LLC, a Delaware limited liability company, as general partner, and by Kingfisher I LLC ("Kingfisher"), Peregrine I LLC ("Peregrine"), and Osprey Trust, a Delaware business trust, as limited partners.

Houston Pipe Line Company ("HPL"), a Delaware corporation, is a wholly-owned subsidiary of Enron. Among other things, HPL owns (i) the Bammel Storage Facility Reservoir, a depleted oil reservoir natural gas storage facility located in Harris County, Texas, (ii) certain wells, facilities, pipe and equipment located on a contiguous surface area over and around the Bammel Storage Facility, and (iii) the Houston Loop pipelines and the Texas City Loop pipelines, which are high pressure natural gas pipelines and related facilities located primarily in Harris and Galveston Counties, Texas (collectively, the "Bammel Assets").

Kingfisher is a Delaware limited liability company whose sole member is Enron.

Peregrine is a Delaware limited liability company whose sole member is Enron.

HPL Asset Holdings L.P. ("HPL Asset Holdings"), a Delaware limited partnership formed on November 9, 1999, is owned 0.01 percent by HPL, as general partner (the "HPL Asset Holdings General Partnership Interest"), 98.99 percent by HPL, as limited partner (the "HPL Asset Holdings Limited Partnership Interest") and 1.0 percent by Peregrine, as limited partner. In return for the HPL Asset Holdings General Partnership Interest and the HPL Asset Holdings Limited Partnership Interest, HPL assigned and contributed the Bammel Assets, as more fully described in the Assignment and Contribution Agreement (Bammel Storage Facility Reservoir), dated November 10, 1999, the Assignment and Contribution Agreement (Bammel Storage Facility Equipment), dated November 10, 1999, and the Assignment and Contribution Agreement (Houston Loop and Texas City Loop), dated November 10, 1999.

Blue Heron I LLC ("Blue Heron") is a Delaware limited liability company whose sole member is Whitewing.

B. Summary of the Transaction

Pursuant to the terms of the Assignment Agreement (Membership Interest in Kingfisher), dated as of November 10, 1999, between Enron and HPL, Enron assigned and contributed 100 percent of its membership interest in Kingfisher to HPL.

Pursuant to the terms of the Assignment Agreement (General Partnership Interest in HPL Asset Holdings L.P.), dated as of November 10, 1999, between HPL and Blue Heron, HPL assigned the HPL Asset Holdings General Partnership Interest to Blue Heron in return for a membership interest in Blue Heron.

Pursuant to the terms of the Assignment Agreement (Membership Interest in Blue Heron I LLC and Limited Partnership Interest in HPL Asset Holdings L.P.), dated as of November 10, 1999, between HPL and Whitewing, HPL assigned and contributed (i) the HPL Asset Holdings Limited Partnership Interest and (ii) its membership interest in Blue Heron to Whitewing in exchange for a limited partnership interest in Whitewing.

Immediately thereafter, pursuant to the terms of the Assignment Agreement (Limited Partnership Interest in Whitewing Associates L.P.), dated as of November 10, 1999, between HPL and Kingfisher, HPL assigned and contributed its limited partnership interest in Whitewing to Kingfisher.

Thus, after giving effect to the assignments described above, the partnership interests in HPL Asset Holdings are held as follows: (i) the HPL Asset Holdings General Partnership Interest is owned by Blue Heron, (ii) the HPL Asset Holdings Limited Partnership Interest is owned by Whitewing, and (iii) the remaining 1.0 percent limited partnership interest is held by Peregrine.

Pursuant to the terms of the Lease Agreement, effective November 10, 1999, between HPL Asset Holdings and HPL, HPL Asset Holdings leased the Bammel Assets to HPL for an eighteen year term.

II. REPRESENTATIONS

In rendering our opinions herein set forth, the following facts have been represented to us:

1. No election will be made to classify Kingfisher, Peregrine or Blue Heron as an association taxable as a corporation for federal tax purposes.

2. Less than 80 percent of the value of the assets held by HPL Asset Holdings immediately after its formation consist of stock and securities within the meaning of section 351(e)(1)(B).

3. Less than 80 percent of the value of the assets held by Whitewing immediately after the contribution of the HPL Asset Holdings Limited Partnership Interest by HPL consist of stock and securities within the meaning of section 351(e)(1)(B).

4. HPL has a zero basis in the Bammel Assets.

5. The Bammel Assets would have a 15 year applicable recovery period if such assets were newly purchased property that was placed in service at the time of their contribution by HPL to HPL Asset Holdings.

6. The fair market value of the Bammel Assets will exceed HPL's adjusted tax basis in such assets upon contribution to HPL Asset Holdings.

7. HPL Asset Holdings and Whitewing will adopt the remedial method described in Treas. Reg. § 1.704-3(d) with respect to allocations of income, gain, loss or deduction attributable to the Bammel Assets and the HPL Asset Holdings Limited Partnership Interest contributed by HPL to HPL Asset Holdings and Whitewing, respectively.

8. The Bammel Assets will not be disposed of by HPL Asset Holdings before the HPL Asset Holdings Limited Partnership Interest is distributed to HPL in liquidation of its interest in Whitewing.

9. Whitewing will distribute the HPL Asset Holdings Limited Partnership Interest to HPL in liquidation of its interest in Whitewing in [2014].

10. In the year in which Whitewing makes a liquidating distribution to HPL, HPL will have made a section 754 election.

11. A portion of the built-in gain associated with the HPL Asset Holdings Limited Partnership Interest distributed to HPL in liquidation of its interest in Whitewing will not be attributable to depreciation recapture under section 1245 with respect to the Bammel Assets.

Our opinions are conditioned on the initial and continuing accuracy of the representations set forth above, as well as our understanding that the Transaction was carried out in accordance with the Transaction Documents and that there are no agreements, arrangements or understanding among any of the parties to the Transaction Documents other than those reflected in the Transaction Documents.

III. LAW AND ANALYSIS

A. Partnership Formation

Section 721(a) provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. However, under section 721(b) the general nonrecognition rule of section 721(a) does not apply to gain realized on a transfer of property to a partnership investment company (within the meaning of section 351) if the contribution results in the diversification of the transferor's assets.[2] Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property to the partnership is the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time. Section 723 provides that the basis of any property contributed to a partnership by a partner is the adjusted basis of the property in the hands of the contributing partner at the time of the contribution.

In the instant case, the Bammel Assets and the HPL Asset Holdings Limited Partnership Interest should constitute "property" within the meaning of sections 721 and 722. *See, e.g., United States v. Stafford*, 727 F.2d 1043 (11th Cir. 1984) (for purposes of section 721, "the term [property] encompasses whatever may be transferred"). In addition, less than 80 percent of the value of the assets held by Whitewing and HPL Asset Holdings consist of stock and securities as defined in section 351(e)(1)(B). Thus, no gain or loss should be recognized by HPL on either the contribution of the Bammel Assets to HPL Asset Holdings or the contribution of the HPL Asset Holdings Limited Partnership Interest to Whitewing. Moreover, under section 722, because HPL has a zero basis in the Bammel Assets, HPL will have a zero basis in the HPL Asset Holdings Limited Partnership Interest, and, therefore, a zero basis in its interest in Whitewing following the contribution of the HPL Asset Holdings Limited Partnership Interest to Whitewing. In addition, under section 723, the basis of the Bammel Assets in the hands of HPL Asset Holdings is zero, and, therefore, Whitewing's basis in HPL Asset Holdings is zero following the contribution of the HPL Asset Holdings Limited Partnership Interest to Whitewing.

B. Partnership Operations

[2] A partnership generally will be treated as an investment company if, immediately after the transfer or formation, more than 80 percent of its assets are held for investment and consist of "stock and securities," as defined in section 351(e)(1)(B).

Section 704(c)(1)(A) provides that under regulations prescribed by the Secretary income, gain, loss and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution (*i.e.*, a precontribution gain or loss). In general, allocations with respect to precontribution gain or loss under section 704(c) must be made using a reasonable method that is consistent with the purpose of section 704(c) – namely, to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Treas. Reg. § 1.704-3(a)(1).

The Treasury regulations promulgated under section 704 provide three methods of allocating precontribution gain or loss under section 704(c) that are considered generally reasonable: the traditional method, the traditional method with curative allocations and the remedial method. *See* Treas. Reg. § 1.704-3(b), (c) and (d). Under the remedial method, a partnership eliminates distortions caused by the ceiling rule[3] by creating remedial items and allocating those items to its partners. Although remedial items have the same effect as actual tax items on a partner's tax liability and on the partner's adjusted tax basis in his partnership interest, remedial items do not affect the partnership's computation of taxable income under section 703, the partnership's adjusted tax basis in partnership property or partners' book capital accounts. Treas. Reg. § 1.704-3(d)(4).

In the instant case, the Bammel Assets will be considered section 704(c) property with precontribution gain (*i.e.*, built-in gain) upon the contribution of such assets by HPL to HPL Asset Holdings, because the fair market value of the Bammel Assets will exceed HPL's adjusted tax basis in such assets at the time of contribution. Treas. Reg. § 1.704-3(a)(3(i) and (ii). Due to the adoption of the remedial method under Treas. Reg. § 1.704-3(d) by HPL Asset Holdings, HPL initially will be allocated items of income attributable to the built-in gain of the Bammel Assets over 15 years (the recovery period available to HPL if the Bammel Assets were newly purchased property placed in service at the time of contribution by HPL). Treas. Reg. §1.704-3(d)(2)).[4]

[3]The ceiling rule comes into play where the total income, gain, loss or deduction that should be allocated to the partners for a taxable year with respect to a property under the traditional method exceed the amount realized for tax purposes by the partnership with respect to that property for a taxable year. *See* Treas. Reg. § 1.704-3(b)(1).

[4]It is our understanding that Enron will be allocated the corresponding items of deduction attributable to the built-in gain of the Bammel Assets. Thus, because the remedial items will be allocated to members of the same consolidated group, the remedial allocation should offset as a practical matter.

Thereafter, because HPL will contribute the HPL Asset Holdings Limited Partnership Interest to Whitewing, Whitewing will be allocated the items of income attributable to the built-in gain of the Bammel Assets in the same manner as such items would have been allocated to HPL. Treas. Reg. § 1.704-3(a)(7). Moreover, Whitewing must allocate its distributive share of the built-in gain amounts from the Bammel Assets "in a manner that takes into account the contributing partners remaining built-in gain or loss." Treas. Reg. § 1.704-3(a)(9). Hence, the remedial items of income allocated to Whitewing should, in turn, be allocated to HPL. These income allocations will result in an increase in HPL's adjusted tax basis in its partnership interest in Whitewing. Treas. Reg. § 1.704-3(d)(4). [Therefore, at the end of the book life of the Bammel Assets (15 years), HPL's adjusted tax basis in its partnership interest in Whitewing should equal the initial fair market value of such assets assuming no other allocations of income, gain, loss, deduction or credit over such 15 year period.]

C. Liquidation

1. Liquidating Distribution of HPL's Interest in Whitewing

Section 736(b) provides that if payments made in liquidation of the interest of a retiring partner or a deceased partner are considered as a distribution by the partnership, rather than as a distributive share of partnership income or as guaranteed payments, such payments will be treated as made in exchange for such partner's interest in partnership property. Under section 731(a)(1), in the case of a distribution by a partnership to a partner, gain shall not be recognized by a distributee partner unless such partner receives cash in excess of its adjusted tax basis in partnership property. Section 731(a)(2), in turn, provides that upon a distribution in liquidation of a partner's interest in a partnership, a loss will be recognized by a distributee partner if such partner receives no other property other than cash, unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)), and the amount of cash and the tax basis of such assets, as determined under section 732, are less than the distributee' partner's adjusted tax basis in its partnership interest.

Section 751(c) provides that the term "unrealized receivables" includes, among other things, section 1245 property. Section 751(f) provides that in determining whether property of a partnership is an unrealized receivable, such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner. Section 1245(a)(3) provides that "section 1245 property" means, among other things, any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either personal property or certain other depreciable property that was used as an integral part of manufacturing, production or extraction of gas.

Under section 732(b), the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction. In the event basis must be allocated among distributed assets under section 732(b), section 732(c) provides that basis is allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)) in an amount equal to the adjusted basis of each such property to the partnership. Thereafter, to the extent basis remains to be allocated, basis is allocated to other distributed properties in an amount equal to such other property's adjusted basis to the partnership and then, to the extent any increase in basis is required in order to have the adjusted bases of such other distributed properties equal such remaining basis:

> (A) first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation), and (B) then, to the extent such increase is not allocated under subparagraph (A), in proportion to their respective fair market values.

Section 732(c)(2).[5]

In the instant case, some, but not all, of the HPL Asset Holdings Limited Partnership Interest will be considered an unrealized receivable under section 751(c) because the Bammel Assets constitute section 1245 property, and under section 751(f), Whitewing is treated as owning its proportionate share of the unrealized receivables held by HPL Asset Holdings. However, because property other than solely cash, unrealized receivables and inventory are being distributed to HPL upon the liquidation of its interest in Whitewing, HPL will recognize neither gain nor loss upon the distribution of the HPL Asset Holdings Limited Partnership Interest. *See* section 731(a)(1) and (2).

Under section 732(b), the basis of the HPL Asset Holdings Limited Partnership Interest received by HPL will equal HPL's adjusted basis in Whitewing. Under section 732(c), this basis must first be allocated to any unrealized receivables in an amount equal to the adjusted basis of such property in the hands of Whitewing (through the operation of section 751(f)). Under this methodology, no basis should be attributed to the portion of the HPL Asset Holdings Limited Partnership Interest considered an unrealized receivable because such property has no basis in the hands of HPL Asset Holdings. Thus, under section 732, all of HPL's basis in Whitewing will be allocated to the HPL Holding Limited Partnership Interest.

2. *Basis Adjustment to Bammel Assets*

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[5]Section 732(c) states that section 732 shall not apply to the extent that a distribution is treated as a sale or exchange of property under section 751(b). Section 751(b) does not apply, however, to a "distribution of property which the distributee contributed to the partnership." Section 751(b)(2)(A). Therefore, because the HPL Asset Holdings Limited Partnership Interest was originally contributed to Whitewing by HPL, section 751(b) should not apply to recharacterize the distribution by Whitewing of the HPL Asset Holdings Limited Partnership Interest to HPL.

Section 743(b) provides that if a partnership makes a valid section 754 election, the basis of partnership assets is adjusted with respect to a transferee partner upon the transfer of a partnership interest "by sale or exchange or upon the death of a partner." *See also* Treas. Reg. § 1.743-1(a). The amount of the section 743(b) adjustment is equal to the difference between the transferee's initial basis in his partnership interest and his "proportionate share of the adjusted basis of the partnership property." *Id.* If the transferee's basis in his partnership interest is greater than his proportionate share of the basis of the partnership property, the section 743(b) adjustment increases the basis of partnership property with respect to such transferee. Treas. Reg. § 1.743-1(b)(1) If the transferee's basis in his partnership interest is less than his proportionate share of the basis of the partnership property, the section 743(b) adjustment decreases the basis of partnership property with respect to such transferee. Treas. Reg. § 1.743-1(b)(2).

The distribution of the HPL Asset Holdings Limited Partnership Interest to HPL by Whitewing should be considered an exchange for purposes of section 743. Section 761(e)(2). Thus, because (i) HPL Asset Holdings will have made a section 754 election prior to the year of such distribution and (ii) HPL's basis in HPL Asset Holdings is greater than its proportionate share of the basis of the Bammel Assets held by HPL Asset Holdings (zero), HPL Asset Holdings should be permitted to increase the basis of the Bammel Assets with respect to HPL by an amount equal to HPL's basis in HPL Asset Holdings. This increase in basis should be depreciable as if it were newly purchased property under any depreciation method available to HPL for newly purchased property that is placed in service at the time of the distribution. Treas. Reg. § 1.743-1(j)(4)(i)(B).

IV. OPINIONS

Based on the facts, representations, law and analysis set forth above, in our opinion, for federal income tax purposes:

1. Under section 732, the basis of the HPL Asset Holdings Limited Partnership Interest distributed by Whitewing to HPL in liquidation of HPL's interest in Whitewing should be an amount equal to HPL's adjusted basis in Whitewing[, after giving effect to any remedial allocations under section 704(c) attributable to the Bammel Assets.]

2. Upon the distribution of the HPL Asset Holdings Limited Partnership Interest to HPL in liquidation of its interest in Whitewing, HPL Asset Holdings should be permitted to increase the basis of the Bammel Assets with respect to HPL by the excess of HPL's basis in HPL Asset Holdings over HPL's proportionate share of the basis of the Bammel Assets held by HPL Asset Holdings.

Our opinion is based upon the existing provisions of the Code and the Treasury regulations promulgated thereunder, published rulings of the Internal Revenue Service and existing case law. All such authorities are subject to change, and any such change could apply retroactively. Moreover, we express no opinion as to the tax treatment of the Transaction under the provisions of any other section of the Code that also may be applicable thereto ***[, including, but not limited to, section 731(c)]*** or to the tax treatment of any conditions existing at the time of, or effects resulting from, the Transaction that are not specifically addressed in the foregoing opinion.

This opinion is not to be quoted or otherwise referred to or furnished to any governmental agency without our prior written consent.

Very truly yours,

VINSON & ELKINS L.L.P.

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VIII. TAX OPINION LETTERS

RELATING TO

PROJECT TAMMY I

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February 9, 2001

Privileged Attorney-Client Communication

Enron Corp.
1400 Smith Street
Houston, Texas 77002
Attn: R. Davis Maxey

Subject: ***Enron Finance Partners, LLC***

Ladies and Gentlemen:

You have requested our opinion with respect to certain United States federal income tax consequences of a transaction involving the creation of certain entities, the contribution of assets to those entities and a related financing effected with various banks. Our opinion is based upon: (i) the Limited Liability Company Agreement of Enron Finance Partners, LLC ("EFP LLC") dated July 21, 2000, and subsequent amendments (the "EFP Agreement"); (ii) the Limited Liability Company Agreement of Enron Asset Holdings LLC ("EAH LLC"), dated November 3, 2000 and subsequent amendments (the "EAH Agreement"); (iii) the Limited Liability Company Agreement of Zephyrus Investments, LLC ("Zephyrus LLC"), dated November 28, 2000 (the "Zephyrus Agreement"); (iv) the Assignment and Assumption Agreements, the Supplemental Assignment and Assumption Agreements and other instruments related to the assumption of certain liabilities of Enron Corp. ("Enron"); (vi) the Zephyrus LLC Funding Agreement dated November 28, 2000; (vi) the Indemnification Agreement between EFP LLC and Enron dated November 28, 2000; and (vii) certain assumptions and representations by management of Enron as to the existence of certain facts. Capitalized terms not defined herein have the meanings set forth in the EFP Agreement or in the referenced document.

FACTS

A. Parties to the Transaction

EC2 000034142

1. Enron Finance Partners LLC

EFP LLC is a Delaware limited liability company that was formed on July 14, 2000. Enron, an Oregon corporation, Smith Street Land Company, a Delaware corporation ("Smith Street"), Enron Capital Investments Corp., a Delaware corporation ("ECIC"), and Enron Global Exploration & Production Inc. (formerly EOGI-India, Inc.), a Delaware corporation ("Global"), were admitted to EFP LLC as the initial Members, effective as of July 21, 2000. Enron

Caribbean Basin LLC ("Caribbean"), a Delaware limited liability company that is treated for federal income tax purposes as an entity disregarded as separate from its sole owner, Atlantic Commercial Finance, Inc. ("ACFI"), a Delaware corporation, was admitted as a Member pursuant to an amendment and restatement to the EFP Agreement dated October 4, 2000. Each of Smith Street, ECIC, Global and Caribbean (through its owner ACFI) is a member of the affiliated group of corporations filing a consolidated federal income tax return of which Enron is the common parent (the "Enron Group").

Enron, Enron Finance Management, LLC ("EFM LLC"), Smith Street, ECIC, Global and Caribbean entered into a second amendment and restatement to the EFP Agreement, dated November 21, 2000, in order to permit an additional capital contribution by Enron, to reclassify the membership interests of EFP LLC into Class A Membership Interests and Class B Membership Interests, to admit EFM LLC as a Class A Member, and to exchange and convert the membership interests held by Enron, Smith Street, ECIC, Global and Caribbean into Class B Membership Interests. On November 28, 2000, the EFP Agreement was amended and restated for a third time to reclassify and convert the membership interests in EFP LLC into three classes consisting of Class A Members, Class B Members and Class C Members, and to evidence (i) EFM LLC as the Class A Member, (ii) Enron, Smith Street, ECIC, Global and Caribbean as Class B Members, and (iii) the admission of Zephyrus LLC as the initial Class C Member. The EFP Agreement was further amended on December 11, 2000 and on January 2, 2001 to admit Boreas Holdings Corp., a Delaware corporation that is a member of the Enron Group ("Boreas"), as an additional Class B Member, and to provide that the Class B Member interests could not be assigned (other than to an Enron Affiliate) without the consent of the Class C Member, respectively.

2. *Enron Asset Holdings, LLC*

EAH LLC is a Delaware limited liability company that was formed on October 17, 2000. EFP LLC was admitted on November 3, 2000 as its initial Member pursuant to the EAH Agreement. The EAH Agreement was amended and restated on November 20, 2000 to provide that (i) Enron Intermediate Holdings, LLC ("EIH LLC") would replace EFP LLC as a Member; (ii) the membership interests in EAH LLC would be reclassified and converted into two classes consisting of Class A Membership Interests and Class B Membership Interests; (iii) the membership interest held by EIH LLC would be exchanged and converted into a Class B Membership Interest; and (iv) EFM LLC would be admitted as a Class A Member in consideration for a capital contribution of $20 million.

3. *Enron Finance Management, LLC*

EFM LLC is a Delaware limited liability company that was formed on October 23, 2000 to act as the Managing Member of EFP LLC and EAH LLC. Enron became the sole Member of EFM LLC pursuant to the Limited Liability Company Agreement of EFM LLC dated November 15, 2000. EFM LLC is treated for federal income tax purposes as an entity that is disregarded as separate from its sole owner, Enron.

4. Enron Intermediate Holdings, LLC

EIH LLC is a Delaware limited liability company that was formed on November 14, 2000 to hold the Class B Membership Interest in EAH LLC. EFP LLC was admitted as its sole Member on November 20, 2000. EIH LLC is treated for federal income tax purposes as an entity that is disregarded as separate from its sole owner, EFP LLC.

5. Zephyrus Investments, LLC

Zephyrus LLC is a Delaware limited liability company formed on November 17, 2000. Its initial Members, admitted as of November 28, 2000, were Chase Equipment Leasing, Inc. (as a Member and the Managing Member), Bank of America, N.A., BNP Paribas and Fleet National Bank. Royal Bank of Scotland subsequently was admitted as a Member. The Members contributed to Zephyrus LLC an aggregate of $481,725,000 in their capacities as "Lenders" and $18,275,000 in their capacities as "Certificate Purchasers." The Certificates represent the equity interests in Zephyrus LLC.

B. Summary of Transactions

Enron and its affiliates entered into the following series of transactions in order to create a flexible structure through which it could hold certain assets and obtain third-party financing that would be classified as a "minority interest" for financial accounting purposes. It is understood that the Enron Group historically has utilized similar structures to raise such financing, and that the aggregate principal amount of $500 million initially raised through the structure is consistent with amounts raised in such other financings. The term of the initial financing is five years, and it is has been represented that the financing structure described below will remain in existence for not less than five years and will hold assets in connection with its business or the business of the Enron Group, or for investment.

1. Contributions to EFP LLC

From the time of the formation of EFP LLC in July 2000 through November 28, 2000, the Class B Members contributed the following assets to EFP LLC ("Enron Assets") and in connection with such contributions EFP LLC assumed the following amounts of debt that had previously been assumed from Enron by the contributing Class B Member ("Enron Debt"):

(i) Enron contributed 11,500,000 shares of common stock of EOG Resources, Inc., a Delaware corporation ("EOGR"), with an agreed fair market value of $485,875,000, pursuant to an irrevocable stock power. The stock of EOGR is regularly traded on the New York Stock Exchange. In connection with this contribution, EFP LLC assumed approximately $460 million of Enron Debt; following the contribution and assumption, however, Enron remained liable on such Enron Debt.

(ii) Smith Street executed an Option Agreement with EFP LLC pursuant to which it granted EFP LLC an option to purchase for $1.00 all of the capital stock of Enron

Renewable Energy Corp. ("EREC"), with an agreed fair market value of $550,000,000 (the "EREC Option"). The EREC Option was intended to transfer tax ownership of the EREC stock to EFP LLC prior to regulatory approval of the transfer to EFP LLC of legal title to such stock. In connection with this contribution, EFP LLC assumed approximately $524 million of Enron Debt; following the contribution and assumption, however, Smith Street remained liable on such Enron Debt.

(iii) Global contributed all of the outstanding stock of Enron Oil & Gas India Ltd. ("EOGIL"), a Cayman Islands company, with an agreed fair market value of $550,000,000. In connection with this contribution, EFP LLC assumed approximately $523 million of Enron Debt; following the contribution and assumption, however, Global remained liable on such Enron Debt.

(iv) Caribbean contributed all of the outstanding stock of Enron LNG Power (Atlantic) Ltd. ("LNG"), a Cayman Islands company, with an agreed fair market value of $125,000,000. In connection with this contribution, EFP LLC assumed approximately $119 million of Enron Debt; following the contribution and assumption, however, ACFI (the owner of Caribbean) remained liable on such Enron Debt.

(v) On December 11, 2000, Boreas contributed partnership interests in Enron Capital Management III Limited Partnership (the "ECM Interests"), with an agreed fair market value of $99,083,880.[1] In connection with this contribution, EFP LLC assumed approximately $94 million of Enron Debt; following the contribution and assumption, however, Boreas remained liable on such Enron Debt.

(vi) ECIC contributed a Demand Promissory Note, dated July 21, 2000, in the principal amount of $200,000,000, payable by Enron to ECIC (the "Demand Promissory Note"). Enron also contributed a demand note in the principal amount of $125 million (the "Enron Overfunding Note") to ECIC, which in turn contributed that note to EFP LLC.

Following their respective contributions, each of Enron, Smith Street, Global, Caribbean and Boreas contributed 95 percent of their respective Class B Membership Interests in EFP LLC to ECIC in exchange for stock of ECIC. Each contributor remained liable on the portion of the Enron Debt that previously had been assumed by such contributor. It has been represented that EFP LLC will not make an election to adjust the basis of its assets pursuant to section 754 of the Code[2] in connection with the transfers of such membership interests.

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[1] All of the contributions could not be made prior to the closing of the financing transaction on November 28, 2000. Accordingly, Enron agreed in Section 3.01(b) of the EFP Agreement that it would make or cause an Enron Affiliate to make a Capital Contribution, in cash or in kind in any form of property, tangible or intangible (including a promissory note), having a value not less than $5,000,000 on or before December 31, 2000. The contribution by Boreas was made in satisfaction of this covenant. Failure to make such a contribution would have allowed the parties providing the financing to have their interests redeemed in February 2001.

[2] References to the "Code" are to the Internal Revenue Code of 1986, as amended, and references to sections are to sections of the Code unless the context requires otherwise.

2. *Contributions to EIH LLC and EAH LLC*

EFP LLC contributed its sole member interest in EAH LLC plus the Enron Assets (excluding the Enron Overfunding Note) to EIH LLC in exchange for the sole member interest in EIH LLC. Pursuant to certain Supplemental Assignment and Assumption Agreements, EIH LLC assumed the Enron Debt that had been assumed by EFP LLC in connection with the contributions described above, and EFP LLC was released from such obligations. The Enron Overfunding Note was released as collateral on the Enron Debt assumed by EIH LLC. As described above, EIH LLC is disregarded as an entity for tax purposes and thus, for tax purposes. EFP LLC remained liable on the Enron Debt.

Thereafter, EIH LLC contributed all of its assets (excluding the Demand Promissory Note) to EAH LLC and the membership interests in EAH LLC were reclassified into Class A and Class B Membership Interests. In connection with the contribution of EIH LLC and the reclassification, (i) EFM LLC contributed a $20 million Enron demand note to EAH LLC and became the Class A Member of EAH LLC (the "Class A Member"), and (ii) EIH LLC became the Class B Member of EAH LLC (the "Class B Member"). EAH LLC did not assume any of the Enron Debt in connection with such contributions.

The EAH Agreement provides that Profits shall be allocated (i) to the Class A Member, until the cumulative amount of Profits allocated to the Class A Member for the current taxable year and all prior taxable years equals the cumulative amount of Losses allocated to the Class A Member for all prior taxable years; (ii) to the Class B Member, until the cumulative amount of Profits allocated to the Class B Member for the current taxable year and all prior taxable years equals the cumulative amount of Losses allocated to the Class B Member for all prior taxable years; and (iii) thereafter, 75% to the Class B Member and 25% to the Class A Member.

Losses are allocated under the EAH Agreement (i) to the Class B Member, until the cumulative amount of Losses allocated to the Class B Member for the current taxable year and all prior taxable years equals an amount equal to 10% of the initial Capital Contributions of the Class B Member plus the cumulative amount of Profits allocated to the Class B Member for all prior taxable years; (ii) to the Class A Member to the extent of its Adjusted Capital Account; and (iii) thereafter, to the Class B Member.

3. *Admission of Zephyrus as a Class C Member of EFP LLC*

On November 28, 2000, in exchange for a capital contribution of $500 million, Zephyrus was admitted as the initial Class C Member and was issued 10 membership units ("Class C Units") evidencing the Class C Membership Interest. Each such Class C Unit represented a capital contribution of $50 million. The Class C Membership Interest entitles the Class C Member to a Preferred Return with respect to each Quarterly Period generally equal to the Preferred Applicable Rate (LIBOR for such Quarterly Period plus 1.0202 percent per annum) times the Liquidation Preference ($500 million, as increased or decreased periodically). The EFP Agreement contemplates that EFP LLC will acquire certain Financial Assets, including certain "Core Permitted Assets," and will maintain its holding of Core Permitted Assets sufficient to provide the Class C Members with coverage on their Aggregate Liquidation Preference equal to 1.25:1. Failure to maintain such a Core Permitted Assets Coverage Ratio will result in the payment by EFP LLC of a higher rate of Preferred Return (the "Specified Event Rate") on the Class C Units.

Pursuant to the EFP Agreement, Enron recognized that EFP LLC would not be permitted to own the Enron Assets (with the exception of the Demand Promissory Note and the Enron Overfunding Note) unless Enron indemnified EFP LLC against any and all losses, costs, liabilities, damages or expenses that may arise from EFP LLC's acquisition, ownership or disposition of the Enron Assets. In fulfillment of this obligation, Enron entered into an Indemnification Agreement with EFP LLC pursuant to which Enron agreed to indemnify EFP LLC and each Class C Member from and against any such claims related to the Enron Assets.

The EFP Agreement provides that EFP LLC may cause a full or partial redemption of the Class C Units on any Distribution Date on or after the second anniversary of the Closing Date. The EFP Agreement also provides certain redemption rights to holders of the Class C Units, including the right to have the Class C Member's interest redeemed on the Distribution Date occurring in February, 2001.[3] In addition, a holder of Class C Units has the option to have such Units redeemed on the Distribution Date occurring in November, 2005 and on any Distribution Date thereafter, provided that the Class C Member has complied with certain notice requirements. The Class C Member may require EFP LLC to make Full Redemption (or to cause one of its Affiliates to make Full Redemption) of all of the Class C Units held by such Class C Member at a price equal to the Specified Price (*i.e.*, the Liquidation Preference plus the amount of any unpaid Preferred Return).

The EFP Agreement provides that upon redemption of the Class C Membership Interest, EFP LLC (or another acquirer) is required to pay to the disposing Class C Member an amount equal to the Specified Price, except that if EFP LLC is effecting the redemption, no amounts that represent the proceeds of certain of the Enron Assets may be used to effect the redemption until certain percentages of such proceeds have been distributed to or set aside for distribution to Enron or any Member that is a wholly-owned Enron affiliate.

4. Allocations Under the EFP Agreement

The EFP Agreement provides that Profits shall be allocated to the Capital Accounts of the Members as follows: (a) the first 12.5% of all Sub Asset No. 1 Items[4] shall be allocated to ECIC

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[3] This redemption right came into existence only if the capital contribution required to be made pursuant to Section 3.01(b) of the EFP Agreement (*i.e.*, the additional $5 million) was not made on or before December 31, 2000. This right was terminated by the contribution made by Boreas of the ECM Interests on December 11, 2000, as set forth in the First Amendment to Third Amended and Restated Limited Liability Company Agreement of EFP, dated December 11, 2000.

[4] References to Sub Asset No. 1 through Sub Asset No. 4 refer to certain of the stock and partnership interests transferred to EIH LLC and thereafter to EAH LLC. These include the contributions initially made by Caribbean, Global, Boreas and Smith Street to EFP LLC, respectively.

and any transferee of ECIC's Class B Unit; (b) the first 51% of all Sub Asset No. 2 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit; (c) the first 95% of all Sub Asset No. 3 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit, and the remaining 5% of all Sub Asset No. 3 Items shall be allocated to the Class A Member and any transferee of the Class A Member's Class A Unit; (d) if the Class A Member determines that any such allocation is necessary for EFP LLC or any "Company Subsidiary" to comply with any agreements to which such Company Subsidiary or any of its direct or indirect Subsidiaries is bound or by which it is effected, the requisite percentage of Sub Asset No. 4 Items shall be allocated to ECIC and any transferee of ECIC's Class B Units; (e) all other Profits shall be allocated as follows: (i) first, 100% to the Class C Members to reverse Losses previously allocated to the Class C Members under Section 6.02(e)(ii) pro rata in accordance with Losses previously allocated to each Class C Member; (ii) second, 100% to the Class A Member and the Class B Members to reverse Losses previously allocated to the Class A Member and the Class B Members pursuant to Section 6.02(e)(i) and (iii); (iii) third, 100% to each Class C Member up to the Preferred Distribution Amount for each Class C Unit held by such Class C Member; and (iv) the balance to the Class A Member and the Class B Members in proportion to their Sharing Ratios.[5]

The EFP Agreement provides that Losses shall be allocated to the Capital Accounts of the Members as follows: (a) the first 12.5% of all Sub Asset No. 1 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit; (b) the first 51% of all Sub Asset No. 2 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit; (c) the first 95% of all Sub Asset No. 3 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit, and the remaining 5% of all Sub Asset No. 3 Items shall be allocated to the Class A Member and any transferee of the Class A Member's Class A Unit; (d) if the Class A Member determines that any such allocation is necessary for EFP LLC or any Company Subsidiary to comply with any agreements to which such Company Subsidiary or any of its direct or indirect Subsidiaries is bound or by which it is effected, the requisite percentage of Sub Asset No. 4 Items shall be allocated to ECIC and any transferee of ECIC's Class B Units; (e) all other Losses shall be allocated as follows: (i) first, 100% to the Class A Member and the Class B Members to the extent of, and in proportion to, their respective Adjusted Capital Accounts; (ii) second, 100% to each Class C Member to the extent of, and in proportion to, its Adjusted Capital Account; and (iii) the balance to the Class A Member and the Class B Members in proportion to their Sharing Ratios.

5. *Other Transactions*

Enron contemplates that some or all of the Enron Assets will be sold by EAH LLC and the proceeds of such sales used to purchase long-lived assets such as the new Enron office building that is currently under construction (the "Enron Building") and possibly stock or securities of Enron or other members of the Enron Group. It is understood that if the Enron

[5] It is assumed that EFP LLC will adopt the remedial allocation method pursuant to Treas. Reg. § 1.704-3(d).

Building is purchased as planned, the building will be owned by EAH LLC for a period of not less than five years. Thereafter, the building may be distributed in complete redemption of ECIC's interest in EFP LLC. Following such distribution or the complete dissolution of EFP LLC, it is understood that the Enron Building will continue to be owned by a member of the Enron Group.

Other than loans with respect to which repayment is required, it is assumed that no distributions will be made to any of the EFP LLC Members within the two-year period following the date of their respective contributions. In addition, it is assumed that neither EFP LLC nor EAH LLC will own unrealized receivables or inventory items (as those terms are defined in section 751 of the Code). To date, none of the Enron Assets have been sold nor are any such assets subject to a contract for sale.

AUTHORITIES

A. Transfers of Property to EFP LLC

1. General Nonrecognition Rules of Section 721

Section 721(a) of the Code provides that no gain or loss shall be recognized to a partnership or to any of its partners on a contribution of property to the partnership in exchange for an interest in the partnership. Section 721(b) of the Code provides that the nonrecognition rules of section 721(a) will not apply to gain realized on the transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated.

A transfer of property will be considered to be a transfer to an investment company if (i) the transfer results directly or indirectly, in diversification of the transferors' interests, and (ii) the transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80% of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) consist of stocks and securities.[6] Section 351(e) states that for purposes of this rule, items such as money, stock and other equity interests in a corporation and evidences of indebtedness are treated as stock and securities. Treasury Regulation § 1.351-1(c)(2) provides that the determination of whether a corporation is an investment company will ordinarily be made by reference to the circumstances in existence immediately after the transfer in question. However, where circumstances change thereafter pursuant to a plan in existence at the time of the transfer, the determination will be made by reference to later circumstances.

Treasury Regulation §1.351-1(c)(4) provides that in determining whether more than 80% of the value of a transferee corporation's assets are held for investment, stock and securities of subsidiary corporations are disregarded and the parent corporation is deemed to own its ratable share of the subsidiaries' assets. A corporation is considered a subsidiary if the parent

[6] Section 351(e) and Treas. Reg. § 1.351-1(c)(1).

corporation owns 50% or more of (i) the combined voting power of all classes of stock entitled to vote or (ii) the total value of shares of all classes of stock outstanding.

As described above, the Members of EFP LLC will transfer assets consisting of cash, stock of EOGR, the ECM Interests, a $200 million Demand Promissory Note, a $125 million Enron Overfunding Note and the stock (or, with respect to EREC, an option to acquire the stock) of EREC, EOGIL and LNG. Under the regulations described above, EFP LLC (and subsequently EAH LLC) will be considered to hold directly all of the assets held by EREC, EOGIL and LNG. It is assumed that each of these companies is an operating company or holds interests in operating companies that would be treated as "subsidiaries" for purposes of this analysis. Thus, based on the types of assets and assuming the accuracy of the valuations described above, at the time of the contribution of the Enron Assets, more than 80% of EFP LLC's assets should not be treated as consisting of stocks and securities. Accordingly, the general nonrecognition rule of section 721(a) of the Code should apply to the transfers of the Enron Assets to EFP LLC and ultimately to EAH LLC.

Although Enron contemplates that certain of the Enron Assets may be sold and other assets acquired with the proceeds, it is assumed that there is no present plan by Enron or its affiliates to cause EFP LLC or EAH LLC to acquire and hold readily marketable stocks and securities in amounts that would cause either such company to be treated as an investment company under the rules described above.

2. *Disguised Sale Treatment*

Notwithstanding the general nonrecognition rule of section 721(a) of the Code, section 707(a)(2)(B) provides that if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers when viewed together are properly characterized as a sale or exchange of property, then the transfers shall be treated as a transaction between a partnership and one who is not a partner or as a transaction between two or more partners acting other than in their capacity as members of the partnership.

Treasury Regulation § 1.707-3(b) provides that a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, only if based on all of the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of property, and in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. The determination of whether a transfer of property by a partner to a partnership and a transfer of money or other consideration by the partnership to the partner will constitute a sale is made based on all the facts and circumstances in each case.[7] The weight to be

[7] Treas. Reg. § 1.707-3(b)(2).

given each of the facts and circumstances will depend on the particular case. Generally, however, the facts and circumstances existing on the date of the earliest of the transfers are the ones determining the existence of a sale.[8]

Treasury Regulation § 1.707-3(c)(1) provides that if a transfer of property to the partnership and a transfer of money or other consideration to the partner occur within a two-year period, the transfers are presumed to be a sale unless the facts and circumstances clearly establish that the transfers do not constitute a sale. Conversely, transfers made more than two years apart are presumed not to be a sale.

Treasury Regulation § 1.707-5(a)(1) provides that if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability. The regulations provide that a partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations thereunder.[9] A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under Treasury Regulation § 1.752-1(a)(1). Pursuant to that regulation, a partnership liability is a recourse liability to the extent that any partner or a related person bears the economic risk of loss for that liability under Treasury Regulation § 1.752-2.

Treasury Regulation § 1.752-2(b)(1) provides that a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or a related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or a related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. The regulation provides further that upon a constructive liquidation of the partnership, the following events would be deemed to occur simultaneously: (i) all of the partnership's liabilities would become payable in full; (ii) with the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, would have a value of zero; (iii) the partnership would dispose of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership); (iv) all items of income, gain, loss, or deduction would be allocated among the partners; and (v) the partnership would liquidate.

The determination of the extent to which a partner or related person has an obligation to make a payment under the liquidation scenario described above is based on the facts and circumstances at the time of the determination. For this purpose, all statutory and contractual obligations relating to the partnership liability are taken into account, including (i) contractual obligations outside the partnership agreement such as guarantees, indemnifications,

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[8] *Id.*

[9] Treas. Reg. § 1.707-5(a)(2)(i).

reimbursement agreements and other obligations running directly to creditors or to other partners or to the partnership; (ii) obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and (iii) payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law.

As described above, in connection with the contributions of Enron Assets, Enron Debt was assumed by EFP LLC and subsequently assumed by EIH LLC. As EIH LLC is disregarded, for tax purposes EFP LLC remained liable on the Enron Debt. It is assumed that the Enron Debt does not constitute a qualified liability. With respect to each transfer, the Member contributing assets to EFP LLC remained personally liable on the debt. Accordingly, if EFP LLC were deemed to liquidate in the manner described in the regulations and the value of all of its assets were deemed to be zero, it would be unable to repay the Enron Debt and the contributing Members would be liable under their respective Assumption Agreements to repay such indebtedness. Accordingly, in each case the amount of the Enron Debt assumed by EFP LLC does not exceed the Member's share of that liability immediately after the assumption of the liability by EFP LLC. Therefore, none of the Members should be treated as receiving consideration in connection with the transfers of the Enron Assets.

It is possible that proceeds from sales of the Enron Assets may be loaned or distributed to Enron or its affiliates. To the extent that the party receiving such an amount is obligated to repay that amount, the provisions of section 707 will not be applicable. However, to the extent that Enron or one of its affiliates that is a Member of EFP LLC receives a distribution for which no obligation to repay exists, such distribution would need to be analyzed based on the facts and circumstances existing at the time of the distribution to determine if the provisions of section 707 would cause the initial transfer of property and later distribution to be treated as a sale. To the extent any such distribution is made more than two years after the date of the transfer of the relevant Enron Asset, such transfer and distribution will be presumed not to be a sale.

B. Transfers of EFP LLC Member Interests to ECIC

1. General Nonrecognition Rules of Section 351

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock of such corporation if immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of determining control in connection with a transfer pursuant to section 351, stock owned by all members of an affiliated group filing a consolidated income tax return is taken into account.[10] Section 357(c) provides that in an exchange to which section 351 applies, if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred in such exchange, then such excess shall be considered as gain from the sale or exchange or property. Where the property transferred to a controlled

[10] Treas. Reg. § 1.1502-34.

corporation is a partnership interest, a transferor is treated as transferring liabilities to the transferee corporation to the extent that partnership liabilities previously allocated to the transferor are allocated to such corporation and the transferor is relieved of that liability.[11]

Pursuant to section 722 of the Code, the adjusted basis of a partner's interest in a partnership is equal to the amount of money plus the basis of any property contributed by such partner to the partnership. Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership. As described above, a partner's share of a recourse liability of the partnership equals the portion of that liability for which the partner or a related person bears the economic risk of loss.[12]

In the transaction, Enron and certain other Members of EFP LLC transferred 95% of their Member Interests to ECIC in exchange for stock of ECIC and met the general requirement for nonrecognition of gain or loss under section 351(a). Each tranferor Member's basis in its Membership Interest includes such Member's share of the Enron Debt for which it has remained liable. However, because Enron and the other transferors will continue to be Members of EFP LLC and will remain fully liable on the Enron Debt, upon transfer of those Membership Interests to ECIC the transferor Member's share of the Enron Debt will not be decreased. Accordingly, no gain should be recognized pursuant to section 357(c).

2. *Business Purpose Requirement for Section 351 Transfer*

There is no specific requirement in section 351 or the regulations thereunder that a transfer to a controlled corporation be carried out for a non-tax business purpose. The Internal Revenue Service ("IRS") has taken the position in older published rulings that a transfer to a controlled corporation must serve a business purpose or alternatively, that it not be carried out merely to gain a tax advantage.

In Rev. Rul. 55-36, 1955-1 C.B. 340, a shareholder holding 1/6 of the stock of a corporation transferred that stock to a new corporation and then contributed the stock of the new corporation to a charity, which liquidated the new corporation. The IRS held that the transaction did not qualify under the predecessor of section 351 because it served no corporate business purpose as the new corporation did not conduct any business or remain in existence except for the brief time necessary to effect the donation. Moreover, the shareholder did not meet the control requirement of the statute.

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[11] *See* Rev. Rul. 80-323, 1980-2 C.B. 124 (a transferring limited partner's share of nonrecourse liabilities of the partnership is treated as a liability to which the partnership interest is subject for purposes of section 357(c)); *see also* Treas. Reg. § 1.752-2(h), which provides that if a partnership interest is sold or exchanged, the reduction in the transferor's share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder.

[12] Treas. Reg. § 1.752-2(a).

In Rev. Rul. 60-331, 1960-2 C.B. 189, individuals who transferred their stock in a personal holding company to another wholly-owned corporation after receiving information relating to the personal holding company tax but before the distribution of a deficiency dividend were taxable on the dividend. The ruling states that the transaction was effected solely to gain the advantage of the corporate dividends received deduction and therefore would be ignored. Rev. Rul. 68-349, 1968-2 C.B. 143, held that the transfer by an individual of property to a newly-formed corporation did not qualify under section 351. In the ruling, another corporation (which wanted to acquire the property) simultaneously transferred its assets to the new corporation for the purpose of qualifying the individual's transfer and then distributed the stock of the new corporation to its shareholders in redemption of their stock. The ruling held that the new corporation was treated as merely a continuation of the old corporation.

In Rev. Rul. 70-140, 1970-1 C.B. 73, a transfer of assets by an individual to a controlled corporation was disregarded where, pursuant to a prearranged plan, the stock of the new corporation was to be acquired by another corporation. However, Rev. Rul. 76-123, 1976-1 C.B. 94, reached a different result. In the ruling, the stock of two wholly-owned corporations was transferred by their sole shareholder to a new corporation, and thereafter, the new corporation caused the liquidation of one of the transferred corporations. The IRS held that the transfers qualified for nonrecognition under section 351 and section 368(a)(1)(C). The new corporation remained in existence and conducted the business of the liquidated corporation; the ruling held that the arrangement was therefore not employed solely to allow the transfer of stock without the recognition of gain but rather effected the combination of the businesses.

The courts have not strictly imposed a business purpose requirement and generally have disregarded a transfer purporting to be tax-free under section 351 only where either the existence of the corporation or its ownership of the assets is transitory. *See West Coast Marketing Corp. v. Comm'r*, 46 T.C. 32 (1966) (transfer of land to a new corporation followed by exchange of stock and subsequent liquidation of the corporation did not qualify for tax free treatment; existence of corporation was transitory); *cf. Weikel v. Comm'r*, 51 T.C.M. 432 (1986) (individual transferred assets to a controlled corporation and approximately four months later executed a definitive agreement under which the corporation was to be acquired in a reorganization qualifying under section 368(a)(1)(B); transfer to new corporation was not disregarded as the new corporation held the assets and conducted business for almost three years and the definitive agreement was not signed until several months after the incorporation); *Caruth v. United States*, 688 F. Supp. 1129 (N.D. Tex. 1988), *aff'd on other grounds*, 865 F.2d 644 (5th Cir. 1989) (in which the IRS challenged the contribution of stock of one corporation to another wholly-owned corporation several days before a dividend was declared; the court held that the business purpose doctrine applied but found that the taxpayer did establish a valid business purpose for the transfer and there was no evidence that the transferee corporation was used merely for tax avoidance purposes).

Although the authorities described above indicate that some business purpose is required for a transfer to qualify under section 351, the standard applied to such transactions does not appear to be as stringent as that applied in the reorganization context. Moreover, in almost every instance in which tax-free treatment or some other benefit (*e.g.*, the dividends received deduction) has been denied, the transfer to the controlled corporation has been effected immediately prior to the specific event giving rise to the benefit or the existence of the corporation is transitory. Where no immediate tax savings or other tax advantage is realized, the courts generally have been reluctant to disregard the transaction. In this case, ECIC is an existing corporation that currently holds assets and is a member of the Enron Group. The transaction is not being effected to avoid the recognition of gain on assets as any gain recognized by EFP LLC will be fully taxable to the members of the Enron Group to whom such gain is allocated. Moreover, ECIC will receive and hold the EFP LLC interests for at least five years and EFP LLC, through its ownership in EAH LLC, will continue to maintain an interest in the assets underlying those interests. At the time of the transfers, there were no existing agreements to sell the Enron Assets or to exchange the interests in EFP LLC or the stock of ECIC. Accordingly, the transfer of 95% of the EFP Member interests to ECIC is distinguishable from the authorities described above and should be respected as tax-free under section 351 of the Code.

C. Application of Section 704(c) to the Transaction

1. General Allocation Rules

Section 704(c) provides that under regulations prescribed by the Secretary, income, gain, loss and deduction with respect to property contributed to a partnership by a partner shall be shared among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of the contribution.[13] The purpose of Section 704(c) is to prevent the inappropriate shifting of tax consequences among partners with respect to precontribution gain or loss on property contributed to the partnership.[14] Except for certain types of property, section 704(c) is to be applied on a property-by-property basis.[15] Treasury Regulation § 1.704-3(a)(7) provides that if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner; if the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.[16]

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[13] Treasury Regulation § 1.704-3(a)(9) provides that if a partnership contributes section 704(c) property to a second partnership (the lower-tier partnership), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss.

[14] Treas. Reg. § 1.704-3(a)(1).

[15] Treas. Reg. § 1.704-3(a)(2); pursuant to Treas. Reg. § 1.704-3(e)(2), depreciable property, zero-basis property and inventory may be aggregated.

[16] The regulations under section 704(c) do not define a partner's interest in a partnership nor do they indicate how the portion of the partner's interest transferred should be computed. Treas. Reg. § 1.704-1(b)(3) states that for purposes of section 704(b), references to the partners' interests in the partnership signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain,

Except for Treas. Reg. § 1.704-3(a)(7), there is no specific authority dealing with the allocation of section 704(c) gain when a portion of a partnership interest is transferred. In Rev. Rul. 84-53, 1984-1 C.B. 160, the IRS prescribed a method for dealing with the allocation of partnership basis in the case of sales or exchanges of partnership interests. The ruling states that when a partner makes a taxable disposition of a portion of an interest in a partnership, the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest. In a situation in which the partnership has recourse debt and the partner's share of all partnership liabilities does not exceed the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the ruling indicates that the transferor partner shall first exclude from the adjusted basis of such partner's entire interest an amount equal to such partner's share of all partnership liabilities, as determined under Treasury Regulation § 1.752-1(e). A part of the remaining adjusted basis (if any) is to be allocated to the transferred portion of the interest according to the ratio of the fair market value of the transferred portion of the interest to the fair market value of the entire interest under authority of Treas. Reg. § 1.61-6(a). The sum of the amount so allocated plus the amount of the partner's share of liabilities that is considered discharged equals the adjusted basis of the transferred portion of the interest.

There is no indication that the method advocated in Rev. Rul. 84-53 with respect to a partner's interest in a partnership has any application to the allocation of precontribution section 704(c) gain nor is there any indication that a partner's share of partnership liabilities is to be considered in allocating section 704(c) gain. To the contrary, in recent instances where allocation of section 704(c) gain has been an issue, the only authority cited is Treas. Reg. § 1.704-3(a)(7). For example, recently finalized regulations dealing with partnership divisions specifically state that section 704(c) gain attributable to an interest deemed purchased by the partnership in a merger is to be apportioned among the remaining partners in accordance with section 704(c) and Treas. Reg. § 1.704-3(a)(7).[17] Further, in the preamble to final regulations issued under section 1223, Treasury explained that when a partner sells a portion of his partnership interest, the amount of section 704(c) gain transferred to a purchaser is relevant in determining a taxpayer's share of collectibles gain or section 1250 gain. To that end, it is necessary to calculate the gain that would be allocated to the interest sold if the underlying collectibles or section 1250 property were sold for their fair market value.[18] The preamble notes that this issue while important is beyond the scope of the regulations.[19] Significantly, the

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loss, deduction or credit (or item thereof) that is allocated. The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances including: (i) the partners' relative contributions to the partnership; (ii) the interests of the partners in economic profits and losses (if different than that in taxable income or loss); (iii) the interests of the partners in cash flow and other non-liquidating distributions; and (iv) the rights of the partners to distributions of capital upon liquidation.

[17] *See* Treas. Reg. § 1.708-1(c)(5), Example 5.

[18] T.D. 8902, I.R.B. 2000-41, p. 324 (Oct. 10, 2000).

[19] The discussion in the preamble apparently was included in response to comments from the American Bar Association Section of Taxation. The comments encouraged the inclusion of specific guidance and suggested that it

preamble discusses Rev. Rul. 84-53 not in the context of the section 704(c) allocation but only with respect to its holding that a partner has a single basis in his partnership interest.

The section 704(c) gain is an amount determined at the time of a contribution that has no relevance to the partner's basis in his partnership interest and does not take into account subsequent events affecting the contributing partner's partnership basis such as the incurrence of debt by the partnership or the allocation of operating income or loss. Moreover, the amount of such section 704(c) gain is unaffected by liabilities allocated to the contributing partner or a transferee partner. There is no indication that section 704(c) gain would be allocated other than pursuant to Treas. Reg. § 1.704-3(c)(9), that is, proportionate to the interest transferred and the interest retained. The Class B Members transferred to ECIC 95% of each of their Membership Interests in EFP LLC. Such interests represent pro rata portions (by percentage and by fair market value) of the Class B Member interests in EFP LLC and, accordingly, the portion of the interest transferred should be equal to 95% of each transferor's total interest. Therefore, based on Treasury Regulation § 1.704-3(a)(7), 95% of each transferor's section 704(c) gain should be allocated to ECIC.

2. *Section 704(c) Anti-Abuse Rule*

The regulations under section 704(c) contain an anti-abuse rule which states that an allocation method (or combination of methods) is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[20] In order to fall within the ambit of this rule, the proscribed shifting of tax consequences must occur as a result of an allocation method and the allocation of tax items pursuant to this method must be made with a view toward inappropriately shifting the tax consequences among the partners.

The preamble to the final regulations indicates that this rule was not intended for broad application to all aspects of the section 704(c) regulations but rather was specifically directed toward abuses in the use of allocation methods:

> The final regulations provide an anti-abuse rule that has been revised to respond to concerns raised in comments and to target more specifically abusive transactions. The rule applies to all methods of making section 704(c) allocations, including the methods described in the final and temporary regulations. Under the rule, an allocation method (or combination of methods) is not reasonable if the contribution (or other relevant event) and the allocations with respect to the property are made with a view to shifting the tax consequences of built-in gain or

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would be appropriate to allocate the section 704(c) gain between the partners based on the fair market value of the partnership interest transferred over the fair market value of the selling partner's entire presale interest. *See* Tax Notes Today, March 23, 2000.

[20] Treas. Reg. § 1.704-3(a)(10).

loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[21]

The examples in the regulations further confirm that the application of Treasury Regulation § 1.704-3(a)(10) occurs when one of the prescribed allocation methods is used inappropriately. In one example, the traditional method is used in an "unreasonable" manner that results in shifting a significant amount of taxable income to a partner with a low marginal tax rate (through the use of expiring net operating losses) and away from a partner with a high marginal tax rate.[22] In another example, curative allocations are held to be unreasonable where they are used with a view to shifting a significant amount of partnership taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate within a period of time significantly shorter than the economic life of the contributed property.[23] There are no examples illustrating the application of the anti-abuse rule to other than the allocation methods provided in the regulations.

Any shift of section 704(c) gain in the assets contributed to EFP LLC results from the contribution of a portion of the various Class B Membership Interests to ECIC rather than from a chosen allocation method. Under Treasury Regulation § 1.704-3(a)(7), section 704 gain inherent in the Enron Assets is required to be allocated to ECIC "as it would have been allocated to the transferor partner." ECIC, in effect, steps into the shoes of the transferor partner as though it had been the original contributor of the assets to the extent of the portions of the Membership Interests transferred to ECIC. Moreover, there has been no shifting of tax consequences between the Members pursuant to an allocation method as described in the regulations and, therefore, the anti-abuse rule contained in Treasury Regulation § 1.704-3(c)(10) should have no application to the EFP LLC transaction.

D. Substance of the Partnership

Notwithstanding the technical nature of the rules described above, the IRS in certain circumstances has challenged the application of those rules to transactions entered into without a business purpose or under the general anti-abuse rules set forth in Treasury Regulation § 701-2.

1. Business Purpose / Sham Transaction

The authorities make clear that taxpayers are free to structure their business transactions as they wish even if the transactions are motivated by tax avoidance considerations.[24] To be accorded recognition for tax purposes, a transaction generally must have economic substance

[21] T.D. 8500, 1994-1 C.B. 183.

[22] Treas. Reg. § 1.704-3(b)(2), Example 2.

[23] Treas. Reg. § 1.704-3(c)(4), Example 3.

[24] *See Rice's Toyota World, Inc. V. Comm'r*, 81 T.C. 184, 196 (1983), *aff'd* in part, *rev'd* in part and remanded 752, F.2d 89 (4th Cir. 1985).

which is compelled by business realities and is imbued with tax-independent consideration.[25] A sham transaction is one which, though it may be proper in form, lacks economic substance beyond the creation of tax benefits.[26] An evaluation of whether a transaction constitutes a sham transaction generally requires an analysis of the business purpose and a review of the objective economic effect of the transaction.[27] The courts have indicated that a taxpayer may establish that a transaction was entered into for a valid business purpose if the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and economic situation.[28] Although the cases on business purpose are legion, a recent case illustrates that a transaction with economic substance and a significant business purpose will not be disregarded even if there are significant potential tax benefits also associated with it.

In *Salina Partnership LP v. Commissioner*,[29] the Tax Court considered a transaction in which a taxpayer (FPL) invested in a partnership (Salina) in which two foreign limited liability companies owned by an unrelated bank were the other partners.[30] The partnership was promoted by Goldman Sachs as a way to pursue an investment strategy that would allow FPL to earn between 4 and 7 percent over current Treasury bill yields. Goldman Sachs suggested that the transaction be structured through a partnership to achieve favorable "off-balance sheet" financial accounting treatment. In addition, Goldman Sachs was aware that FPL had incurred a substantial capital loss on the sale of certain assets in 1991 (that might expire) and therefore structured the transaction in a manner that would allow FPL to recognize a capital gain and simultaneously create a built-in loss for its partnership interest. On December 28, 1992, FPL purchased a 98 percent interest in Salina, which caused a technical termination of Salina under the existing partnership rules. Through a series of transactions, Salina realized a short-term capital gain in 1992, $337,343,455 of which was reported by FPL and which increased FPL's basis in its partnership interest. On November 30, 1994, Salina made a distribution to FPL of cash and mortgaged-back securities in liquidation of FPL's partnership interest. FPL allocated its adjusted tax basis of $339,631,665 to the mortgage-backed securities. As FPL received payments on these securities during 1994, 1995, 1996 and 1997, it reported ordinary losses of approximately $1.1 million, $14.1 million, $212.3 million and $112 million, respectively. The IRS disallowed the short-term capital gain that FPL reported in 1992, which in turn nearly eliminated the ordinary losses FPL reported on its tax returns for 1994-1997.

The IRS argued that the partnership should be analyzed as two partnerships: one for the period from December 28-31, 1992 and one for the period thereafter. The IRS argued that FPL's investment in Salina during the initial period lacked economic substance because FPL had no

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[25] *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584 (1978).

[26] *See Karr v. Comm'r*, 924 F.2d 1018 (11th Cir. 1991).

[27] *Id.*

[28] *Compaq Computer Corp. & Subs. v. Comm'r*, 113 T.C. 214, 224 (1999).

[29] 80 T.C.M. 686 (Nov. 14, 2000).

[30] FPL is a publicly traded company that owns various subsidiaries the largest of which is Florida Power & Light.

intention to profit from Salina's investment strategy as the intention was always to liquidate the investment held under the initial investment strategy (referred to as "STAMPS") and reinvest under a different strategy (referred to as "MAPS"). The court declined to analyze the economic substance by focusing only on events occurring during the initial period, stating that such approach would violate the principal that the economic substance of a transaction turns on a review of the entire transaction.[31] The court agreed that Goldman Sachs structured FPL's purchase of the Salina partnership interest to provide FPL with a perceived tax benefit but noted that this factor, standing alone, is insufficient to render the transaction a sham in substance. The court concluded that considering all the facts and circumstances, FPL entered into the Salina transaction to achieve a valid business purpose independent of tax benefits. The opinion states that FPL demonstrated that it entered into the Salina partnership for the primary purpose of enhancing the return on its short-term investments and that Salina provided FPL with a reasonable opportunity to earn profits independent of tax benefits. The IRS also argued that while FPL stood to earn approximately \$5.3 million on its investment, it had the potential to save up to \$118.8 million in taxes, based on the assumption that FPL would have been unable to use any of its existing capital loss. The court disagreed with the IRS' calculation and view of the potential tax benefits but did not attempt to precisely quantify their potential value; rather the court held that the potential profits were not *de minimis* relative to the perceived tax benefit and thus, the partnership was not a sham in substance.[32]

A number of aspects of the *Salina* case are similar to the EFP LLC transaction inasmuch as EFP LLC likely will sell some or all of the Enron Assets, which could generate a large taxable gain. Based on the percentage interests held by the Members and the application of the section 704(c) rules, 95 percent of that taxable gain will be allocated to ECIC. Upon distribution of the Enron Building in a subsequent year in liquidation of ECIC's Membership Interest, ECIC's basis will reflect the gain (including 95% of the section 704(c) gain) allocated to it on these asset sales. Under current partnership rules, ECIC would have a substituted basis in the Enron Building equal to its basis in its Membership Interest, which in turn would generate larger depreciation deductions in the future. However, the fact that there may be future potential tax benefits should not be sufficient to cause EFP LLC to be treated as a sham or to cause the foregoing technical rules not to be applied as written.

Enron and the other Class B Members of EFP LLC entered into the transaction to secure \$500 million of financing from unrelated banks through a structure that would provide favorable "minority interest" treatment. This type of financing is consistent with Enron's past practices inasmuch as Enron has contributed assets to other partnership structures in much the same way to secure off-balance sheet financing. Clearly, the transaction serves an important business

[31] The court cited *Kirchman v. Comm'r*, 862 F.2d 1486 (11th Cir. 1989) *aff'g Glass v. Comm'r*, 87 T.C. 1087 (1986).

[32] While the taxpayer in *Salina* won on the sham argument, the IRS' position was sustained based on the technical issue of whether Salina's short sale of Treasury bills constituted a partnership liability. The court agreed that the short position was a liability that the partnership failed to take into account in computing its substituted basis in the assets treated as received from its partners in the technical termination of the partnership.

purpose as it facilitates the raising of $500 million of funds for use within the Enron Group. As in *Salina*, through use of the partnership structure, Enron is able to raise these funds without negatively affecting the group's consolidated financial statements. This is a significant and no less valid business purpose than that considered by the Tax Court in *Salina*. The fact that Enron might have accomplished the financing through a different structure or by using more, less or different assets to capitalize the partnership is not relevant. Enron is entitled to structure its business transactions in a manner that serves its various business needs and goals even if potential tax benefits are involved. Accordingly, the EFP LLC financing transaction should not be treated as a sham or without substance.

2. *Application of Partnership Anti-Abuse Rule*

In addition to the judicial authorities dealing with sham transactions, the anti-abuse regulations also provide the IRS with another avenue to attack transactions which have no economic substance. Treasury Regulation § 1.701-2(a), which was promulgated for this purpose, states that implicit in the intent of Subchapter K are the requirements that (i) the partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose, (ii) the form of each partnership transaction must be respected under substance over form principles, and (iii) except as otherwise provided in the regulations, the tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partners' income.

The regulations provide that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K: (i) the purported partnership should be disregarded in whole or in part and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners; (ii) one or more of the partners should not be treated as a partner; (iii) the methods of accounting used by the partnership or a partner should be adjusted to more clearly reflect income; (iv) the partnership's items of income, gain, loss, deduction or credit should be reallocated; or (v) the claimed tax treatment should otherwise be adjusted or modified.[33]

Treasury Regulation § 1.701-2(c) provides a facts and circumstances test that is to be applied in determining whether a partnership is formed or availed of for the proscribed purpose. This test involves a comparison of the claimed business purpose and the claimed tax benefits resulting from the transaction. In addition, the regulation sets forth the following list of seven non-exclusive factors that may indicate, but do not necessarily establish, that a partnership was used in such a manner:

[33] Treas. Reg. § 1.701-2(b).

(1) the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership assets and conducted the partnership's business directly;

(2) the present value of the partners' aggregate federal tax liability is substantially less than would be the case if purported separate transactions that are designed to achieve a particular result are integrated and treated as steps in a single transaction;

(3) one or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from risk of loss, or have little or no participation in the profits from the partnership's activities;

(4) substantially all of the partners are related to each other;

(5) partnership items are allocated in compliance with the literal language of Treasury Regulation §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and such regulations; in this regard, particular scrutiny is paid to partnerships in which income or gain is specially allocated to a partner that is either legally or effectively tax exempt (such as an exempt organization, foreign person, or a taxpayer with certain tax attributes, such as net operating losses);

(6) the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained by the contributing partner or a related person; and

(7) the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part shifted to a distributee partner before or after such property is actually distributed to such distributee partner or a related person.

Treasury Regulation § 1.701-2(a)(3) expressly states that certain provisions of Subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. However, the proper reflection of income requirement may nonetheless be satisfied to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all relevant facts and circumstances, are clearly contemplated by that provision. Two examples in the regulations involve the basis rules under section 732(b) and illustrate the circumstances under which the application of these rules and resulting effects will or will not meet the clear reflection of income standard.

The first example describes a partnership "which has for several years been engaged in substantial bona fide business activities."[34] For valid business reasons, the partners agree that one partner's (A's) interest, which has a basis of $100, will be liquidated and a nondepreciable asset with a value of $60 and a basis to the partnership of $40 and related equipment with two

[34] Treas. Reg. § 1.701-2(d), Example 10.

years of cost recovery remaining and a value and basis of $40 will be distributed to A. Under section 732(b) and (c), A's $100 basis in its partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to the partnership's bases in those assets, or $50 to the nondepreciable asset and $50 to the equipment. Thus, A will have a $10 built-in gain in the nondepreciable asset and a $10 built-in loss in the equipment, which it expects to recover rapidly through cost recovery deductions. The example states that in selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in its partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A with no offsetting detriment to B or C.

The example notes that the transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard, are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. The example holds that in this instance, taking into account the facts and circumstances, the transaction will be treated as meeting the proper reflection of income standard.

Another similar example reaches a different result with respect to a partnership that had been engaged for several years in the development and management of commercial real estate projects.[35] In the example, an unrelated party (X) that wished to acquire and hold land owned by the partnership contributed $100 to the partnership in exchange for an interest. Subsequently (at a time when the value of the partnership's assets had not materially changed), the partnership distributed the land (with a value of $95 and basis of $5) and another asset (with a value and basis of $5) in liquidation of X's interest. The ruling indicates that the second asset was an insignificant part of the economic transaction but was important to achieve the desired tax results. Under section 732(b) and (c), X's $100 basis is allocated between the assets distributed in proportion to their bases to the partnership, or $50 each. X then planned to sell the second asset for its value of $5, recognizing a loss of $45, and thus recovering a substantial portion of the purchase price of the land almost immediately.

The example notes that in selecting the assets to be distributed, the partners had a principal purpose to take advantage of the fact that section 732(b) and (c) would cause a shift of a portion of the partner's basis economically allocable to the land that X intended to retain to an inconsequential asset that X intended to dispose of quickly. The example states that section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. Accordingly, the

[35] Treas. Reg. § 1.701-2(d), Example 11.

example holds that the transaction does not properly reflect income due to the basis distortions caused by shifting a significant portion of the partner's basis to an inconsequential asset.

In the case of EFP LLC, it is not clear that the creation and use of the partnership financing structure will result in an aggregate federal tax liability substantially less, taking into account present value concepts, than had Enron and the other Class B Members owned the partnership assets directly (Factor 1). Factor 2 should not apply because there are no separate transactions that could be integrated to achieve a different result. Factor 3 also should not apply because all Enron Members have an interest in the capital and profits of EFP LLC of not less than five percent and the holder of the Class C Preferred interest has no effect on the basis determinations that may give rise to a future tax benefit. With respect to factor 4, all of the Members of EFP LLC are Enron affiliates except for Zephyrus LLC, the Class C Member. Although it is possible that the IRS could challenge the treatment of the Class C Member as a partner, the presence of this unrelated party confirms that this is not merely an intragroup transaction but rather is subject to outside scrutiny and influence.[36] Accordingly, even if the Class C Member were not treated as a partner, it is nonetheless an important participant in the transaction and this factor should not be applicable. Factors 5, 6 and 7 should not apply as none of the members are effectively tax exempt and the benefits and burdens of the property contributed actually have been transferred to EFP LLC.[37]

In addition, the transaction should not be vulnerable to attack under the foregoing regulation, even if there are significant potential tax benefits, as it was entered into for the valid business purpose of obtaining $500 million of financing in a manner that permits favorable financial accounting treatment. Moreover, to the extent that any of the Enron Assets are sold, such sales will produce taxable gain that will be allocated to members of the Enron Group and will be subject to taxation just as if such sales had been made directly by the Class A Members. As illustrated by Example 10 described above, the fact that the operation of the partnership basis rules may result in a substituted basis for the Enron Building that reflects a substantial part of that gain is not sufficient to disregard the transaction as not satisfying the proper reflection of income standard. Rather, unlike Example 11 which involved an "inconsequential" asset, the Enron Building clearly is a valuable asset that is integral to the operation of the business of the Enron Group. As a result, the anti-abuse provisions of Treas. Reg. § 701-2 should not be applicable to the transaction.

OPINIONS

Based on the initial and continuing accuracy of all of the foregoing facts, assumptions, representations and documents, it is our opinion that for U.S. federal income tax purposes:

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[36] Even if the Class C Member were disregarded as a partner, EFP LLC nonetheless should be treated as a partnership. *See* Rev. Rul. 75-19, 1975-1 C.B. 382.

[37] The Enron Group currently has net operating losses that may be used to offset gain from the sales of assets; however, the gain would be included in the Enron Group's consolidated tax return in exactly the same manner regardless of whether the Enron Assets continued to be held by members of the Enron Group or by EAH LLC.

(i) no gain or loss should be recognized by Enron or the other Class B Members upon the contributions of the Enron Assets to EFP LLC, EIH LLC and EAH LLC;

(ii) no gain or loss should be recognized by ECIC or the Class B Members upon the contribution to ECIC of 95% of the Class B Members' Class B Membership Interests in EFP LLC;

(iii) 95% of the section 704(c) built-in gain with respect to the Enron Assets should be allocable to ECIC by reason of the contribution of 95% of the Class B Membership Interests to ECIC, and upon the sale of any of the Enron Assets, ECIC's basis in its Class B Membership Interest in EFP LLC should be increased by the amount of such built-in gain; and

(iv) the creation and use of EFP LLC as a financing vehicle should not be disregarded as a sham nor subject to the anti-abuse provisions of either Treas. Reg. § 1.704-3(c)(10) or Treas. Reg. § 1.701-2.

We express no opinion as to the tax treatment of any transaction not specifically addressed in the foregoing opinion. Our opinion is based upon the existing provisions of the Internal Revenue Code of 1986, as amended, regulations (and administrative pronouncements) promulgated or proposed thereunder, and interpretations thereof by the Internal Revenue Service and the courts, all as of the date hereof, all of which are subject to change with prospective or retroactive effect, and our opinion could be adversely affected or rendered obsolete by such change.

This opinion is given to you by us solely for your use and is not to be quoted or otherwise referred to or furnished to any governmental agency (other than the Internal Revenue Service in connection with an examination of the transactions contemplated herein) or to other persons without our prior written consent.

Very truly yours.

Vinson & Elkins L.L.P.

VINSON & ELKINS L.L.P.

Houston:462294_3.DOC

IX. TAX OPINION LETTERS RELATING TO PROJECT APACHE

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WRITER'S DIRECT NUMBER:

May 28, 1999

Privileged & Confidential
Attorney-Client Work Product

Enron Corp.
1400 Smith Street
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Preferred Units Financing

Ladies and Gentlemen:

This letter sets forth our opinion with respect to certain United States federal income and withholding tax ("U.S. tax") aspects of the transactions described below (collectively, the "Transaction") under the Internal Revenue Code of 1986, as amended (the "Code").[1]

We understand that Enron Corp. ("Company") and its affiliates are engaging in the Transaction to accomplish the objectives of factoring receivables, raising capital for their business operations and to retire existing indebtedness.

TRANSACTION

For U.S. tax purposes, Company is the common parent of an affiliated group that files a consolidated U.S. tax return on a calendar basis and uses the accrual method of accounting.

Company will transfer $748.5 million[2] to Seminole Capital L.L.C., a newly-formed Delaware limited liability company ("Company LLC"), in exchange for 99.8 percent of the member interests in Company LLC, and The Lucelia Foundation, a New York not-for-profit

1 Unless otherwise indicated, all "Section" references are to the Code and all "Treas. Reg." references are to the Treasury Regulations promulgated thereunder.

2 All numerical amounts used herein are approximations.

corporation which is unrelated to Company ("TLF", and together with Company, the "Company LLC Members") will transfer $1.5 million to Company LLC in exchange for 0.2 percent of the member interests in Company LLC.

Company LLC will contribute $20,000 to Cheyenne Finance S.a r.l., a newly-formed Luxembourg company ("SARL"), in exchange for all of its outstanding common stock, and will transfer $749.98 million to SARL in exchange for Subordinated Convertible Equity Certificates (the "Certificates"). Payments on the Certificates will be made if, as and when declared by SARL's board of managers. The Certificates will have a term of 99 years and will be subordinate to all present and future obligations and interests in SARL other than its common stock.

Rabo Merchant Bank N.V., a Dutch limited liability company ("Rabo"), will organize Choctaw Investors B.V., a Dutch company ("Investor BV"), and will contribute $15 million to Investor BV in exchange for all of its common stock. Investor BV will borrow $485 million from various lenders.

SARL and Investor BV will organize Cherokee Finance V.O.F., a general partnership *(vennootschap onder firma)* organized under the laws of the Netherlands ("Dutch VOF"). Dutch VOF will have two classes of outstanding units, common and preferred, as described below.

SARL will contribute $750 million to Dutch VOF in exchange for 100 percent of the common units of Dutch VOF (the "Common Units"). SARL will be the common general partner of Dutch VOF. The Common Units will have: (i) no final maturity, and (ii) no right to distributions while the Preferred Units (as defined below) remain outstanding. In addition, the holder of the Common Units will elect two of the three members of the board of directors of Dutch VOF (the "Board"). A ruling issued by the Luxembourg tax inspectorate (the "Luxembourg Tax Ruling") states that SARL will be required, on an annual basis, to include in its gross income, for Luxembourg tax purposes, its allocable share of income derived by Dutch VOF.

Investor BV will contribute $500 million to Dutch VOF in exchange for 100 percent of the preferred units of Dutch VOF (the "Preferred Units"), which will be placed with Investor BV by Chase Securities, Inc. ("Chase"). The Preferred Units will have: (i) the right to a floating rate, cumulative distribution equal to a formula percentage multiplied by the liquidation preference of such units if, as and when declared by the Board (the "Preferred Distribution") out of retained earnings (as determined for U.S. GAAP purposes), (ii) an initial liquidation preference of $500 million, which will thereafter be increased by any accrued but unpaid Preferred Distributions, and reduced by the amount of any Redemption Proceeds (as defined below) received with respect to the Preferred Units, and (iii) a ten-year stated redemption date, at which time the Preferred Units will be redeemed for their liquidation preference at that time. In addition, the Preferred Units generally will be redeemable in whole or in part at any time at the option of Dutch VOF. (Amounts paid by Dutch VOF to Investor BV in an optional redemption of Preferred Units will be referred to hereinafter as "Redemption Proceeds.")

The holder of the Preferred Units will elect one of the three Board members. In addition, without the affirmative vote of the holders of more than 50 percent of the Preferred Units, Dutch VOF will not undertake any of a number of actions, including (i) entering into any transaction of merger or consolidation, (ii) liquidating, winding up or dissolving itself, or commencing a voluntary case, action or proceeding under any bankruptcy or insolvency laws, or (iii) conveying, selling, leasing, transferring or otherwise disposing of, in one transaction or a series of transactions, all or substantially all of the property of Dutch VOF.

At the end of five years, the Preferred Units holder, at its option, will be permitted to hold the Preferred Units at the then current Preferred Distribution rate for the subsequent five-year period. If the holder elects not to continue to hold the Preferred Units at the then current Preferred Distribution rate, the holder and Dutch VOF may agree to a new distribution rate for Preferred Distributions. If the holder of the Preferred Units and Dutch VOF cannot agree on a new distribution rate, the holder may tender its shares to a security agent, who will attempt to set such dividend rate, using a "Dutch auction rate" mechanism, at the lowest possible rate which would allow the units to be sold for an amount equal to their liquidation preference. If the holder opts to tender all or any portion of its Preferred Units, and the security agent cannot place the Preferred Units, the holder will be required to hold the Preferred Units at a "default rate." In the case of a failed placement of the Preferred Units, a new auction will be conducted each month until the Preferred Units have been successfully placed by the security agent. A ruling issued by the Dutch tax inspectorate (the "Dutch Tax Ruling") states that Investor BV will be required, on an annual basis, to include in its income, for Dutch tax purposes, its allocable share of income derived by Dutch VOF.

Pursuant to an agreement between Company LLC and Rabo, Company LLC will have an option to purchase all of the outstanding shares of Investor BV. This option will terminate after nine and one-half years (*i.e.*, six months prior to the ten-year stated redemption date).

Dutch VOF (i) will have its books and records maintained outside of the United States; (ii) will have its activities conducted by its own officers, employees and/or agents hired by Dutch VOF and not those of Company or its affiliates (although such officers, employees and/or agents may be employed by both Dutch VOF and Company or one of its affiliates); (iii) will pay all of its own expenses, including taxes, from the earnings on its investments (other than organizational expenses, which will be paid out of the capital contributed by SARL); and (iv) will engage in all transactions on an arm's-length basis, including compensating on an arm's-length basis any related or unrelated person for services provided to Dutch VOF. Interest paid on any loans made by Dutch VOF to Company (or an affiliate of Company) will be within the range of market interest rates, taking into account all the terms and conditions of the loans. Dutch VOF's books of account, trial balances and tax returns will be prepared by outside accountants. Board meetings will be held outside of the United States, at which time any investment or lending decision for Dutch VOF for the succeeding period will be made and certified by the Board.

Dutch VOF generally will be permitted to invest its capital and earnings in the following: (i) cash equivalents; (ii) debt securities of any U.S. corporation rated "A" or better by

S&P or "A2" or better by Moody's; (iii) indebtedness of Company; (iv) indebtedness of any affiliate of Company, provided that such indebtedness is guaranteed by Company and (v) regular interests ("FASIT Interests") in entities which elect to be treated as fixed asset securitization investment trusts ("FASITs") for U.S. tax purposes (the assets collectively described in clauses (i) through (v) shall be known as "Core Permitted Assets").[3] It is anticipated that Dutch VOF will initially use most of the cash it receives to purchase FASIT Interests. Dutch VOF also may invest in any other debt securities ("Other Permitted Assets") so long as (i) the ratio of Core Permitted Assets (subject to certain other limitations such as duration of investment) to the current liquidation preference of the Preferred Units equals or exceeds 1.5 to 1, and (ii) the ratio of the sum of Core Permitted Assets and Other Permitted Assets to the current liquidation preference of the Preferred Units equals or exceeds 2.5 to 1.

ASSUMPTIONS

In rendering the opinions set forth below, we have relied, with your permission and without independent investigation or verification, on the following assumptions:

1. Under U.S. GAAP, Dutch VOF will be consolidated with Company for financial accounting purposes, and the Preferred Units will be reflected as a "minority interest in subsidiary" on the balance sheet of Company.

2. SARL will not elect, pursuant to Treas. Reg. § 301.7701-2, to be disregarded as an entity separate from Company LLC for U.S. tax purposes.

3. Dutch VOF will elect, pursuant to Treas. Reg. § 301.7701-2, to be classified as an association taxable as a corporation for U.S. tax purposes.

4. Investor BV will not elect, pursuant to Treas. Reg. § 301.7701-2, to be disregarded as an entity separate from Rabo for U.S. tax purposes.

5. Company LLC will not elect, pursuant to Treas. Reg. § 301.7701-2, to be classified as an association taxable as a corporation for U.S. tax purposes.

6. The general partnership agreement of Dutch VOF will provide for rights and remedies to the holder of the Preferred Units upon a default in the payment of any Preferred Distribution that are customary and consistent with the rights and remedies set forth in other privately placed preferred stock.

7. Investor BV and its direct and indirect owners will treat the Preferred Units as equity for U.S. tax purposes and will not take any action that is inconsistent with such treatment.

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3 Certain U.S. tax issues relating to the FASIT Interests are discussed in a separate opinion letter to you dated the date hereof.

8. The business of Dutch VOF largely will consist of holding FASIT Interests, lending funds to Company and its affiliates and purchasing, selling and investing in Core Permitted Assets and Other Permitted Assets. Dutch VOF will conduct this business outside of the United States and will not have a place of management, branch or office in the United States.

9. Any loans made by Dutch VOF to Company or any Company affiliate will constitute valid indebtedness for U.S. tax purposes.

10. More than 70 percent of Dutch VOF's gross income will consist of income with respect to FASIT Interests and interest paid by Company or Company Affiliates with respect to loans made by Dutch VOF to Company or its affiliates.

11. The Company affiliated group will have current and accumulated earnings and profits for each year in which the Preferred Units are outstanding in excess of the aggregate amount of distributions that may reasonably be anticipated to be made to shareholders of Company for such year, and Dutch VOF, therefore, is not being formed and will not be availed of with a view to permit the Company affiliated group to avoid making dividend distributions to Company's shareholders.

12. The shareholders of Investor BV will not be at least ten percent related through ownership with Company.

13. More than 50 percent of the stock of Investor BV (by vote and value) will be owned, directly or indirectly, by persons who are entitled to the benefits of the Dutch Treaty (as defined below) under paragraph 1 of Article 26 of the Dutch Treaty.

14. Either (i) less than 50 percent of the gross income of Investor BV will be used, directly or indirectly, to make payments that are deductible for Netherlands income tax purposes in a given taxable year to persons that are not entitled to the benefits of the Dutch Treaty under paragraph 1 of Article 26 of the Dutch Treaty, or (ii) both (A) less than 70 percent of the gross income of Investor BV will be used, directly or indirectly, to make payments that are deductible for Netherlands income tax purposes in a given taxable year to persons that are not entitled to the benefits of the Dutch Treaty under paragraph 1 of Article 26 of the Dutch Treaty and (B) less than 30 percent of the gross income of Investor BV will be used, directly or indirectly, to make payments that are deductible for Netherlands income tax purposes in a given taxable year to persons that are neither entitled to the benefits of the Dutch Treaty under paragraph 1 of Article 26 of the Dutch Treaty nor "residents of member states of the European Communities" (as such term is defined in the Dutch Treaty).

15. The aggregate number of shares in the principal class of Company shares that are traded on a recognized stock exchange (as defined in the Dutch Treaty) per year has exceeded and is expected to continue to exceed 6 percent of the average number of shares outstanding in such class during that taxable year.

16. Less than 50 percent of the income of SARL will be used, directly or indirectly, to make payments that are deductible for Luxembourg income tax purposes in a given taxable year to persons that are not entitled to the benefits of the New Luxembourg Treaty (as defined below) under paragraph 2 of Article 24 of the New Luxembourg Treaty.

17. The placement fees paid by Company and Dutch VOF to Chase in connection with the issuance of the Preferred Units are reasonable and consistent with fees charged for other quasi-equity financing transactions in the market, such as "MIPS" and "TOPrS."

18. The aggregate fair market value of the assets contributed to Dutch VOF by SARL is not in excess of what would be reasonably necessary to secure the lowest possible Preferred Distribution rate on the Preferred Units in light of the assets of Dutch VOF following such contribution and the terms of the Preferred Units.

19. At least $5 million of Dutch VOF's assets will be invested at all times in instruments that are not issued or guaranteed by Company or a Company affiliate.

20. A realistic possibility exists that Company would let the Preferred Units be auctioned, rather than call such stock, in the event that the holder of the Preferred Units chose to tender such stock for auction.

21. The default rates associated with a defaulted auction are commercially reasonable in light of other auction rate preferred equity interests issued out of companies with similar credit quality.

22. Company LLC might, based on objective economic factors (and ignoring tax considerations), exercise its option to acquire the shares of Investor BV.

23. No side letters (inconsistent with any of the foregoing assumptions or facts) or unwritten understandings exist relating to the Transaction.

24. Investor BV will not engage in any activities that will cause Investor BV to be considered as engaged in the conduct of a trade or business in the United States.

Assumptions 6, 17, 18, 20, 21 and 22 will be confirmed through representations made in writing by The Chase Manhattan Bank. Assumption 13 will be confirmed through a representation made in writing by Rabo.

SUMMARY OF OPINIONS

The conclusions expressed herein are based upon our interpretations of current U.S. tax law, such law being subject to change both prospectively and retroactively, and upon the facts, statements and assumptions discussed herein. In addition, we have relied on the opinion of

Dutch counsel to the effect that the provisions of the Dutch VOF agreement are effective under local law.

Based upon and subject to the analysis set forth below and the assumptions and statements referred to herein, it is our opinion that for U.S. tax purposes:

1. Dutch VOF should be treated as a corporation.

2. The Preferred Units should be characterized as equity, not debt.

3. The Certificates should be characterized as equity, not debt.

4. For each taxable year, subpart F income (as defined in Section 952(a)) of Dutch VOF equal to the sum of (i) the Preferred Distributions made or accrued in such year and (ii) the outstanding liquidation preference of the Preferred Units on the last day of such year should be taken into account by the holder of the Preferred Units. Any remaining subpart F income should be taken into account by Company LLC as indirect holder of the Common Units.

5. Dutch VOF should not be classified as a passive foreign investment company with respect to the holders of the Common Units.

6. The direct and indirect holders of the Common Units should have no inclusion of income under the foreign personal holding company rules with respect to the Common Units.

7. Dutch VOF should not be subject to the accumulated earnings tax.

8. The form of the Transaction should be respected and not disregarded on the grounds that it constitutes an economic sham.

9. Dutch VOF's initial issuance of the Preferred Units should not be treated as creating a "fast-pay arrangement" within the meaning of Prop. Reg. § 1.7701(l)-3(b)(1).

10. Section 269 should not be applied to reallocate subpart F income to Company.

In rendering the opinions contained herein, we have relied on the accuracy and completeness of the facts, information, covenants, statements and representations contained in (1) the General Partnership Agreement of Dutch VOF, (2) the Option Agreement between Company LLC and Rabo, (3) the Contribution Agreements between Investor BV and Dutch VOF and between SARL and Dutch VOF, (4) the $485 million Credit Agreement of Investor BV (the "Investor BV Credit Agreement"), (5) the limited liability company agreement of Company LLC, (6) statements and information provided to us by Company, Chase and Rabo, and (7) such other statements, information and documents as we have deemed relevant. We have assumed that such statements and documents reflect all material facts regarding the formation and operation of Dutch VOF and all related transactions. In addition, we have assumed that the Transaction has been and will be carried out in accordance with such statements and documents, that all statements (whether or not set forth in a document) were true and correct when made and continue to be true and correct and that none of the material terms contained in any document have been or will be waived or modified. In our examination of the documents, we have assumed that all documents submitted to us are authentic and have been duly executed by appropriate and authorized parties.

We have not considered and do not express any opinion as to any U.S. tax consequences of the Transaction other than those expressly stated above. Specifically, we do not address compliance issues and form filing requirements (including the filing of Form 5471 and forms required in order to secure any treaty exemption) except as otherwise noted. We also have not considered and do not express any opinion with respect to the tax consequences of the Transaction under any state, local or foreign tax law.

The opinions set forth above are based upon current U.S. tax law and administrative practice as in effect on the date hereof. In rendering such opinions, we have considered the pertinent facts and circumstances and the current U.S. tax law and administrative practice as it relates to such facts and circumstances. We do not undertake to advise you as to future changes in U.S. tax law that may affect the opinions contained herein.

This opinion is being furnished to you solely for your use in regard to the Transaction and is not to be used, relied upon, circulated, quoted or otherwise referred to for any other purpose without our prior written consent.

An opinion of counsel is not binding on the Internal Revenue Service (the "IRS") or the courts. There can be no assurance that the IRS will not take a contrary position with respect to the conclusions set forth above or as to how a court would decide the issues discussed herein.

DISCUSSION

I. STATUS OF SARL, INVESTOR BV AND DUTCH VOF FOR U.S. TAX PURPOSES

We have been advised to assume that SARL will not elect to be disregarded as an entity separate from Company LLC for U.S. tax purposes. A foreign entity that does not elect otherwise is generally treated as an association if all of the entity's members have limited liability.[4] Based on the opnion of Luxembourg counsel that members of an SARL have limited liability, and assuming no election is made, SARL should be treated as an association taxable as a corporation for U.S. tax purposes.

We have also been advised to assume that Investor BV will not elect to be disregarded as an entity separate from Rabo for U.S. tax purposes. Based on the opinion of

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4 Treas. Reg. § 301.7701-3(b)(2)(i)(B).

Dutch counsel that members of a BV have limited liability, and assuming no election is made, Investor BV should be treated as an association taxable as a corporation for U.S. tax purposes.

We have also been advised to assume that Dutch VOF will elect to be treated as an association taxable as a corporation for U.S. tax purposes. Accordingly, Dutch VOF should be classified as a foreign corporation for U.S. tax purposes, and the interests held by each of SARL and Investor BV should be treated as stock interests in Dutch VOF.[5]

II. DUTCH VOF SHOULD BE RESPECTED AS A SEPARATE ENTITY FOR U.S. TAX PURPOSES

Although the existence of an entity (such as Dutch VOF) can, under certain circumstances, be ignored for U.S. tax purposes if necessary to reflect the true substance of a transaction, this result would not be appropriate with respect to Dutch VOF's participation in the Transaction. In *Moline Properties, Inc. v. Commissioner*,[6] the Supreme Court applied the substance over form doctrine for the purpose of determining whether an entity should be respected for U.S. tax purposes. In *Moline Properties*, the taxpayer, who was the sole shareholder of a corporation, attempted to characterize gain from the sale of real property, title to which was held by the corporation, as gain to the sole shareholder individually, and to declare the existence of the corporation "merely fictitious" for U.S. tax purposes. The Supreme Court held that the taxpayer could not disregard the corporate form of his business organization unless such form was a "sham."

In so holding, the Supreme Court stated:

> Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.[7]

This standard has been consistently applied by courts in determining whether corporations should be respected as separate entities.[8]

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5 Treas. Reg. § 301.7701-3(a).

6 319 U.S. 436 (1942).

7 *Id.* at 438-39.

8 *See, e.g.*, *Bollinger v. Commissioner*, 485 U.S. 340 (1988); *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945); *Nutt v. Commissioner*, 39 T.C. 231 (1962), *rem'd on another issue*, 351 F.2d 452 (9th Cir. 1965), *cert. denied*, 384 U.S. 918 (1966), *acq.* 1964-2 C.B. 5; *Siegel v. Commissioner*, 45 T.C. 566 (1966), *acq.* 1966-2 C.B. 7; *Bass v. Commissioner*, 50 T.C. 595 (1968).

The Supreme Court in *Moline Properties* explicitly established a two-prong disjunctive test for determining whether an entity should be disregarded. The first prong is a subjective standard requiring the taxpayer to demonstrate a legitimate, non-tax business purpose that is served by the selection of the corporate form as a separate and independent vehicle for owning and conducting the subject activity. The second prong is an objective standard merely requiring a demonstration that the entity has engaged in sufficient business activity to warrant its recognition as that particular type of entity. If either prong of the test is satisfied, the organization will be recognized as a separate entity.[9]

In *Moline Properties*, the corporation's only business activity was to lease a portion of land held by it prior to sale. The corporation transacted no other business, kept no books of account and maintained no bank account for the deposit of the rental funds, yet the form of the corporation was respected. In *Rogers v. Commissioner*,[10] the absence of an office, employees, books and records did not result in finding a lack of business activity. The entity's negotiation and renegotiation of loans, use of bank accounts, payment of state taxes and filing of certain reports and statements were found to constitute sufficient activity to satisfy the active business test.

The primary business purpose for the formation of Dutch VOF, and the Transaction in general, is to raise capital. The form permits Company to characterize the transaction as quasi-equity "minority" interest for accounting purposes. That there may be some alternative structure available to the parties to undertake the financing which would result in an increased tax liability to the parties is not relevant because, as stated in *Gregory v. Helvering*,[11] taxpayers are free to structure a transaction in a form that minimizes or eliminates taxes that would arise under any other structure.

The second prong of the *Moline* test should also be satisfied because Dutch VOF's business activities will include substantial investments. Dutch VOF will receive [$750 million] from Company LLC and [$500 million] from Investor BV. Dutch VOF will (i) invest in FASIT Interests, (ii) make loans to Company and Company affiliates, (iii) have the authority to lend to third parties, (iv) maintain books and records, and (v) file local tax returns. In addition, it is expected that Dutch VOF will accumulate significant funds on an annual basis which it will reinvest in "permitted assets." Therefore, Dutch VOF should have sufficient business activity to assure separate corporate recognition under the second prong of the *Moline* test.

III. DEBT/EQUITY ANALYSIS

A. Characterization of the Preferred Units

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9 *See, e.g., Rogers v. Commissioner*, 34 T.C.M. (CCH) 1254, 1256 (1975) ("*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity [citations omitted]. Business purpose or business activity are alternative requirements").

10 34 T.C.M. (CCH) 1254 (1975).

11 293 U.S. 465 (1935).

The vast majority of the cases that analyze the characterization of an instrument as debt or equity for U.S. tax purposes focus on whether investments in a corporation that are structured in the form of debt are, in substance, debt or, instead, are equity in the corporation. Under these cases, the characterization of an instrument as debt or equity for U.S. tax purposes depends on all the facts and circumstances surrounding the issuance and operation of a particular instrument. For example, the Third Circuit Court of Appeals, in *Fin Hay Realty Co. v. United States,*[12] listed 16 factors to be used to judge whether an investment which is in the form of a debt is, in fact, equity:

> (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal [subordination]; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments [out of earnings or out of all assets]; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.[13]

Courts, in determining whether a particular instrument evidences a debtor-creditor or equity ownership relationship, must rank and weigh the relative importance of the various factors present in an instrument. The Supreme Court has stated that "[t]here is no one characteristic . . . which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."[14]

Although the preponderance of authorities involving debt/equity characterization involve the issue of whether an instrument structured, in form, as debt should be recharacterized, in substance, as equity, there are a limited number of authorities which discuss the attempted recharacterization of an instrument structured in form as equity as debt. These authorities, in testing the economic substance of the security, generally apply the same *Fin Hay* factors that have been applied in the more traditional cases involving the recharacterization of debt as equity.[15]

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12 398 F.2d 694 (3d Cir. 1968).

13 *Id.* at 696.

14 *See John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946).

15 *See, e.g., Zilkha & Sons v. Commissioner*, 52 T.C. 607 (1969), *acq.* 1970-2 C.B. xxi (court concluded that preferred interests were dependent upon success of business and that, notwithstanding various protections designed to minimize risk, preferred interests were equity for U.S. tax purposes); *Ragland Investment Company v. Commissioner*, 52 T.C. 867 (1969), *aff'd*, 435 F.2d 118 (6th Cir. 1970) (same); G.C.M. 34529 (June 18, 1971); G.C.M. 39187 (Mar. 13, 1984).

The intention of the issuing entity (*i.e.*, Dutch VOF) that the Preferred Units issued to Investor BV constitute equity is evidenced by the following: (1) the Preferred Units will be issued under the Dutch VOF partnership agreement and (2) Dutch VOF will at all times treat transactions involving the shares in a manner consistent with their characterization as preferred equity, including for accounting purposes and for purposes of filings with any regulatory bodies. Thus, the formal documentation and the intent of the issuer and the interest holders reflected in that documentation will support the treatment of the Preferred Units as equity interests.

The Preferred Units contain a stated preferential distribution. Periodic distributions on the Preferred Units issued by Dutch VOF, however, are solely out of Dutch VOF's retained earnings and only if, as and when declared by the Board. The sole source, therefore, of Investor BV's Preferred Distribution is Dutch VOF's retained earnings. A creditor would require payment on its instrument in all events and such payment could be made out of the company's capital funding.

Although, in form, Dutch VOF will be organized as a general partnership, the equity interest holders in Dutch VOF have agreed that Dutch VOF will be managed by a Board. The holder of the Dutch VOF Preferred Units will be entitled to elect, on a cumulative basis, [two] of the [five] Dutch VOF directors with 40 percent of Dutch VOF's total voting power. Accordingly, the Preferred Units will possess the equity characteristic of voting rights.

Investor BV, as an equity holder in Dutch VOF, will be subordinated to all creditors of Dutch VOF. This is a significant characteristic of an equity instrument. In fact, since the Preferred Units are dependent upon Dutch VOF's retained earnings for a return on investment, and are dependent upon sufficient remaining equity for a return of investment, Investor BV is even subordinated to ordinary trade creditors of Dutch VOF. Generally, the presence of subordination, as a legal matter, is significant regardless of whether the parties to the transaction contemplate at the outset the incurrence of meaningful liabilities. In the instant case, however, we note that Dutch VOF is contractually prohibited from borrowing money other than unsecured indebtedness in an amount not to exceed $1 million. Thus, the potential for incurring meaningful liabilities, even unanticipated liabilities, is somewhat limited. Nevertheless, if Dutch VOF breached the provisions set forth under the Dutch VOF agreement, Investor BV would be subordinated to the claims of those creditors vis-à-vis their rights to the assets of Dutch VOF.

Finally, the Preferred Units do not grant Investor BV any traditional creditor remedies, such as the right to accelerate payment on default. In addition, it has been represented to us that the rights and remedies contained in the Dutch VOF agreement which are available to holders of the Preferred Units upon a default are customary and consistent with those of other privately placed preferred equity instruments that serve as collateral for bank loans.

Although the Preferred Units will have a fixed maturity date, we view this factor as neutral in the debt/equity analysis. While the absence of a fixed maturity date is often conclusive of a determination that an instrument constitutes equity, "it is not unusual for preferred stock to have a maturity or retirement date."[16] Furthermore, the IRS has publicly ruled that five-year mandatorily redeemable preferred stock qualifies as equity in the context of a reorganization.[17] We have also considered how the auction rate mechanism embedded in the Dutch VOF Preferred Units will affect the debt/equity nature of the Dutch VOF Preferred Units. More specifically, we have considered whether the presence of such feature could lead one to conclude that the Preferred Units have a redemption date which is earlier than the ten-year stated redemption date.

We note that Company will indemnify Investor BV for possible breaches of fiduciary duties by Dutch VOF directors appointed by it and for a limited number of possible breaches of the constituent documents of Dutch VOF that are within the control of such directors. In addition, certain breaches of constituent documents will trigger the right of Investor BV to have its Preferred Units redeemed. We believe that on balance the rights provided to Investor BV do not represent significant creditors' rights, and are sufficiently discrete and remote that they should not negate our conclusion that the Preferred Units should be respected as equity in Dutch VOF for U.S. tax purposes.

The Preferred Units issued to Investor BV in the Transaction are quite similar in their terms to the "Dutch-auction rate preferred stock" which were the subject of Revenue Ruling 90-27.[18] The IRS ruled in Revenue Ruling 90-27 that certain types of Dutch-auction rate preferred stock are treated as equity for tax purposes and can qualify for the intercorporate dividends received deduction under certain circumstances. In Revenue Ruling 90-27, a publicly-held domestic corporation issued 1,000 shares of Dutch-auction rate preferred stock with a liquidation preference of $100,000 per share. Each prospective purchaser was required to execute a purchaser's letter agreeing to sell the shares only through a Dutch-auction proceeding to an authorized broker-dealer or to a purchaser that has executed a similar purchaser's letter. In each auction, potential holders (and existing holders wishing to increase the number of shares held) bid to purchase shares offered for sale. The stock traded at its liquidation preference so each bid consisted of a proposed dividend rate at which the bidder was willing to purchase the offered shares at a price equal to the liquidation preference.

At each auction looked at in Revenue Ruling 90-27, (1) an existing holder could choose to hold its shares at whatever rate was set for the next dividend period, (2) it could place a bid order to hold its shares if the rate for the next dividend period was not below the rate specified in the bid (which was treated as a sell order if the dividend rate was lower), or (3) it could place a sell order regardless of the applicable dividend rate. If all existing holders chose to hold their shares, the dividend rate was set at 59 percent of the AA Composite Commercial Paper Rate. If there were insufficient bids, the auction "failed" and the dividend rate was set at the applicable maximum bid rate for that auction (expressed as a percentage of the AA Composite Commercial Paper Rate, ranging anywhere from 110 to 250 percent). There were no express or implied agreements that would

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16 *Huisking & Co. v. Commissioner*, 4 T.C. 595, 599 (1945) (subordinated debentures held to be "more nearly like preferred stock than indebtedness" and recast as equity, notwithstanding form and fixed maturity date where interest was payable at the discretion of the company, and where debentures were unsecured and subordinated to claims of all creditors).

17 Rev. Rul. 78-142, 1978-1 C.B. 111.

18 1990-1 C.B. 50.

guarantee any holder the right to sell, and the holders could not compel the issuer to redeem the shares. Dividends were cumulative and were required to be declared by the board of directors out of legally available funds. The IRS concluded that such stock should be treated as equity, not debt.

In the instant case, we have been advised to assume that there is a realistic possibility that Company would let the Dutch VOF Preferred Units be auctioned, rather than call such stock, in the event that the holder of the Dutch VOF Preferred Units chose to tender such stock for auction. We have been informed that the default rates associated with a defaulted auction are commercially reasonable in light of other auction rate preferred equity interests issued out of companies with similar credit quality. Most importantly, however, is the fact that the holders of the Dutch VOF Preferred Units cannot require the units to be redeemed prior to the ten-year redemption date, even in the event of a defaulted auction. The presence of the auction rate mechanism in the Dutch VOF Preferred Units, therefore, should not be viewed as creating a fixed maturity date prior to the ten-year redemption date.

We believe of the most significant factors applied in distinguishing between debt and equity, a preponderance of such factors favors an equity characterization of the Preferred Units. Thus, we believe the Preferred Units should be characterized for U.S. tax purposes as equity, not debt.[19]

B. <u>Characterization of the Certificates</u>

Based on the characteristics distinguishing debt from equity described above, the Certificates should, subject to the discussion of Section 385(c) below, be characterized as equity for U.S. tax purposes. Section 385(c)(1) provides that "[t]he characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)." This provision does not apply, however, where the holder of an interest discloses on its return that it is treating the interest in a manner inconsistent with the issuer's characterization.[20]

The Certificates are instruments which, while treated as debt for Luxembourg tax purposes, are labeled on their face as equity. In addition, the Certificates provide by their terms that they will be characterized (within the meaning of Section 385(c)) as equity rather than indebtedness of SARL. Consequently, Company LLC may characterize the Certificates as equity for U.S. tax purposes. In addition, because this characterization by Company LLC would be consistent with SARL's characterization of the Certificates, no disclosure would be required under Section 385(c)(2).

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19 We note that the legislative history of Section 351(g), enacted as part of the Taxpayer Relief Act of 1997, states that the "Treasury Secretary has regulatory authority to . . . prescribe treatment of preferred stock subject to this provision under other provisions of the Code (*e.g.*, secs. 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code." H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. (1997). Although the Preferred Units fall within the scope of Section 351(g), no regulations have been issued thereunder. Moreover, there is no indication that, were regulations issued, such regulations would characterize the Preferred Units as debt rather than equity.

20 I.R.C. § 385(c)(2).

Similarly, Company LLC should not be prevented from treating the Certificates as equity for U.S. tax purposes under the so-called "Danielson rule" because the U.S. tax treatment of the Certificates by Company LLC and will be consistent with both the form of the Certificates and the treatment of the Certificates by the issuer.

IV. U.S. TAXATION OF INCOME RECEIVED BY DUTCH VOF

A. General

A foreign corporation that is engaged in a trade or business in the United States (a "U.S. trade or business") generally is subject to income tax on its income that is effectively connected with the U.S. trade or business at the same graduated rates of taxation as a U.S. corporation (*i.e.*, up to 35 percent). Income derived from U.S. sources that is not effectively connected with a U.S. trade or business generally is subject to a flat 30 percent U.S. income tax and the related U.S. withholding tax if the income is "fixed or determinable annual or periodical" ("FDAP income"),[21] such as interest, dividends, rents and royalties. As such, Dutch VOF could be subject to tax on income derived from its investment in FASIT Interests or its lending activities if such income is (i) effectively connected with the conduct by Dutch VOF of a U.S. trade or business or (ii) non-effectively connected U.S. source FDAP income. However, income derived with respect to the FASIT Interests should generally qualify for the "portfolio interest exemption."[22] In addition, (i) the income tax treaty between the United States and the Netherlands (the "Dutch Treaty"), [23] (ii) the income tax treaty between the United States and Luxembourg that is currently in force (the "Current Luxembourg Treaty"),[24] and (iii) the income tax treaty between the United States and Luxembourg that has been signed, but has not yet entered into force (the "New Luxembourg Treaty"),[25] each provides that interest arising in the United States that is derived by a resident of the Netherlands and Luxembourg, respectively, that is not attributable to a "permanent establishment" of such resident in the United States, is not subject to U.S. tax, irrespective of whether such interest is effectively connected with a U.S. trade or business. Accordingly, so long as Dutch VOF does not maintain a permanent establishment in the United States, Dutch VOF will not be subject to tax on U.S. source interest paid to Dutch VOF regardless of whether such income is treated

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21 I.R.C. §§ 881, 1441(a), 1442; Treas. Reg. § 1.1441-4(a).

22 I.R.C. § 881(c); Treas. Reg. § 1.871-14(d).

23 Convention Between Netherlands and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, which was signed on December 18, 1992 and entered into force on December 31, 1993.

24 Convention Between the United States of America and the Grand Duchy of Luxembourg with Respect to Taxes on Income and Property, which was signed on December 18, 1962 and entered into force on January 1, 1964.

25 Convention Between the Government of the Grand Duchy of Luxembourg and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, which was signed on April 3, 1996 and has not yet entered into force.

as effectively connected with a U.S. trade or business or as non-effectively connected U.S. source FDAP income.

B. U.S. Trade or Business

Whether a foreign corporation is engaged in a U.S. trade or business is a question of fact. However, Treas. Reg. § 1.864-4(c)(5)(i) provides that a "foreign corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation or any other person who would be a related person within the meaning of Section 954(d)(3) if such foreign corporation were a controlled foreign corporation shall not be considered to be engaged in the active conduct of a banking, financing or similar business in the United States." Also, investing or trading in stocks and debt securities for the taxpayer's own account will not constitute a U.S. trade or business.[26] These provisions support the conclusion that Dutch VOF's investing in FASIT Interests, lending to Company and its affiliates and investing in public debt of U.S. issuers would not cause Dutch VOF to be engaged in a U.S. trade or business.

In Rev. Rul. 73-227,[27] the Service held that a foreign corporation ("X") with its principal office in the United States was engaged in a trade or business in the United States by reason of its activity of borrowing funds and relending them to its domestic parent ("M") and parent affiliates. The ruling stated that "X's trade or business consists of the borrowing of funds and the relending of such funds to M and M's domestic and foreign subsidiaries or affiliates. The activities incident to this trade or business are virtually all carried on in the United States through X's United States office. Accordingly, X is engaged in the active conduct of a trade or business in the United States." The conclusion in Rev. Rul. 73-227 appeared inconsistent with Treas. Reg. § 1.864-4(c)(5)(i) by finding a U.S. trade or business where the regulations specifically provided that none existed.

Revenue Ruling 88-3[28] revoked Revenue Ruling 73-227, stating that the conclusion contained therein may be "unsound" because the ruling did not discuss and apply the proper legal standard for making the highly factual determination of whether X was engaged in a United States trade or business. Thus, Revenue Ruling 88-3 may be read to create a negative inference that where a foreign person's activities are limited to borrowing money and lending such money to affiliates, it does not have a trade or business and, therefore, cannot be engaged in a U.S. trade or business. In any case, however, so long as Dutch VOF's activities are conducted outside the United States, we believe that Dutch VOF should not be viewed as being engaged in a U.S. trade or business.

The case of *Scottish American Investment Co., Ltd. v. Commissioner*[29] provides helpful authority in this regard. In *Scottish American*, a foreign corporation was in the business of

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26 I.R.C. § 864(c)(2)(A)(ii).

27 1973-1 C.B. 338.

28 1988-1 C.B. 268.

29 12 T.C. 49 (1949).

investing in securities and maintained a U.S. office through which it monitored its investments. All business decisions relating to such investments, however, were made from outside of the United States. The Tax Court held that the corporation was not engaged in a U.S. trade or business because the U.S. office was simply a "helpful adjunct" to the corporation's business.

Further, as stated above, the Dutch Treaty and the Current and New Luxembourg Treaties provide that, so long as Dutch VOF does not maintain a U.S. permanent establishment, Dutch VOF will not be subject to U.S. tax on its interest income.

In addition to any tax imposed on a foreign corporation under Section 882, such foreign corporation may be subject to the 30 percent branch profits tax imposed under Section 884. If Dutch VOF is deemed to be engaged in a trade or business within the United States, Dutch VOF may be subject to the branch profits tax on its dividend equivalent amount.[30] The dividend equivalent amount generally means the foreign corporation's effectively connected earnings and profits adjusted for reductions and increases in U.S. net equity.[31] Under Article 11 of the Dutch Treaty, U.S. branch profits tax may only be imposed to the extent that the business profits of a Dutch company are effectively connected with the conduct of a U.S. trade or business and are attributable to a permanent establishment in the United States. The branch profits tax of a foreign corporation may not be eliminated under a U.S. tax treaty unless the subject foreign corporation is a "qualified resident" of such foreign country under the branch profits tax rules.[32] A foreign corporation will be considered a qualified resident of a foreign country for these purposes unless (i) 50 percent or more of its stock (by value) is owned directly or indirectly by individuals who are neither U.S. citizens or resident aliens nor residents of such foreign country, or (ii) 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are neither U.S. citizens or residents nor residents of such foreign country.[33] Because U.S. citizens or residents will indirectly own more than 50 percent of Dutch VOF's stock and less than 50 percent of Dutch VOF's income will be used to meet liabilities of persons who are neither U.S. nor Dutch, Dutch VOF should be considered a qualified resident of the Netherlands for purposes of the branch profits tax rules and, therefore, should not be subject to the branch profits tax even if it is deemed to have a U.S. permanent establishment.

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30 I.R.C. § 882(a).

31 I.R.C. § 884(b).

32 I.R.C. § 884(e)(1).

33 I.R.C. § 884(e)(4).

C. Qualification for Treaty Benefits

1. Application of Section 894

Temp. Reg. § 1.894-1T(d)(1)[34] provides that the tax imposed by Section 881(a) on a payment made by a U.S. resident to a foreign person is eligible for exemption or reduction under a U.S. income tax treaty if (i) such payment is treated as derived by a resident of an applicable treaty jurisdiction, (ii) such resident is a beneficial owner of the payment, and (iii) all other applicable requirements for benefits under the treaty are satisfied.[35] A payment received by an entity is treated as derived by a resident of an applicable treaty jurisdiction only to the extent the payment is subject to tax in the hands of a resident of such jurisdiction.[36] A payment received by an entity that is treated as fiscally transparent by an applicable treaty jurisdiction is considered a payment subject to tax in the hands of a resident of the jurisdiction to the extent that the interest holders in the entity are residents of the jurisdiction.[37] An entity is treated as fiscally transparent by a jurisdiction to the extent the jurisdiction requires interest holders in the entity to take into account separately on a current basis their respective shares of the items of income paid to the entity and to determine the character of such items as if such items were realized directly from the source from which realized by the entity (for purposes of the tax laws of the jurisdiction).[38]

Based on the opinion of Luxembourg and Dutch tax advisors to SARL and Investor BV that SARL and Investor BV will be required to take into account separately on a current basis their respective shares of the items of income paid to Dutch VOF and to determine the character of such items as if such items were realized directly from the source from which realized by the entity (for purposes of the tax laws of Luxembourg and the Netherlands, respectively), Dutch VOF should constitute a fiscally transparent entity under the laws of both Luxembourg and the Netherlands. In addition, Luxembourg and Dutch tax advisors have opined that each of SARL and Investor BV will be liable for Luxembourg and Dutch corporate income taxes, respectively, as residents of such

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34 The temporary regulations promulgated under Section 894 are effective with respect to amounts paid on or after January 1, 1998. Temp. Treas. Reg. § 1.894-1T(d)(7). The rules contained in Temp. Treas. Reg. § 1.894-1T(d) apply in respect of all income tax treaties to which the United States is a party unless the applicable treaty partner would not grant a reduced rate under the treaty to a U.S. resident in similar circumstances, as evidenced by a mutual agreement between the competent authorities or by a public notice of the treaty partner, which mutual agreement or notice shall be announced by the IRS. Temp. Treas. Reg. § 1.894-1T(d)(5). No such announcement has been made.

35 The term "entity" is defined as a person that is treated by the United States or the applicable treaty jurisdiction as other than an individual. Temp. Treas. Reg. § 1.894-1T(d)(4)(i). The term resident has the meaning assigned to such term in the applicable treaty. Temp. Treas. Reg. § 1.894-1T(d)(4)(iv). The determination of whether a person is a beneficial owner of a payment shall be made under U.S. tax laws. Temp. Treas. Reg. § 1.894-1T(d)(2)(ii)(B).

36 Temp. Treas. Reg. § 1.894-1T(d)(1).

37 *Id.*

38 Temp. Treas. Reg. § 1.894-1T(d)(4)(ii).

jurisdictions on their respective shares of Dutch VOF's income. Accordingly, for purposes of Section 894, the interest paid by Company to Dutch VOF should be treated as subject to tax in the hands of a resident of Luxembourg to the extent allocable to SARL and as subject to tax in the hands of a resident of the Netherlands to the extent allocable to Investor BV.

A resident of an applicable treaty jurisdiction that derives a payment received by an entity that is fiscally transparent under the laws of the applicable tax jurisdiction shall be treated as the beneficial owner of the payment unless (i) such resident would not have been treated as the beneficial owner of the payment had such payment been received directly by the resident or (ii) the entity receiving the payment is not treated as a beneficial owner of the payment.[39] For instance, SARL and Investor BV would not be considered the beneficial owners of interest received by Dutch VOF from Company if either they or Dutch VOF were viewed as acting either as a nominee or a conduit for another person.[40] Under U.S. tax principles, Dutch VOF should be viewed as the beneficial owner of any interest payment actually made by Company to Dutch VOF, and each of SARL and Investor BV would be viewed as the beneficial owner of any payment made by Company had such payment been made directly to it.[41] Accordingly, for purposes of these regulations, SARL and Investor BV should be viewed as the beneficial owners of the interest payments received by Dutch VOF from Company.

Because (i) income received by Dutch VOF should be considered as having been received by residents of the Netherlands (with respect to Investor BV's interest) and Luxembourg (with respect to SARL's interest), and (ii) Dutch VOF should be viewed as the beneficial owner of income received by Dutch VOF, the income tax imposed by Section 881(a) (and the withholding tax imposed by Section 1442) on U.S.-source interest paid to a foreign corporation should not apply to interest received by Dutch VOF so long as such interest is entitled to an exemption under a bilateral income tax treaty to which the United States is a party.[42]

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39 Temp. Treas. Reg. § 1.894-1T(d)(2)(ii)(A).

40 *See* Temp. Treas. Reg. § 1.894-1T(d)(2)(ii)(B).

41 In *Aiken Industries v. Commissioner*, 56 T.C. 925 (1971) *acq.* 1972-2 C.B. 1, discussed in detail below, an intermediate entity in a back-to-back loan arrangement was disregarded for purposes of determining whether U.S. withholding tax should be imposed on interest paid to a foreign lender. The court in *Aiken* stated that the intermediate entity lacked dominion and control over the funds it received as it was required to pay out as interest all of the interest payments it received. As such, the court found that it could not be said that the interest was in fact "received by" the intermediate entity. In contrast, SARL will not be required to pay (and in fact is not expected to pay) any amounts on the Certificates until maturity. Further, unlike the situation in *Aiken*, SARL's return on the Common Units is expected to exceed the yield on the Certificates, such that SARL will generate a profit from its investment in the Common Units. *See Northern Indiana Public Service Company, infra.*

42 *See* Temp. Treas. Reg. § 1.894-1T(d)(6), Ex. 9.

2. Treaty Analysis

As described above, payments received by Dutch VOF from U.S. sources may be entitled to an exemption from U.S. withholding tax under the Dutch Treaty to the extent attributable to Investor BV's interest in Dutch VOF, and, under the Current Luxembourg Treaty (or under the New Luxembourg Treaty with respect to payments made after such treaty enters into force), to the extent attributable to SARL's interest in Dutch VOF. We analyze below whether Investor BV is entitled to benefits under the Dutch Treaty and whether SARL is entitled to benefits under the Current and New Luxembourg Treaties.

a. Dutch Treaty

Article 12 of the Dutch Treaty provides an exemption from U.S. withholding tax on interest derived by a resident of the Netherlands from U.S. sources. For purposes of the Dutch Treaty, a resident of a state means any person who, under the laws of that state, is liable to tax therein by reason of, among other things, place of incorporation.[43] We have been advised by Dutch tax advisors that Investor BV is subject to tax in the Netherlands based on its place of incorporation and is therefore a resident of the Netherlands for purposes of the Dutch Treaty.

A resident of a contracting state is entitled to benefits under the Dutch Treaty only if such person qualifies for such benefits under the Treaty's "Limitation on Benefits" provision (a "qualified resident").[44] A person is considered a qualified resident for purposes of the Dutch Treaty if, among other things, it is a person (i) more than 50 percent of the beneficial interest in which (or, in the case of a company, more than 50 percent of the aggregate vote and value of all of its shares, and more than 50 percent of the shares of any "disproportionate class of shares") is owned, directly or indirectly, by qualified residents (the "Stock Ownership Test") and (ii) which meets the base reduction test described in Article 26 paragraph 5 (the "Base Erosion Test").[45]

More than 50 percent of the stock of Investor BV will be owned by Rabo, which will represent to Dutch VOF that it is a person described in paragraph 1 of Article 26 of the Dutch Treaty.

The Base Erosion Test will be met if either (i) less that 50 percent of such person's gross income is used, directly or indirectly, to make deductible payments in the current year to persons that are not qualified residents, or (ii) in the case of a person resident in The Netherlands, (A) less than 70 percent of such gross income is used, directly or indirectly, to make deductible payments to persons that are not qualified residents, and (B) less than 30 percent of such gross income is used, directly or indirectly, to make deductible payments to persons that are neither qualified residents nor residents of the member states of the European Communities. Based on assumption 14 above, the initial lenders to Investor BV under the Investor BV Credit Agreement will satisfy the Base Erosion Test. In addition,

43 Dutch Treaty, art. 4.

44 Dutch Treaty, art. 26(1).

45 Dutch Treaty, art. 26(1)(d).

under Section 11.6(f) of the Investor BV Credit Agreement, each lender is not permitted to assign its rights and obligations under the Investor BV Credit Agreement if such assignment would cause Investor BV to fail the Base Erosion Test. Therefore, Investor BV should satisfy the Base Erosion Test of the Dutch Treaty and, consequently, should be a qualified resident under the Dutch Treaty.

As stated above, the Dutch Treaty provides that no tax will be imposed on interest paid to a qualified resident unless such interest income is attributable to a "permanent establishment" in the source country.[46] A "permanent establishment" is a "fixed place of business through which the business of the enterprise is wholly or partly carried on," and includes especially a place of management, a branch and an office.[47] Because all of Dutch VOF's business will be carried on outside the United States, and it will not have a place of management, a branch or an office in the United States, Dutch VOF should not be deemed to have a "permanent establishment" in the United States. Accordingly, any interest derived by Dutch VOF from U.S. sources (and attributable to Investor BV's interest) should not be subject to U.S. tax.

b. Luxembourg Treaties

i. Current Luxembourg Treaty

Under Article VIII of the Current Luxembourg Treaty, interest received by a Luxembourg corporation or resident that does not have a U.S. permanent establishment is exempt from U.S. tax. The term "resident corporation" means a juridical person that has its business management or seat in Luxembourg.[48] We have been advised by Luxembourg counsel that SARL is a juridical person for Luxembourg purposes that will have its seat in Luxembourg.[49] Accordingly, interest paid to Dutch VOF attributable to SARL's interest will be exempt from U.S. tax under the Current Luxembourg Treaty so long as SARL does not have a U.S. permanent establishment.

Under the Current Luxembourg Treaty, a "permanent establishment" is a "fixed place of business in which the business of the enterprise is wholly or partly carried on," and includes especially a place of management, a branch and an office.[50] Notwithstanding this definition, an enterprise will be treated as having a permanent establishment in a state if a person (other than an independent contractor) acts on behalf of the enterprise and has, and habitually exercises, in the state an authority to conclude contracts in the name of the enterprise.[51] No person will have the authority to conclude contracts on behalf of SARL in the United States. While SARL's directors will be U.S.

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46 Dutch Treaty, art. 12.

47 Dutch Treaty, art. 5(2).

48 Current Luxembourg Treaty, art. II(e).

49 The Current Luxembourg Treaty contains no limitation on benefits provision.

50 Dutch Treaty, art. II(f).

51 Current Luxembourg Treaty, art. II(f)(iv).

citizens and residents, its directors will be specifically precluded from concluding any contract on behalf of SARL and from making any management decisions in the United States. Accordingly, SARL should not have a U.S. permanent establishment.

ii. New Luxembourg Treaty

Under Article 12 of the New Luxembourg Treaty, interest arising in the United States and paid to a resident of Luxembourg that does not have a U.S. permanent establishment is exempt from U.S. tax. A Luxembourg resident includes any person who is liable to tax in Luxembourg by reason of its place of incorporation.[52] The Luxembourg Tax Ruling provides that SARL is subject to tax in Luxembourg based on its place of incorporation.[53] Accordingly, SARL should be considered a resident of Luxembourg for purposes of the New Luxembourg Treaty.

Under the New Luxembourg Treaty's Limitation on Benefits provision, a resident of a contracting state is entitled to benefits of the treaty only if such person is a "qualified resident" as defined in that provision. A Luxembourg company will be a qualified resident if, among other things, (i) at least 50 percent of the principal class of shares in the company is ultimately owned by persons that are qualified residents or U.S. citizens (the "Stock Ownership Requirement"), and (ii) deductible amounts paid or accrued by the company during its taxable year to persons that are neither qualified residents nor U.S. citizens do not exceed 50 percent of the gross income of the company for that year (the "Base Erosion Requirement").[54] Thus, SARL will be considered a qualified person (and thus entitled to benefits under the New Treaty) so long as Company is a qualified person, because in such case (i) at least 50 percent of SARL's shares would be owned ultimately by a qualified resident (Company), and (ii) SARL's only deductible amounts would be accrued with respect to Company LLC, which by virtue of being wholly-owned by Company, would be at least 50 percent owned by a qualified resident under the New Luxembourg Treaty.[55]

Company will be considered a qualified resident if its principal class of shares is substantially and regularly traded on one or more recognized stock exchanges.[56] While the New Treaty does not define the term "principal class of shares," the treaty's technical explanation states that such term is understood to mean the company's ordinary or common shares, but only if such shares possess a majority of the company's voting power and value. Company's common stock represents more than 50 percent of its vote and value and, therefore, is considered its principal class of shares.

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52 New Luxembourg Treaty, art. 4(1).

53 We note that Company LLC will not receive any U.S. foreign tax credits for Luxembourg taxes paid by SARL.

54 New Luxembourg Treaty, art. 24(2)(c).

55 New Luxembourg Treaty, art. 25(2)( ).

56 New Luxembourg Treaty, art. 25(2)(d).

Shares in a class are considered to be substantially and regularly traded if the aggregate number of shares of that class traded during the previous taxable year is at least 6 percent of the average number of shares outstanding in that class during that taxable year. Based on assumption 15 above, Company should be considered a qualified resident of Luxembourg because its principal class of shares is substantially and regularly traded on one or more recognized stock exchanges. Accordingly, Company should be considered a qualified person for purposes of the New Luxembourg Treaty. Consequently, for the reasons discussed above, SARL will satisfy the Stock Ownership and Base Erosion Requirements and, therefore, will be considered a qualified person under the New Luxembourg Treaty.

Further, SARL will not make any deductible payments to persons that are not qualified residents. Accordingly, SARL will meet the Base Erosion Test and, therefore, SARL should be treated as a qualified resident under the Dutch Treaty.

The definition of "permanent establishment" in the New Luxembourg Treaty is substantially the same as that in the Current Luxembourg Treaty. As stated above, because no person will have the authority to conclude contracts on behalf of SARL in the United States, SARL should not have a U.S. permanent establishment.

Based on the foregoing, because (i) the income derived by Dutch VOF will be treated as derived by residents of The Netherlands and Luxembourg, (ii) each of the members of Dutch VOF should be treated as beneficial owners of the payments made by Company to Dutch VOF, and (iii) Investor BV and SARL are qualified residents of the Netherlands and Luxembourg, respectively, Dutch VOF should be entitled to the benefits of the Dutch Treaty and either the Current Luxembourg Treaty or the New Luxembourg Treaty (whichever shall apply) with respect to payments made by Company.

3. Disclosure of Treaty-Based Return Positions

Section 6114 provides that, unless waived by the IRS, any taxpayer who takes the position that a U.S. treaty overrules or otherwise modifies a U.S. internal revenue law with respect to any tax imposed under the Code must disclose such position in the manner prescribed by the IRS. With respect to interest payments made prior to January 1, 2000, the IRS has waived (except in limited circumstances not applicable here) the reporting requirement for treaty exemptions from U.S. withholding tax.[57] For interest payments made after December 31, 1999, however, a taxpayer must disclose that it is claiming an exemption from U.S. withholding tax under a treaty that contains a limitation on benefits article where (i) the recipient of the interest income is related to the person obligated to pay the income, (ii) the income exceeds $500,000, and (iii) a foreign person (other than an individual or State) meets the requirements of the limitation on benefits article of the treaty.[58] No disclosure will be required with respect to payments received by Dutch VOF on FASIT Interests it holds because the Dutch VOF and the FASIT should not be treated as related persons. However,

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57 Treas. Reg. § 301.6114-1(c)(1)(ii) (prior to amendment by T.D. 8733, 1997-43 I.R.B. 8).

58 Treas. Reg. § 301.6114-1(b)(4)(ii)(C) (as amended by T.D. 8733, *supra*).

Dutch VOF must disclose that is relying on an exemption from U.S. withholding tax under the Dutch Treaty (and, if applicable, the New Luxembourg Treaty) with respect to payments under any loan made by Dutch VOF to Company or a U.S. affiliate of Company (so long as the income element of such payment is at least $500,000) unless such payments are otherwise exempt from U.S. withholding tax absent application of such treaties.[59]

V. ALLOCATION OF SUBPART F INCOME UNDER THE MULTIPLE CLASS OF STOCK RULES

A. General Allocation Rules

Section 957(a) defines a controlled foreign corporation ("CFC") as any foreign corporation if more than 50 percent of either the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such corporation is owned, or treated as owned under certain constructive ownership rules, by "U.S. shareholders." A "U.S. shareholder" is a U.S. person who owns, or is treated as owning, 10 percent or more of the combined voting power of stock entitled to vote in the corporation.[60] Because Company LLC (a U.S. person by virtue of being organized in the United States) should be viewed as owning stock in Dutch VOF with at least a ten percent vote, and such stock in the aggregate constitutes more than 50 percent of the value of Dutch VOF, Dutch VOF should be classified as a CFC.

A U.S. shareholder of a CFC generally must include in income its pro rata share of certain types of income and earnings, referred to as subpart F income, of the CFC,[61] regardless of whether the U.S. shareholder receives a distribution of cash or property from the CFC.[62] Subpart F income includes foreign base company income, which includes foreign personal holding company income, which in turn generally includes interest income. Subject to certain exceptions not relevant here, if a corporation's foreign base company income for a taxable year exceeds 70 percent of its gross income, the corporation's entire gross income is treated as foreign base company income.[63] Because more than 70 percent of Dutch VOF's gross income will consist of interest income, all of Dutch VOF's income will be treated as subpart F income.

As stated above, a U.S. shareholder of a CFC must include in income its pro rata share of the CFC's subpart F income for the year. Therefore, each Dutch VOF shareholder's pro rata share of Dutch VOF's subpart F income must be determined. A shareholder's pro rata share of subpart F

59 Where required, disclosure of a treaty-based return position must be made on a Fo Return Position Disclosure Under Section 6114 or 7701(b)).

60 I.R.C. § 951(b).

61 I.R.C. § 951(a)(1)(A)(i).

62 I.R.C. § 951(a).

63 I.R.C. § 954(b)(3)(B).

income is generally equal to the amount which would have been distributed to the shareholder if the corporation's subpart F income was distributed on the last day of the year. (For this purpose, actual distributions do not reduce the amount of subpart F income subject to inclusion. Such distributions, however, may be excluded from gross income under Section 959 as previously taxed income to the extent they represent amounts that have been subject to tax under the subpart F provisions.)

Treas. Reg. § 1.951-1(e)(2) provides the following special rule for determining a U.S. shareholder's pro rata share of subpart F income where there are multiple classes of stock outstanding:

> If a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of such corporation's subpart F income, withdrawal, or increase in investment, for the taxable year which shall be taken into account with respect to any one class of such stock . . . shall be that amount which bears the same ratio to the total of such subpart F income, withdrawal, or increase in investment for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation bear to the total earnings and profits of such corporation for such taxable year.

The examples further illustrate how such allocation is made where the corporation has classes of common and preferred stock outstanding. The examples illustrate that a determination of the earnings and profits which would have been distributed to the preferred shareholders is first made.[64] Such determination is based on the dividend payable with respect to such preferred shares.[65] The remaining earnings and profits would then be deemed distributed to the holders of the common shares. Once such ratios have been established, the subpart F income of a CFC is allocated in accordance with such ratios.

The Dutch VOF agreement provides that the holders of the Common Units cannot receive dividends while any Preferred Units remain outstanding. It further provides that at any time Dutch VOF may redeem, in whole or in part, the Preferred Units through the payment of Redemption Proceeds up to an amount equal to the remainder of the retained earnings (after payment of the Preferred Distribution) of Dutch VOF. Thus, to the extent earnings are distributed, they must (to the extent the earnings remaining after payment of the Preferred Distribution do not exceed the liquidation preference of the Preferred Units) be paid to holders of the Preferred Units while such units remains outstanding. As analyzed below, any Redemption Proceeds paid in full or partial redemption of the Preferred Units should be considered a distribution (and hence a dividend to the extent of current and accumulated earnings and profits) so long as Company LLC's option to purchase the stock of Investor BV remains outstanding. Accordingly, pursuant to Treas. Reg. § 1.951-1(e)(2), as long as Dutch VOF's earnings and profits for any taxable year do not exceed the sum of the Preferred Distribution and the current outstanding liquidation preference on the Preferred Units, all of Dutch VOF's subpart F

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64 *See* Treas. Reg. § 1.951-1(e)(4), Ex. 1.

65 Special rules may apply if an arrearage in dividends for prior taxable years exists.

income should be allocated to the holders of the Preferred Units and Company LLC's pro rata share of Dutch VOF's subpart F income should be zero.[66]

We also note the potential application of Treas. Reg. § 1.951-1(e)(3), which provides that where two or more classes of stock are outstanding, and a body of persons has discretion as to how dividends should be distributed among the classes in a taxable year, the allocation for subpart F purposes will be made as if there were only one class of stock in which each share had the same rights to dividends as any other share. This regulation will not apply to Dutch VOF because no body of persons has discretion to make a distribution with respect to the Common Units while the Preferred Units are outstanding.

B. Case Law

The facts and conclusions set forth in *Barnette v. Commissioner*[67] also provide support for the allocation of subpart F income as described above. In *Barnette,* the taxpayer owned in excess of 95 percent of the stock of Allied Corporation, a Delaware corporation that had its principal office in Florida at all times during the taxable years 1976 through 1986. J.E.T.S. and Jets Services, both incorporated in Florida, were wholly owned subsidiaries of Allied. Allied was in the business of government contracting. Allied would bid for and perform the contracts through J.E.T.S. and Jets Services. In May 1976, J.E.T.S. submitted a bid to operate certain laundry and dry cleaning plants in West Germany. In order to qualify to do business in West Germany, J.E.T.S. formed a wholly owned GmbH, J.E.T.S. Wascherei. The contracts were awarded to J.E.T.S. Wascherei on May 1, 1977.

The taxpayer acquired control of a Panamanian corporation, Old Dominion, in March 1977. In 1977, J.E.T.S. sold J.E.T.S. Wascherei to Old Dominion. Old Dominion was to earn license income from J.E.T.S. Wascherei. In December of 1980, Old Dominion amended its Articles of Incorporation to authorize a class of preferred stock that provided for the payment of dividends at a fixed percentage of the stock's liquidation preference. The terms of the preferred stock also provided that any dividends paid to preferred shareholders in excess of the stated fixed rate would reduce the preferred stock's liquidation preference and that no dividends could be paid on the common stock while the preferred stock remained outstanding. Between December 24th and December 26th, the following occurred. Taxpayer caused Old Dominion to issue a stock warrant to taxpayer for 3,000 shares of preferred stock at $1 per share. The shares subject to the warrant had a liquidation preference of $1,000 per share. Taxpayer exercised the warrant and acquired the 3,000 shares of Old Dominion preferred stock. It then transferred all 3,000 shares of the Old Dominion preferred stock and 10 percent of its Common Units to Allied. Allied then transferred those shares to Jets Services.

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66 We also note that the loans to Company and its domestic affiliates will result in an investment of earnings in U.S. property within the meaning of Section 956. In general, a U.S. shareholder of a CFC must include its pro rata share of the CFC's increase in investment of earnings in U.S. property during the taxable year. I.R.C. § 951(a)(1)(B). However, Treas. Reg. § 1.951-1(e)(4) applies to determine a U.S. shareholder's pro rata portion of a CFC's investment in U.S. property as well as the CFC's subpart F income. Accordingly, Dutch VOF's investment in U.S. property should not result in an inclusion to Company LLC under Section 951(a)(1)(B).

67 63 T.C.M. (CCH) 3201 (1992), *reh'g denied*, 64 T.C.M. (CCH) 998 (1992).

As a result of these transaction, Jets Services owned 10 percent of the common stock of Old Dominion and all of the preferred shares from December 1980 until they were redeemed in January 1985.

For the years in question, *i.e.*, 1980 through 1985, the foreign personal holding company rules took precedence over the subpart F rules.[68] Nevertheless, for the years in question the income of Old Dominion constituted either subpart F income or income subject to inclusion under the foreign personal holding company regime. Treas. Reg. § 1.551-2(c), relating to foreign personal holding company income, provides that:

> The amount which each United States shareholder must return is that amount which he would have received as a dividend if the above-specified portion of the undistributed foreign personal holding company income had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year on which the required United States group existed. Such amount is determined, therefore, by the interest of the United States shareholder in the foreign personal holding company, that is, by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders, then the assumed distribution of the stated portion of the undistributed foreign personal holding company income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

The preferred stock in Old Dominion was issued purposely to deflect away foreign personal holding company income from the taxpayer. The court assumed, and the petitioners conceded, that the issuance of the preferred stock was tax-motivated. The court stated, however, that even if the "only purpose for the creating of the preferred stock was tax avoidance, we fail to see how the existence of the preferred stock can be ignored."[69] The court noted that the taxpayer did not need a business purpose to issue the stock, because the business purpose doctrine "covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally."[70] Moreover, the court found that the taxpayer's financial position was in fact changed because, notwithstanding the fact that the taxpayer owned 98 percent of the corporation that ultimately held the preferred stock, the evidence did not support a finding that the corporation could be disregarded under *Moline Properties*. The court ruled for the taxpayer, respecting the rights of the stock as set forth in the corporate charter.

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68 Section 951(d) was amended, effective for taxable years beginning after July 18, 1984, to provide that, if an amount would be includible under both the subpart F rules and the foreign personal holding company rules of Section 551, such amount shall be included in the gross income of the shareholder solely under the subpart F rules.

69 63 T.C.M. at 3201-18.

70 *Id.* (citation omitted).

Having concluded that the preferred stock should be respected as being outstanding for U.S. tax purposes, the Tax Court concluded that the holder of such stock was properly taxable on all subpart F income and undistributed foreign personal holding company income during the years in question. Most notably, even though Jets Services was only entitled to a first preference of $240,714 and $241,966 for the taxable years ended 1983 and 1984, respectively, it was allocated undistributed foreign personal holding company income of $426,708 and $1,140,237 for those years, respectively. In fact, the aggregate cash distributions (current and liquidating) eventually received by Jets Services amounted to $3,707,573. Even though Jets Services only received approximately $700,000 in cash over the liquidation preference of the preferred shares, it was allocated substantially more income under the subpart F and foreign personal holding company rules.

We note that the Preferred Units provide Dutch VOF the right to redeem some or all of the units by paying Redemption Proceeds, in contrast to the *Barnette* case in which the issuer was merely accorded the right to pay additional dividends to the preferred shareholders. Nevertheless, the redemption right with respect to the Preferred Units is substantially identical to the right to pay additional dividends in *Barnette* in both an economic and a tax sense, because any amounts paid by the issuer would reduce the stock's liquidation preference and would represent the payment of a dividend for tax purposes.

Dutch VOF's earnings and profits should be wholly allocable to the holder of the Preferred Units under the multiple class of stock regulations and the *Barnette* case so long as such earnings and profits do not exceed the sum of (i) the Preferred Distribution and (ii) the current outstanding liquidation preference on the Preferred Units. Notwithstanding this, however, the IRS may argue that the Redemption Proceeds, if paid, would not constitute a dividend distribution and thus should not result in an allocation of earnings and profits, but rather would result in a constructive redemption of a portion of the Preferred Units.

In addition, in the context of the Transaction, Company LLC will be granted an option to purchase the stock of Investor BV at its then current fair market value. This option will expire six months prior to the ten-year stated redemption date of the Preferred Units.[71]

A redemption of stock is taxable to the redeemed shareholder as a distribution potentially taxable as a dividend under Section 301, rather than as a sale or exchange of the redeemed shares, unless the redemption is either (i) not essentially equivalent to a dividend under Section 302(b)(1), (ii) a substantially disproportionate redemption under Section 302(b)(2) or (iii) a complete termination of the shareholder's interest in the corporation.

In determining whether a redemption qualifies as a sale or exchange under Section 302(b) or a distribution potentially taxable as a dividend under Section 301, the constructive

71 Neither Section 318 nor the Treasury Regulations thereunder define the term "option." However, the IRS has ruled that an option that is "exercisable only after the lapse of a fixed period of time . . . is an option within the meaning of Section 318(a)(4) of the Code." Rev. Rul. 89-64, 1989-1 C.B. 91, 92.

ownership rules of Section 318(a) must be taken into account.[72] Section 318(a)(4) provides that "[i]f any person has an option to acquire stock, such stock shall be considered as owned by such person." Because Company LLC will have an option to acquire the stock of Investor BV, Company LLC should be treated as the constructive owner of 100 percent of Investor BV under Section 318(a)(4). Section 318(a)(5)(A) provides (with exceptions not relevant here) that stock constructively owned by a person under Section 318(a)(4) shall be considered as actually owned for purposes of applying Section 318(a)(2). Section 318(a)(2)(C) provides that if a person owns 50 percent or more of the value of stock in a corporation, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.[73] Therefore, since Company LLC is treated as owning all of the stock of Investor BV, Investor BV should be viewed as owning all of the Dutch VOF Common Units held by Company LLC (through SARL), and thus should be treated as owning 100 percent of the stock of Dutch VOF at all times prior to the expiration of the option.

A redemption of stock will qualify for sale or exchange treatment as "substantially disproportionate" within the meaning of Section 302(b)(2) if immediately after the redemption (i) the shareholder whose stock is redeemed owns less than 50 percent of the total voting power of the redeeming corporation and (ii) such shareholder's percentage interest in voting stock of the corporation is less than 80 percent of the shareholder's percentage interest in such stock immediately before the redemption. Because under the constructive attribution rules discussed above, Investor BV, at all times, should be viewed as owning 100 percent of the stock of Dutch VOF, any redemption, whether deemed or actual, should not qualify as "substantially disproportionate." In addition, such redemption should not qualify as a complete termination of its interest in Dutch VOF for the same reason.

Section 302(b)(1) also provides for sale or exchange treatment if a redemption is not "essentially equivalent to a dividend." Neither the Code nor the regulations define the phrase "essentially equivalent to a dividend." The regulations provide a facts and circumstances test and specifically require the Section 318(a) constructive ownership of the redeemed shareholder to be "one of the facts" considered in determining whether the redemption proceeds are the equivalent of a dividend.[74]

In *United States v. Davis*,[75] the Supreme Court held that a redemption must always be viewed as essentially equivalent to a dividend unless it results "in a meaningful reduction of the shareholder's proportionate interest in the corporation."[76] In determining whether a redemption effects a meaningful reduction in the shareholder's interest, the Court held that all shares constructively owned as a result of Section 318 attribution must be treated as actually owned by such shareholder.

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[72] I.R.C. § 302(c).

[73] I.R.C. § 318(a)(3)(C).

[74] Treas. Reg. § 1.302-2(b).

[75] 397 U.S. 301 (1970), *reh'g denied*, 397 U.S. 1071 (1970).

[76] *Id.* at 313.

The IRS and the courts have interpreted *Davis* as requiring the shareholder to be treated as receiving a Section 301 distribution unless the proportionate interest of a redeemed shareholder, after taking into account the attribution rules, has been reduced as a result of the redemption.[77] Again, because under the constructive attribution rules discussed above Investor BV should be viewed at all times as owning 100 percent of the stock of Dutch VOF, the redemption should be viewed as essentially equivalent to a dividend.[78]

VI. TREATMENT OF DUTCH VOF AS A PASSIVE FOREIGN INVESTMENT COMPANY (A "PFIC")

A foreign corporation will be classified as a PFIC if either (i) 75 percent or more of its gross income for a taxable year is passive income,[79] or (ii) the average percentage of assets (by value)[80] held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent.[81] Section 1297(b)(1) provides that passive income generally means foreign personal holding company income as defined in Section 954(c),[82] unless an exception applies. Because foreign personal holding company income generally includes interest income, Dutch VOF will satisfy the income test and be classified as a PFIC unless an exception

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77 *See Metzger Trust v. Commissioner*, 76 T.C. 42, 61 (1981), *aff'd*, 693 F.2d 459 (5th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983); *Cerone v. Commissioner*, 87 T.C. 1, 22 (1986) (notwithstanding family hostility); Rev. Rul. 78-60, 1978-1 C.B. 81 (shareholder could elect not to participate in future serial redemptions); Rev. Rul. 77-427, 1977-2 C.B. 100 (subsidiary sold to corporation owning 10 percent of seller); Rev. Rul. 77-218, 1977-1 C.B. 81 (controlled corporation sold to related controlled corporation); Rev. Rul. 71-261, 1971-1 C.B. 108 (redemption of stock from estate where beneficiaries owned remaining stock); Priv. Ltr. Rul. 9131059; Priv. Ltr. Rul. 8651026; Tech. Adv. Mem. 8552009; Priv. Ltr. Rul. 7933038 (actual ownership reduced to zero). At least one court has accepted the view that family hostility can be taken into account in applying the constructive ownership rules of Section 318(a)(1). *See Haft Trust v. Commissioner*, 510 F.2d 43 (1st Cir. 1975). The IRS, however, rejected the First Circuit's decision in *Haft Trust* and indicated that it will apply the Section 318 attribution rules mechanically. *See* Rev. Rul. 80-26, 1980-1 C.B. 66.

78 Section 305(c) and Treasury Regulations promulgated thereunder provide that a change in the redemption price of stock may give rise to a deemed distribution if the change has the result of the receipt of property by some shareholders and an increase in the proportionate interests of the other shareholders in the assets or earnings and profits of the corporation. Any reduction in the liquidation preference of the Preferred Units as a result of payment of Redemption Proceeds should not be treated as giving rise to a deemed distribution under the above rule because the proportionate interest in the assets and earnings and profits of the corporation of the holders of the Common Units remains the same irrespective of whether any Redemption Proceeds are paid.

79 I.R.C. § 1297(a)(1).

80 In the case of a CFC (or any other foreign corporation if such foreign corporation so elects), the determination is made based on the adjusted bases of property.

81 I.R.C. § 1297(a)(2).

82 I.R.C. § 1297(b)(1). Under Section 954(c), foreign personal holding company income generally includes (but is not limited to) dividends, interest, rents and royalty income.

applies. Because Dutch VOF's assets will consist solely of interest-producing assets, Dutch VOF will also satisfy the asset test unless an exception applies.

Notwithstanding the fact that Dutch VOF may be a PFIC, the Taxpayer Relief Act of 1997 enacted Section 1297(e), which provides that for taxable years of U.S. persons beginning after December 31, 1997 and for taxable years of foreign corporations ending on or within such years, a corporation that is a CFC will not be treated as a PFIC with respect to any U.S. shareholder. Thus, Dutch VOF should not be a PFIC with respect to Company LLC.[83]

VII. TREATMENT OF DUTCH VOF AS A FOREIGN PERSONAL HOLDING COMPANY (AN "FPHC")

Under the FPHC rules,[84] citizens or residents of the United States, domestic corporations, and partnerships and estates or trusts (other than foreign estates or trusts) who are direct or indirect shareholders of an FPHC must include in income their pro rata share of the FPHC's undistributed foreign personal holding company income ("UFPHCI").

Section 552 generally provides that an FPHC is any foreign corporation that satisfies a gross income requirement and a stock ownership requirement. A corporation satisfies the gross income requirement if at least 50 percent of its income is foreign personal holding company income. It satisfies the stock ownership requirement if, at any time during the taxable year, not more than five individuals who are citizens or residents of the United States own, directly or indirectly, more than 50 percent of either the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such corporation. As discussed above, Dutch VOF's income will be interest income that qualifies as foreign personal holding company income. Therefore, Dutch VOF will satisfy the gross income requirement. Section 554 sets forth constructive ownership rules used to determine

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83 Dutch VOF will also be a "foreign investment company" (a "FIC"). A foreign corporation will be a FIC if it satisfies an investment business test and a stock ownership test. Section 1246(b). The investment business test is satisfied if a corporation is either (i) registered under the Investment Company Act of 1940, or (ii) engages, or holds itself out as engaging, primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest in securities or commodities. The stock ownership test is satisfied if U.S. persons own, directly or indirectly, 50 percent or more of the stock of the foreign corporation by vote or value. Because Dutch VOF will be engaged in the business of investing in securities, which include notes and any evidence of indebtedness, Dutch VOF will satisfy the investment business test. Because Company LLC is a U.S. person and indirectly owns more than 50 percent of the stock of Dutch VOF, Dutch VOF will be treated as a FIC. As such, some or all of the gain recognized by Dutch VOF's U.S. shareholders (*i.e.*, Company LLC) on a taxable sale or exchange of the FIC stock may be characterized as ordinary income. While not stated explicitly, the FIC rules should not apply to gain realized, but not recognized, in a nonrecognition transfer, such as a complete liquidation of the FIC under Section 332. *See* Kuntz & Peroni, *U.S. International Taxation*, ¶ B2.07[3][a].

84 We note that Dutch VOF will not be a personal holding company, as defined in Section 542, because a company that meets the requirements to be treated as an FPHC cannot be a "personal holding company." I.R.C. § 542(c) Thus, to the extent the tests of Sections 542 and 552 were both met, Dutch VOF should be classified as an FPHC and not a PHC.

whether a corporation satisfies the stock ownership requirement. Based on our understanding of the facts, Dutch VOF would not satisfy the stock ownership test.

Assuming, however, that Dutch VOF is an FPHC, U.S. shareholders would have to include in income their pro-rata share of Dutch VOF's UFPHCI. These pro-rata shares, however, would be determined under the method described in the discussion of *Barnette* in Part V.B above, although the CFC rules achieve the result under a different regulation. As discussed above, the Tax Court considered Treas. Reg. § 1.551-2(c) in *Barnette*[85] and concluded that the preferred shareholders should be allocated all of the UFPHCI under facts similar to the Transaction. Therefore, under the reasoning of *Barnette*, Company LLC should have no inclusion under the FPHC rules since all of Dutch VOF's UFPHCI should be allocated to Investor BV.

VIII. THE ACCUMULATED EARNINGS TAX

Assuming that Dutch VOF declares and pays only Preferred Distributions with respect to the Preferred Units, it will accumulate substantial earnings and profits each year. Section 531 imposes an accumulated earnings tax equal to 39.6 percent of accumulated taxable income on any corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders, or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being distributed.[86] The fact that a corporation is a mere holding or investment company is prima facie evidence of the purpose to avoid the income tax with respect to shareholders.[87] Based on the activities we understand Dutch VOF will engage in, it should be a holding or investment company within the meaning of Section 533(b). Accordingly, Dutch VOF would have the burden of going forward with evidence relating to the tax avoidance purpose, or lack thereof, for its accumulation of earnings and profits.

The purpose that is prescribed in Section 532 is an intent to avoid the imposition of the individual income tax on the ultimate individual shareholders of the corporation.[88] Under the governing documents, any distribution of retained earnings must be made to Investor BV. Accordingly, we believe that the accumulated earnings tax should not be applied to Dutch VOF's accumulation of its earnings and profits. In addition, even if the IRS could successfully argue that a portion of the accumulated earnings and profits were allocable to Company, we have assumed that the Company affiliated group will have current and accumulated earnings and profits for each year in which the Preferred Units are outstanding in excess of the aggregate amount of distributions that may reasonably be anticipated to be made to shareholders of Company for such year. Dutch VOF, therefore, is not being formed and will not be availed of with a view to permit the Company affiliated

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85 63 T.C.M. (CCH) 3201 (1992).

86 I.R.C. § 532(a).

87 I.R.C. § 533(b).

88 *See* Treas. Reg. § 1.532-1(a); Priv. Ltr. Rul. 9330011 (Apr. 28, 1993); Priv. Ltr. Rul. 9330010 (Apr. 28, 1993); Priv. Ltr. Rul. 9229025 (Apr. 21, 1992).

group to avoid making dividend distributions to Company's shareholders..[89] Accordingly, the accumulated earnings tax should not apply.

IX. THE FORM OF THE TRANSACTION SHOULD BE RESPECTED AND NOT DISREGARDED AS AN ECONOMIC SHAM

The IRS may attempt to alter the characterization of the Transaction on the grounds that it constitutes an economic sham. In *Frank Lyon Co. v. United States*,[90] the Supreme Court held that a transaction will be recognized for tax purposes only if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached . . ."[91] *Frank Lyon* has been construed to create a two-prong test for determining whether a transaction is a "sham" to be disregarded for tax purposes entirely: "(1) has the taxpayer shown that it has a business purpose for engaging in the transaction other than tax avoidance? (2) has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits?"[92]

The Fourth Circuit Court of Appeals in *Rice's Toyota World, Inc. v. Commissioner* has interpreted the two-prong inquiry set forth in *Frank Lyon* as follows: a tax-favored transaction may be treated as an economic sham and tax benefits denied where (i) the taxpayer has no business purpose other than obtaining tax benefits and (ii) the transaction lacks economic substance because no reasonable possibility of a pre-tax profit exists.[93] Other courts have avoided a rigid approach to these two criteria, preferring to view them as relevant inquiries to consider in applying the traditional sham transaction analysis.[94] It should be noted that, where the claimed business purpose of the taxpayer is to

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89 In addition, although Section 532(c) provides that the determination of whether the accumulated earnings tax applies is to be made without reference to the number of shareholders of the corporation, courts are loath to impose the tax on publicly held corporations. William L. Raby, *When Will Accumulated Earnings Tax be Imposed on Publicly Traded Corporations?*, 61 Tax Notes 1491 (1993). Company, Dutch VOF's ultimate parent, will be publicly held, and only at the Company shareholder level are there shareholders liable for the *individual* income tax. As such, Dutch VOF should be treated no differently than a publicly held corporation for accumulated earnings tax purposes.

90 435 U.S. 561, 583-84 (1978).

91 *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978). *See also United States v. Wexler*, 31 F.3d 117, 122 (3d Cir. 1994), *cert. denied,* 513 U.S. 1190 and cases cited; *Peerless Industries, Inc. v. United States,* 94-1 USTC ¶ 50,043 at 83,171 (E.D. Pa. 1994), *aff'd in an unpublished opinion*, 37 F.3d 1488 (3d Cir. 1994); *Seykota v. Commissioner*, 61 T.C.M. (CCH) 2706, 2721 and 2726 (1991).

92 *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990); *Rasmussen v. Commissioner*, 63 T.C.M. (CCH) 2710 (1992); *see also Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1548-49 (9th Cir. 1987).

93 752 F.2d 89, 91-95 (4th Cir. 1985).

94 *Shriver v. Commissioner*, 899 F.2d 724 (8th Cir. 1990); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990); *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988), *cert. denied,* 488 U.S. 824 (1988); *Cherin v. Commissioner*, 89 T.C. 986, 993 (1987).

earn a profit by entering into the transaction, unlike the transaction in *Frank Lyon* which was also guided by accounting and regulatory concerns, the two prongs of the test for determining whether an economic sham exists overlap to a large extent. A series of cases, discussed below, illustrate how the economic substance prong of the test for determining whether an economic sham exists has been the sole basis for the courts in disregarding the form of the transaction where the taxpayer's only claimed business purpose was to earn a profit.

In *Knetsch v. United States*,[95] the taxpayer purchased deferred savings annuity bonds from an insurance company, borrowing virtually the entire purchase price from the insurance company and then borrowing to pay the annual interest expense on the loan in a manner such that the taxpayer was assured of an economic loss each year. The taxpayer had a locked-in loss from the inception of the transaction. The Court said that the transaction "did not appreciably affect the taxpayer's beneficial interest except to reduce his tax" and that "it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."[96] Accordingly the transaction was "a sham," and the Supreme Court disallowed the taxpayer's interest expense deductions.

Similarly, in *Goldstein v. United States*,[97] the taxpayer borrowed money at a high interest rate to purchase Treasury securities bearing a low interest rate and then prepaid the interest on her borrowings. Similar to *Knetsch*, the taxpayer in *Goldstein* had locked in an economic loss from the inception of the transaction. The Second Circuit Court of Appeals disallowed the interest deduction claimed under Section 163 citing a lack of economic substance as well as a lack of a non-tax business purpose.

The Tax Court applied these principles in *Sheldon v. Commissioner*,[98] where in certain of the transactions before the court the taxpayer demonstrated that it could have made a profit. In *Sheldon*, a seller of Treasury Bills bought securities and obtained financing from the seller through a repurchase agreement. The petitioner and seller established through confirmation tickets that the petitioner had bought the securities and then placed them with the seller to collateralize the seller financing. However, the seller neither acquired nor delivered any securities to the petitioner. Because the Treasury Bills were purchased and sold to the same dealer, the transactions could be settled, as they would be in the Transaction, by "pair-offs." The court explicitly acknowledged that this method of settling the transactions permitted the petitioner to buy and finance Treasury Bills without any potential for delivery by himself or the seller. The purchases were therefore not fictitious or factual shams.

The court, however, denied the claimed deductions stating that "[i]n instances where intermediate repos could have or did generate some gain from the [positive] carry, these amounts were

95 364 U.S. 361 (1960).

96 *Id.* at 366.

97 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

98 94 T.C. 738 (1990).

nominal, either fixed or short-term and stable and, in any event, merely reduced the fixed losses by relatively insignificant amounts." The Tax Court ultimately found that even what nominal profit there was in *Sheldon* was absorbed by losses on related and, arguably, integrated transactions.[99] It is unclear to what extent the majority opinion in *Sheldon* can be construed as authority for comparing the tax benefits of a transaction to the amount of pre-tax profit potential in determining its economic substance. Nevertheless, the insignificant profit potential which was found to exist provided the court with ample support to conclude that the taxpayer (i) lacked a non-tax business purpose and (ii) the transaction lacked economic substance under the test set forth in *Rice's Toyota World, Inc.* since no reasonable possibility of a pre-tax profit in excess of a de minimis amount existed.

Most recently, in *ACM Partnership v. Commissioner*,[100] the Tax Court disregarded transactions entered into by a partnership as lacking economic substance. In *ACM*, foreign affiliates of a foreign bank, Colgate-Palmolive ("Colgate") and Merrill Lynch formed a partnership. The partners received partnership interests of 82.63 percent, 17.07 percent and .029 percent, respectively. The partnership bought a debt instrument for $205 million and then sold a significant portion of such debt instrument within a relatively short time period. The consideration received by the partnership included $140 million in cash and installment notes which provided for payments based on LIBOR. The installment notes had a net present value of $35 million and, based on their terms, qualified the transaction for contingent payment installment sale treatment. Under the contingent payment installment sale regulations, the partnership initially realized and recognized a large capital gain, attributable to the fact that it could only offset basis of $29 million from the notes sold against the $140 million of cash proceeds. The partnership allocated the income to the partners in accordance with the terms of the partnership agreement such that the foreign bank affiliates (with 82.63 percent) were allocated most of the capital gain. The partnership then allocated basis of $146 million to the installment notes (in accordance with the Section 453 basis allocation rules). The notes thus had a net present value of $35 million and a basis of $146 million. The notes were then subsequently disposed of in a manner which yielded a capital loss that was substantially allocated to Colgate.

Colgate asserted that it had multiple business purposes for entering into the transaction. First, it argued that it had a non-tax economic profit motive for its overall ACM investment. Second, Colgate argued that the ACM investment structure allowed it to manage its debt financing costs. In connection with this second business purpose, it asserted that the partnership could be used to acquire Colgate long-term debt and such debt could then be exchanged for Colgate medium-term debt. In an extremely complex analysis, the Tax Court noted the subjective nature of the second business purpose, examined the facts to determine whether they were consistent with such subjective business purpose and concluded that they were not.

The Tax Court then focused on the non-tax economic profit motive of Colgate and whether the transaction had economic substance in light of such non-tax economic profit motive. In making the determination as to whether a transaction has economic substance, courts look to whether

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99 *Id.* at 768-69. *See also Estate of Baron v. Commissioner*, 83 T.C. 542, *aff'd*, 798 F.2d 65 (2d Cir. 1986).

100 73 T.C.M. (CCH) 2189 (1997).

the transaction is "rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions."[101] Although a non-tax economic profit motive clearly existed without taking into account transaction costs, the Tax Court noted that the transaction had to be segregated into its multiple valid business purposes and transaction costs allocated to each business purpose. Having determined that the liability management business purpose was not valid since the facts were inconsistent with such business purpose, the Tax Court noted that the non-tax economic profit motive was the sole business purpose of the transaction. After allocating all transaction costs to such business purpose, the Tax Court concluded that (i) there was no reasonable potential for Colgate to have earned any pre-tax profit from its investment unless the notes either increased in credit quality or a 400 to 500 percent basis point increase occurred in the 3-month LIBOR interest rates, neither of which the court thought likely on the evidence presented, and (ii) therefore, Colgate's strategy was not "consistent with rational profit-motivated behavior on the bases of expected tax benefits." Accordingly, the court upheld the IRS's disallowance of the capital loss taken by Colgate.

In a recent decision, the Third Circuit Court of Appeals affirmed the Tax Court's decision. In doing so, the Court of Appeals emphasized that the "inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the objective economic substance of the transactions and the subjective business motivation behind them." Both of these "factors" inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. Nevertheless, the Court of Appeals noted that "it is well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations." The *ACM* court cited for this proposition *Northern Indiana Public Service*. The *ACM* court also noted that "in analyzing both the objective and subjective aspects of [the *ACM* transaction] where the objective attributes of an economically substantive transaction were lacking, we do not intend to suggest that a transaction which has actual, objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations."

As discussed above, *Knetsch*, *Goldstein*, *Sheldon* and *ACM* (based on the Tax Court's conclusion that the facts of the case were inconsistent with the liability management business purpose asserted by Colgate) all involve the courts' evaluation of the economic substance of a transaction in light of the taxpayer's ability to earn a pre-tax profit. In all of those cases, the courts either found a locked-in loss or a lack of a reasonable possibility to earn a pre-tax profit by more than a de minimis amount. We believe that the Transaction is distinguishable from those transactions, and more akin to the transaction described in *Frank Lyon*, in that it is imbued with significant non-tax attributes. Although the Transaction will be structured such that there is a reasonable possibility for Dutch VOF and Company to earn a pre-tax profit by more than a de minimis amount, the primary business purpose for the formation of Dutch VOF, and the Transaction in general, is to raise capital. With respect to Company, the form permits Company to characterize the financing as quasi-equity "minority" interest for accounting purposes. In addition, it has been represented to us that the transaction costs associated with the Transaction are reasonable and consistent with other quasi-equity financing structures in the market.

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101 *ACM*, 23 T.C.M. at 2217.

It should also be noted that the Seventh Circuit Court of Appeals in *Northern Indiana Public Service Company* noted that even though the formation of the intermediate entity was heavily guided by tax considerations *(i.e.*, the ability of the taxpayer to reduce the withholding tax that would have otherwise been imposed on the foreign lenders had such lenders made loans directly to the taxpayer), such structure allowed the taxpayer to raise lower cost financing from foreign capital markets which it would not have been able to access without the benefit of the structure. In fact, the Seventh Circuit specifically discussed the application of *Knetsch* to that case and found that line of authority unpersuasive. The IRS had tried to argue that the transaction between the intermediate entity and its parent should be ignored and that, absent such transaction, the intermediate entity had no profit potential. The Seventh Circuit held that:

> it is unnecessary, and we think inappropriate, for us to sever a corporation from its transactions in analyzing a case, such as this one, where the corporation was formed with the intent of structuring its economic transactions to take advantage of laws that afford tax savings. Finance's existence, its interest transactions with Taxpayer and its other economic activities are all relevant to our analysis. Moreover, *Knetsch* and the captive insurance company cases do not dictate the outcome the Commissioner desires. Those cases allow the Commissioner to disregard transactions which are designed to manipulate the Tax Code so as to create artificial deductions. They do not allow the Commissioner to disregard economic transactions, such as the transactions in this case, which result in actual, non-tax related changes in economic position.[102]

Because the Transaction results in actual non-tax related changes in the economic position of Company and Dutch VOF and serves a significant business purpose, other than earning a pre-tax economic profit, the form of the Transaction should be respected and not disregarded as an economic sham or lacking economic substance.

X. SECTION 7701(l): PROPOSED "FAST PAY" REGULATIONS

Section 7701(l), which was enacted specifically to address what is described, in the legislative history, as "unwarranted" tax avoidance, provides as follows:

> The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title.

Under proposed regulations recently promulgated under Section 7701(l), the IRS may recharacterize an arrangement in which a corporation has outstanding fast-pay stock (where tax avoidance is a principal purpose for the arrangement) as an arrangement directly between the non-fast-

102 *Northern Indiana Public Service Company*, 101 T.C. 294, *aff'd*, 115 F.3d 506 (7th Cir. 1997).

pay (or "benefited") shareholders and the fast-pay shareholders in which the benefited shareholders issue financial instruments directly to the fast-pay shareholders.[103]

It should be noted that where a fast-pay arrangement is recharacterized, the nature of the financial instruments deemed issued (*i.e.*, as debt or equity) is determined under general income tax principles. If the Transaction were considered a fast-pay arrangement, it is unclear which direct or indirect holder of the Common Units would be deemed to issue financial instruments to Investor BV. Under such circumstances, we believe it is likely that SARL would not be treated as issuing such instruments because such a recharacterization would itself most likely constitute a fast-pay arrangement under the same reasoning. As a result, we believe the most likely recharacterization of the Transaction would be as an arrangement between Company LLC and Investor BV. Under this characterization, the classification of such instruments as debt or equity would likely have little U.S. tax effect to the Company group because classification as debt would provide Company LLC with an interest deduction and classification as equity would divert an equal amount of income away from the Company group and to Investor BV. Nonetheless, the subpart F income of Dutch BV for each taxable year in excess of the Preferred Distribution paid during such year would be taxable to the Company group.

Furthermore, if the IRS could successfully recharacterize the Transaction as an arrangement involving the issuance by the Company LLC Members of financial instruments to Investor BV (which recharacterization we think is unlikely), the classification of such financial instruments as debt or equity would become vitally important. (It is unclear under this recharacterization whether the financial instruments deemed issued would constitute debt or equity.) Under an equity classification, the Company group would be taxable on all of Dutch VOF's subpart F income, but would receive no deduction for Preferred Distributions paid by Dutch VOF to Investor BV. In contrast, debt classification would result in the Company group including in income all of Dutch VOF's subpart F income, which would be offset to the extent of the interest deduction for Preferred Distributions paid to Investor BV.

The regulations define fast-pay stock as follows:

> Stock is fast-pay stock if it is structured so that the dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if --
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> (A) It is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant); or

103 Prop. Reg. § 1.7701(l)-3(c)(2).

> (B) It is issued for an amount that exceeds [parenthetical omitted] the amount at which the holder can be compelled to dispose of the stock.[104]

The determination of whether stock is fast-pay stock is based on all of the facts and circumstances, including any related agreements such as options or forward contracts.[105] The determination is made when the stock is issued, when there is a modification, or when there is a significant change in the facts and circumstances.[106]

Although both economically and in form a redemption, the payment of Redemption Proceeds would be treated as a dividend under Section 316 for tax purposes because (i) the amounts paid would be treated as a distribution on stock under Section 302 (through the option attribution rule in Sections 318(a)(4) and 318(a)(2)(C)) and (ii) the amounts would be paid out of earnings and profits.

As to presumption (A) of the regulations, the Preferred Units do not have a dividend rate that is reasonably expected to decline. Dutch VOF is expected to pay the Preferred Distribution (which distribution is LIBOR-based) while the Preferred Units are outstanding. The amount of the Preferred Distribution would be reduced in the event that Redemption Proceeds were transferred to Investor BV in partial redemption of the Preferred Units because the liquidation preference of the Preferred Units would be reduced. As a result, at the time of their issuance, the Preferred Units should not implicate presumption (A) of the fast-pay regulations.

However, in the event of a "significant change in the facts and circumstances," which might be considered to occur to the extent Redemption Proceeds were paid, the status of the stock as fast-pay stock would be retested. (The regulations do not specify whether such a recharacterization would be effective retroactively, or just from the time of the change in the facts and circumstances.) The Preferred Units could conceivably be recharacterized as a fast-pay arrangement to the extent that Redemption Proceeds reduced the liquidation preference of the Preferred Units, such that future Preferred Distributions were reduced. Nonetheless, we would argue that prepayment affects timing but not the effective dividend rate and thus even in these circumstances should not implicate presumption (A).

As to presumption (B), payment of Redemption Proceeds would give rise to a reduction in the liquidation preference of the outstanding Preferred Units. As such, it could be argued that, if such Redemption Proceeds were paid, Investor BV could then be forced to dispose of the Preferred Units for less than their original issue price, thus raising the issue of the application of presumption (B) above. This argument should not prevail because, on a per-share basis, Investor BV actually receives the issue price in redemption for each share of the Preferred Units. As such, it cannot be compelled to dispose of any Preferred Unit for less than that unit's issue price. Moreover, as with

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104 Prop. Reg. § 1.7701(l)-3(b)(2)(i).

105 Prop. Reg. § 1.7701(l)-3(b)(2)(ii).

106 *Id.*

presumption (A), such a reduction of the liquidation preference of the Preferred Units is not expected to occur. Although the regulations do not state that a dividend must be reasonably expected to be paid for it to be taken into account in applying the presumptions, we believe that such a requirement should be considered implicit in the regulation's use of the term "structured," a term that suggests purpose or expectation.

The question arises whether, apart from the two presumptions in the regulations, the Preferred Units are "structured so that the dividends (as defined in Section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on a holder's investment)." Any payment of Redemption Proceeds arguably will constitute a return of the holder's investment because such payment will result in a corresponding reduction in the liquidation preference of the Preferred Units. Moreover, the because the Transaction is structured to provide for two payments each of which constitutes a dividend under Section 316 and one of which would constitute a return of the holder's investment if actually paid, it could be argued that the Preferred Units should be treated as fast-pay stock. It could also be asserted that while the Redemption Proceeds need not be paid in order to achieve the intended result, the regulations do not, on their face, require such a causal connection. Nevertheless, we believe that an instrument cannot be "structured" to provide for dividends that are economically a return of the holder's investment where the only dividends that could create a return of the holder's investment are within the discretion of the issuer's board of directors and are not reasonably expected to be paid.

However, we believe that the regulations were aimed at transactions in which the dividends intended to be paid resulted in a return of the holder's investment, and that only where this intention exists should a transaction be considered to be "structured so that dividends paid" constitute a return of the holder's investment.

XI. SECTION 269 SHOULD NOT APPLY TO DISALLOW ANY DEDUCTION, CREDIT, OR ALLOWANCE ARISING FROM THE TRANSACTION

Section 269(a) provides in pertinent part that:

> . . . if any person or persons acquire . . . directly or indirectly, control of a corporation . . . and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which such person . . . would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance . . . . [C]ontrol 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.

By acquiring at least 50 percent of the total value of Dutch VOF stock, Company will have acquired control for purposes of Section 269.[107] However, Company will not acquire control of

107 *James Realty Co. v. United States*, 280 F.2d 394 (8th Cir. 1960) (acquisition of a controlling interest in a newly organized corporation is considered an acquisition of control in the corporation for purposes of

Dutch VOF with the principal purpose of tax evasion by securing a benefit ". . . which such corporation or person would not *otherwise* enjoy . . ." (emphasis added). The Tax Court held in *Commodores Point Terminal Corp. v. Commissioner*[108] that a corporation acquiring 58 percent of a target corporation was not prohibited under the predecessor of Section 269 from utilizing the dividends-received deduction because the acquiring corporation could have enjoyed such deduction even if it had acquired stock that did not constitute control of the target. Specifically, the court held that "the word otherwise can only be interpreted to mean that the deduction, credit or allowance, if it is to be disallowed, must stem from the acquired control . . . ."[109] In *Cromwell Corp. v. Commissioner*,[110] the Tax Court refused to apply Section 269 because the taxpayer could have "otherwise enjoyed" the same tax benefit without acquiring control.[111]

The allocation of subpart F income to Investor BV rather than Company LLC does not depend on Company LLC acquiring control of Dutch VOF, but rather depends on the rights of the holders of the Common Units and the Preferred Units to the earnings and profits of Dutch VOF. Accordingly, Section 269 should not apply to reallocate any of Dutch VOF's subpart F income to Company LLC.

Moreover, the reallocation of income from the holders of the Dutch VOF Preferred Units to the holders of the Dutch VOF Common Units should not be viewed as the denial of a "deduction, credit or other allowance" within the context of Section 269. The Treasury Regulations promulgated under Section 269 provide that "the term allowance refers to anything in the internal revenue laws which has the effect of diminishing tax liability."[112] The courts, however, have consistently held that the tax benefit at issue must fit within the accepted usage of one of the quoted terms.

Section 269); *see also Dillier v. Commissioner*, 41 T.C. 762 (1964), *aff'd sub nom*, *Made Rite Inv. Co. v. Commissioner*, 357 F.2d 647 (9th Cir. 1966); *Bobsee Corp. v. United States*, 411 F.2d 231 (5th Cir. 1969).

108 11 T.C. 411 (1948).

109 *Id.* at 17.

110 43 T.C. 313 (1964).

111 In *Cromwell Corp. v. Commissioner*, 43 T.C. 313 (1964), four individuals formed a new corporation in order to effectuate a bootstrap acquisition of another corporation. The new corporation borrowed money and used the proceeds as part of the consideration. After the acquisition, the acquired corporation borrowed money and distributed the proceeds to the acquiring corporation, which in turn repaid its loan. The IRS sought to prevent the two corporations from enjoying the benefit of filing as a consolidated group. The Tax Court held for the taxpayer and indicated that "the course of action pursued did not result in securing a benefit not *otherwise obtainable* since similar methods of acquisition have been approved by the courts." 43 T.C. at 317 (emphasis added). The court held that "[w]e rest our decision upon the ground that, irrespective of purpose, there has been no securing of a benefit which *would not otherwise have been enjoyed*." 43 T.C. at 317 (emphasis added).

112 Treas. Reg. § 1.269-1(a).

For example, in *Nutt v. Commissioner*,[113] the taxpayer sold property to his wholly-owned corporation, which subsequently sold the property at a profit. The IRS asserted that Section 269 should be applied to reallocate income earned by the corporation to the corporation's shareholder because the IRS believed that, in substance, the income had been earned by the shareholder.[114] Reasoning that the IRS was attempting to increase both the income and deductions claimed by taxpayer on its return rather than "to disallow to petitioners a deduction, credit, or other allowance claimed by them," the Tax Court held that "Section 269 of the Internal Revenue Code of 1954 is by its terms inapplicable."[115]

In *Siegel v. Commissioner*,[116] a U.S. taxpayer formed a foreign corporation which, under then-current law, was not subject to current U.S. taxation on its foreign profits.[117] Upon a liquidation or sale of the corporation, however, the taxpayer would have recognized capital gain. Similar to *Nutt*, the IRS challenged the nonrecognition of income at the shareholder level under Section 269. Specifically, the IRS asserted that a reallocation of income from the corporation to its shareholder was warranted under Section 269. The Tax Court first noted that the existence of a substantial business reason for forming the corporation (albeit a foreign corporation) goes far to render Section 269 inapplicable.[118] The Tax Court also held that, in any event, similar to *Nutt*, Section 269 was inapplicable because the IRS did not seek to disallow any "deduction, credit or other allowance" claimed by the taxpayer. Rather, the IRS sought to utilize Section 269 to add to the taxpayer's reported income by disregarding the intervening corporation and treating the shareholder as if he owned the interest in the activity directly that earned the income.[119]

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113 39 T.C. 231 (1962), *acq.*, 1964-2 C.B. 5, *remanded on other issues*, 351 F.2d 452 (9th Cir. 1965), *cert. denied*, 384 U.S. 918 (1966), *on remand*, 48 T.C. 718 (1967), *remanded*, 69-2 USTC ¶ 9501 (9th Cir. 1969), *on remand*, 52 T.C. 484 (1969), *rev'd*, 447 F.2d 1109 (9th Cir. 1971).

114 Arguably, the economic value of the stock held by the subject taxpayers in the cases, discussed *infra*, had appreciated to the extent of the economic accrual of such income at the corporate level. Presumably, a sale or liquidation of the stock of the subject corporation would have resulted in recognition of capital gain by the shareholder. Thus, the IRS in these cases was attempting to preclude the taxpayer from deferring recognition of that gain and in some instances, converting ordinary income to capital gain.

115 *See Cherry v. United States*, 264 F. Supp. 969, 983 (C.D. Cal. 1967), where the court stated that the terms "deduction," "credit" and "allowance," as used in Section 269, are technical terms, each having their own precise meanings in the Code. The court, in *Cherry*, then cited *Nutt* for the proposition that a statutory provision dealing with the nonrecognition of gain is not a "deduction," "credit" or "allowance" so that Section 269 does not deal with nonrecognition concepts.

116 45 T.C. 566 (1966), *acq.*, 1966-2 C.B. 7.

117 The years in question preceded the enactment of subpart F and Section 1248. Under these provisions, either the taxpayer would have been currently taxed on the ordinary income of the corporation or any capital gain on the sale or liquidation of the corporation would have been converted into ordinary income.

118 *Id.* at 577.

119 *Id.* at 578.

We also note that the Tax Court has refused to apply Section 269 in a series of cases where the nonrecognition of gain event was permanent. For example, in *Bijou Park Properties, Inc. v. Commissioner*,[120] the taxpayer formed Company A. Company A was in the business of developing and subdividing land. Company A then sold the parcels for long term installment notes. Approximately ten years later, Company B was formed by the taxpayer for purposes of buying all of the Company A stock. Subsequent to the purchase, Company A was liquidated into Company B. Under the Code as in effect at that time, where a corporation purchased all of the stock of another corporation and liquidated it within two years in a transaction to which Section 332 applied, the acquiring corporation was entitled to a stepped-up tax basis in the assets received from the acquired corporation under Section 334(b)(2). Company B, therefore, allocated a substantial portion of its cost basis in Company A stock to the installment notes (such notes representing substantially all the assets of Company A). The IRS argued that under Section 269, Company A had made a taxable disposition of the installment notes requiring recognition of any gain which had been deferred under Section 453.[121] The Tax Court found that, as a factual matter, the acquisition of control of Company A did not have as its principal purpose the "evasion or avoidance of Federal income tax."[122] Moreover, the Tax Court concluded that, as a matter of law, the benefit of the nonrecognition of gain by Company A was not a "deduction, credit or other allowance."[123] Under the provisions in existence at that time, however, the Tax Court concluded that Company B was related to Company A and was, therefore, not entitled to a basis step-up in the assets.

The court's refusal to apply Section 269 in *Bijou Park* is particularly relevant in analyzing the subsequent case, *Cherry v. United States*.[124] *Cherry* involved facts similar to those presented in *Bijou Park* except that the purchasing corporation was not deemed to already own the stock of the acquired corporation by virtue of the constructive ownership rules under Section 318. The IRS, however, did not contend that the acquired corporation should be treated as having disposed of its installment notes. Rather, the IRS limited its argument under Section 269 to precluding the acquiring corporation from the tax "allowance" under Section 334(b)(2), *i.e.*, the stepped-up tax basis of the installment notes. The District Court held that the acquiring corporation was entitled to a step-up in the tax basis of the installment obligations upon a liquidation of the acquired corporation. The Court further noted that:

> It is true, as the Government points out, that the deferred profit on the installment obligations, not previously taxed to the predecessor corporations, will, in part, escape taxation at the corporate level once the successor, parent corporations acquire a new

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120 47 T.C. 207 (1966).

121 The IRS did not challenge the existence of Company A under *Moline Properties*. This argument on its face, however, would have had no merit inasmuch as Company A had been in existence for ten years prior to its sale and had been engaged in substantial business activity during that period.

122 *Id.* at 214.

123 *Id.*

124 264 F. Supp. 969 (C.D. Cal. 1967).

> basis determined by reference to the purchase price paid for the shares of stock acquired. But that is the inevitable result of the rule originally judicially fashioned by the courts and legislatively adopted by Congress in Section 334(b)(2) which treats the parent corporations as though they had purchased assets directly.[125]

By contending that Company LLC should be allocated additional subpart F income, the IRS would be attempting to "increase" the income of the taxpayer as opposed to "disallowing" a deduction, credit or other allowance.

Based on the authorities discussed above, we do not believe that the IRS should be able to apply Section 269 in this manner.

Very truly yours,

Shearman & Sterling

RAR
ACG
MBS

[125] *Id.* at 981.

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Sequoia Financial Assets LLC

Ladies and Gentlemen:

We have acted as tax counsel to Enron Corp., an Oregon corporation ("Enron"), in connection with (i) the formation of Sequoia Financial Assets LLC (the "Company"), a Delaware limited liability company that will elect to be treated as a financial asset securitization trust (a "FASIT") for U.S. federal income tax purposes, (ii) the sale to the Company by U.S. subsidiaries of Enron (the "Sellers") of certain accounts receivable arising from the operations of the Sellers and certain debt of Enron issued to the Sellers (the "Enron Debt"), (iii) the sale to the Company by Enron of certain debt of the Sellers guaranteed by Enron (the "Seller Debt"), and (iv) the issuance and sale by the Company of the Class O Interest, the Class A Interests, and the Secured Notes (including each Monthly Note and each Interim Note). You have requested our opinions as to certain United States federal income tax consequences regarding the formation of the Company and the issuance and sale of the Class O Interest, the Class A Interests and the Secured Notes.

The Class O Interest and the Class A Interests are membership interests in the Company arising under the Sequoia Financial Assets LLC Company Agreement, dated as of May 28, 1999 (the "Company Agreement"), between Enron and the holder of the Class O Interest (the "Class O Interest Holder"). The Secured Notes will be issued by the Company in the form of debt instruments pursuant to the Security Agreement, dated as of May 28, 1999 (the "Security Agreement"), among the Company, Enron, Cherokee Finance V.O.F. ("Cherokee"), and the Class O Interest Holder and the Note Purchase Agreement, dated as of May 28, 1999 (the "Note Purchase Agreement"), between the Company and Cherokee as the Noteholder. The Company acquired, and will acquire, the accounts receivable, Enron Debt and Seller Debt from the Sellers and Enron pursuant to the Sale and Servicing Agreement, dated as of May 28, 1999 (the "Sale and Servicing Agreement"), among the Company, the Sellers and Enron, in its capacity as the Servicer. The Sale and Servicing Agreement, the Company Agreement, the Security Agreement and the Note Purchase Agreement together are hereinafter referred to as the "Transaction Documents." Capitalized terms used herein and not otherwise defined shall have the meaning given to such terms in the Transaction Documents.

In connection with your request, we have examined the Transaction Documents and such other materials relating to the transactions described therein as we have deemed necessary and appropriate. The opinions set forth are based on the following assumptions: (i) the Transaction Documents represent the entire legal documentation relevant to the formation and capitalization of the Company and all related transactions; (ii) all of the parties to the Transaction Documents will, at all times, comply with the provisions of the Transaction Documents; (iii) the facts and representations set forth in such Transaction Documents are accurate; and (iv) the Class O Interest, the Class A Interests, the Secured Notes and any other certificates or instruments issued by the Company will be issued and administered in a manner consistent with the descriptions contained in the Transaction Documents. In rendering our opinions, we have relied on the accuracy and completeness of the facts, information, covenants, statements and representations contained in the Transaction Documents and such other statements, information and documents as we have deemed relevant. To the extent that our opinions rest on matters set forth in the Transaction Documents or such other statements, information and documents as we have deemed relevant, our opinions are subject to the assumptions, qualifications, exceptions and limitations set forth in the Transaction Documents and any other statements or representation of facts with respect to such matters.

Based upon, and subject to, the analysis set forth below and the assumptions and statements referred to herein, having regard for such legal counterclaims as we have deemed relevant, and subject to the qualifications set forth herein, we are of the opinion that for U.S. federal income tax purposes:

(1) The Company will qualify as a FASIT.

(2) The Class O Interest will be a FASIT ownership interest.

(3) Each Monthly Note, each Interim Note and each Class A Interest will be a FASIT regular interest.

(4) The Class O Interest Holder will be able to deduct the discount on the FASIT regular interests and such deductions may offset its income on the Assets and its upfront gain (if any) from the transfer of the Assets to the Company.

(5) The transfers of the accounts receivable by the Sellers should be respected as true sales.

(6) Enron and the Sellers should not be denied, or required to defer, their deduction for interest paid or accrued on the Enron Debt or the Seller Debt sold to the Company by reason of section 163(j).

(7) Based on the exception for portfolio debt investments and certain income tax treaties applicable to the holders of member interests in Cherokee,[1] the interest payments made by the Company to Cherokee on the regular interests held by Cherokee should not be subject to U.S. withholding tax.

Our opinions in this regard are based upon the Internal Revenue Code of 1986, as amended, the Treasury regulations promulgated thereunder, the relevant case law and administrative pronouncements of the Internal Revenue Service (the "IRS"), all as of the date hereof. Our opinions are limited to the federal income tax laws of the United States and we do not express any opinion herein as to any other law. In particular, we

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[1] Convention Between Netherlands and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, which was signed on December 18, 1992 and entered into force on December 31, 1993; Convention Between the United States of America and the Grand Duchy of Luxembourg with Respect to Taxes on Income and Property, which was signed on December 18, 1962 and entered into force on January 1, 1964; Convention Between the Government of the Grand Duchy of Luxembourg and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, which was signed on April 3, 1996 and has not yet entered into force. Cherokee will rely on the exception for portfolio debt investments and will not take a treaty-based return position that it would have to disclose.

have not considered and do not express any opinion as to the consequences of the transactions under any state, local or foreign tax law.

The opinions expressed above are furnished by us as counsel to you, and are solely for your benefit in connection with the transactions described herein. Without our prior written consent, you shall not be entitled to rely on this letter for any other purpose or in any other capacity, and no other person shall be entitled to rely on this letter for any purpose whatsoever. The opinions expressed should not be accepted as guarantees that a court of law or an administrative agency will concur in the opinions. In particular, our analysis of the foregoing issues is not binding on the IRS or the courts. No assurance can be given that the IRS will not challenge our analysis of the tax treatment of certain matters discussed herein or, if it does, that it will not be successful. No rulings have been requested or received from the IRS as to any of the matters discussed herein.

This letter speaks only as of the date hereof. We do not undertake to advise you of any development or circumstance of any kind, including any change of law or fact that may occur after the date hereof, irrespective of whether such development, circumstance or change may affect the legal analysis, a legal conclusion, or any other matter set forth in or relating to this letter.

The comments set forth below are intended to provide you with additional analysis and information regarding certain of our opinions, as we have deemed appropriate.

(1) A tax is imposed on income earned by a FASIT on loans it originates. Section 860L(e)(2)(C). The Company is not an originator of the accounts receivable, which are originated by the Sellers in the ordinary courses of their businesses. A question may arise, however, as to whether the Company is the originator of the Enron Debt and the Seller Debt. While the Seller Debt will be originally issued by the Sellers to Enron and the Enron Debt originally issued by Enron to the Sellers, the Company may acquire the Enron Debt and the Seller Debt immediately following its issuance pursuant to an arrangement. We believe the prohibition against origination was intended to prevent FASITs from being engaged in an active lending business and was certainly not intended to preclude acquisitions of debt instruments shortly after their issuance. For example, credit card receivables are generally acquired by securitization vehicles immediately following their creation pursuant to a prearranged plan. Such arrangements are typical in revolving credit card receivable financings, which the FASIT rules are

intended to facilitate.[2] The Company's activities are consistent with those necessarily performed by a vehicle for revolving credit securitizations and are, furthermore, essentially passive. *Cf.* Treas. Reg. § 1.864-4(c)(5) (foreign entity acting merely as a financing vehicle for borrowing funds is not considered to be in the active conduct of the business of banking or financing in the U.S.). Given the passivity of the Company in the present situation, we believe that, while there is no official guidance regarding engaging in origination, the Company is not an originator of the Enron Debt or the Seller Debt.

(2) A FASIT regular interest is any interest issued by a FASIT, which is designated as a FASIT regular interest, if it meets certain requirements. Section 860L(b)(1)(A). In particular, a FASIT regular interest must unconditionally entitle the holder to receive a specified principal amount (or similar amount) and must not have a stated maturity (including options to renew) of more than 30 years. Section 860L(b)(1)(A)(i) and (ii).[3]

(a) The question may arise whether a member interest issued by a limited liability company, such as a Class A Interest, may be a FASIT regular interest. The definition of a "FASIT regular interest" clearly provides that it may be any interest issued by a FASIT meeting listed requirements so long as it is designated as a FASIT regular interest. Furthermore, for federal income tax purposes, a FASIT regular interest is treated as a debt instrument even if it is not otherwise a debt instrument. Section 860H(c)(1). Each Class A Interest issued by the Company will be designated as a FASIT regular interest and will meet all of the listed requirements for FASIT regular interests. Consequently, each Class A Interest will be a FASIT regular interest.

(b) The fact that the holders of the Secured Notes and the Class A Interests are expected to reinvest the proceeds of those interests upon maturity may raise the question of whether the requirement that a FASIT regular interest entitle the holder to receive a specified principle amount is met. Each Secured Note and each Class A Interest entitles the holder to payment of a specified principal amount and matures no later than the end of the month in which it was issued. While the holders are expected to reinvest such amounts, the holders have the

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[2] *See* New York State Bar Report on Proposed Regulations to be Issued Under FASIT Provisions (1997).

[3] Application of the FASIT anti-abuse rule, section 860L(h), is discussed below in relation to the discussion of section 163(j).

discretion to stop reinvesting and to receive the stated principal amount. The planned reinvestment does not, therefore, violate the unconditional entitlement requirement. *See* Rev. Rul. 81-238, 1981-2 C.B. 248 (dividend reinvestment plan merely creates agency relationship where investor has discretion to terminate reinvestments); P.L.R. 6407295200A (July 29, 1964) (dividends subject to reinvestment in regulated investment company pursuant to plan allowing investor to withdraw at any time are paid for purposes of dividends paid deductions). While the principal amount is not delivered to the holders, the holders have control over the principal amount and are paid for federal income tax purposes.

(c) Because the holders are expected to reinvest the amounts received on each Secured Note and each Class A Interest, the question might also arise whether the Secured Notes and the Class A Interests have stated maturities of less than 30 years. As noted, the holders are not required to reinvest and may stop reinvesting upon the maturity of a Secured Note or a Class A Interest. Because the Secured Notes and the Class A Interests mature each month and are paid at that time, they do not have terms to maturity of more than one month.

(3) The FASIT ownership interest is the interest issued by a FASIT that is designated as an ownership interest and that is not a FASIT regular interest. Section 860L(b)(2). The Class O Interest will be designated as the ownership interest in the Company and will not be designated or treated as a regular interest. The question may arise whether the form will be respected in this case where (i) the Class A Interests entitle the holder to control the Company, (ii) the holder of the Class A Interests is entitled to receive a fee for servicing the assets of the Company, and (iii) the holder of the Class A Interest has indemnified the Class O Interest Holder for any taxes imposed on the Class O Interest Holder as a consequence of holding the ownership interest. One of the purposes of the FASIT rules is to provide certainty as to the classification of interests for federal income tax purposes, regardless of traditional debt/equity analysis. Consequently, we believe that these factors will not cause the designation of the Class O Interest as the ownership interest to be disregarded or the Class A Interests to be treated as an ownership interest. First, as discussed above, the FASIT rules anticipate that a FASIT regular interest may be a membership interest in a limited liability company (or some other form of equity interest in a business entity). Since many securitization transactions are structured to make the ownership interest as small as possible, it was foreseeable that membership interests treated as debt for tax purposes might entitle the holders thereof to the right to control the entity. Consequently, it was foreseeable that the holder of the designated ownership interest in the FASIT might not have such control. Second, FASITs are intended to

be passive entities, as discussed with respect to origination. The need to pay a servicer is a consequence of the passive nature of a FASIT. Therefore, the fact that the Company pays an arms-length servicing fee to Enron, which happens to be the holder of the Class A Interest is not significant. Third, the FASIT rules require that the holder of the ownership interest, which must be a domestic, taxable corporation, take into account the tax items of the FASIT. The rule is intended to assure that certain income does not escape taxation at the corporate level. While the Class A Interest holder will indemnify the Class O Interest Holder for any taxes imposed that are attributable to the FASIT, the Class O Interest Holder is not relieved of its liability for such taxes. The indemnification is a separate contractual relationship between the Class A Interest Holder and the Class O Interest Holder that exists outside of the FASIT and does not affect the status of the Class A Interest as a regular interest or the Class O Interest as an ownership interest. *See* Treas. Reg. § 1.860G-2(i)(1) (form respected where contractual rights are coupled with real estate mortgage investment conduit ("REMIC") regular interests). The status of the Class O Interest as the ownership interest is also supported by the real economic investment by the Class O Interest Holder, the yield on which depends on the performance of the Company's assets.

(4) The income from the disposition of an asset by a FASIT is generally subject to the tax on prohibited transactions. Section 860L(e)(2)(B). Because the Company may dispose of an account receivable if it is not paid on the due date, the question may arise whether the Company would be subject to the tax on prohibited transactions. There is an exception to the rule for dispositions incident to foreclosure, default or imminent default on the debt instrument. Sections 860L(e)(3)(A)(i) and 860F(a)(2)(A)(iii). According to the Sale and Servicing Agreement, default occurs in the event that nonpayment of a scheduled payment is not cured within three days of receipt of written notice by the Seller and the Servicer. While "imminent default" is not defined in the Code, we believe that nonpayment of a scheduled payment gives rise to a situation where default is imminent. Therefore, the Company will not be subject to the tax on prohibited transactions upon a disposition of an account receivable upon non-payment.

(5) Property acquired by a FASIT from someone other than the holder of the ownership interest is treated (i) as having been acquired by the holder of the ownership interest for an amount equal to the FASIT's cost of acquiring the property and (ii) as having been sold to the FASIT by such holder at its value. Section 860I(a)(2). For this purpose, value is determined under special FASIT valuation rules. If the value of the property exceeds the ownership interest holder's

cost basis in the property, the holder of the ownership interest recognizes gain to the extent of such excess ("upfront gain"). Section 860I(a)(1).

For purposes of determining its taxable income, the holder of the ownership interest is treated as the direct owner of all assets acquired by the FASIT, and as the direct obligor on all liabilities (regular interests) issued by the FASIT. If the holder recognizes upfront gain, the holder's basis in the assets of the FASIT is increased by the amount of gain recognized. Consequently, the holder of the ownership interest will recognize a gain each month with respect to the receivables and other assets of the FASIT equal to the sum of (i) the upfront gain, if any, and (ii) the excess of (x) the face amount of the assets over (y) the holder's basis in the assets (adjusted for upfront gain, if any). That gain generally should equal the interest expense on the regular interests issued by the FASIT.[4]

The holder of the ownership interest will be entitled to offset its upfront gain (if any) with interest expense on the regular interests, even in the unlikely event that the upfront gain is treated as derived outside of the FASIT. The FASIT provisions do not prohibit the use of FASIT losses (*i.e.*, interest expense on the regular interests) from offsetting non-FASIT gains. The FASIT rules only prohibit using non-FASIT losses to offset FASIT gains. *See* section 860J(a).

(6) The transfer of accounts receivables to the Company is structured as a transfer of the right to collect the full amount of the accounts receivable owed by the Seller's customers. The Sellers have agreed with their customers to offset the amount owed by the customers on the accounts receivable against the amounts owed by the Sellers to the customers. It might be argued that when the Company acquires the accounts receivable from the Sellers, it is acquiring a net position. We understand that the netting arrangement relates only to the manner and method of payment of the accounts receivable; the netting arrangement does not alter the obligations of a customer to the respective Seller in any other manner. Consequently, based on the form of the accounts receivable, a customer is unconditionally obligated to pay the full amount of the account receivable and the Seller has a legally enforceable right to receive the full amount of the receivable. Furthermore, at the time a customer takes delivery and incurs its obligation the amount of the offset is not determinable. Regardless of the netting, therefore, the gross amount of the accounts receivable transferred by the Sellers should have

[4] The holder of the ownership interest presumably will recognize some taxable income, however, reflecting at a minimum the economic income generated by the ownership interest.

economic significance. *See, e.g., Peracchi v. Comm'r*, 98-1 U.S.T.C. 84,009 (9th Cir. 1998). Consequently, while there is no authority directly on point, the customers' obligations should be respected as independent obligations for the full amount of the receivables. *See e.g., Sacks v. Comm'r*, 69 F.3d 982, 989-90 (9th Cir. 1995).

(7) If the transfers of the accounts receivable to the Company are not treated as sales, but as pledges of the assets to secure repayment of amounts advanced to the Sellers, the Company would be viewed as holding debt instruments issued by the Sellers. While such debt instruments should be good assets for purposes of the FASIT asset qualification tests under section 860L(c)(1)(B), this characterization would raise the origination issue[5] and could result in the application of the anti-abuse rule relating to section 163(j), described in more detail below.

To determine whether a transfer constitutes a sale for federal income tax purposes, the courts and the IRS have adopted a multi-factor analysis to ascertain whether the "substantial incidents of ownership" have been relinquished in the transfer. *See, e.g., Mathers v. Comm'r*, 57 T.C. 666, 674 (1972), *acq.*, 1973-1 C.B. 1; PLR 8338043 (June 17, 1983); GCM 34602 (Sept. 9, 1971); GCM 38147 (Oct. 26, 1979); GCM 37848 (Feb. 5, 1979); *see generally*, TAM 9237004 (April 8, 1992). Two key factors clearly indicate that a sale has occurred. First, the Company acquires the accounts receivable from the Sellers for a price fixed up-front so that the Company enjoys all of the benefits, in the form of increased yield by reason of earlier than expected prepayment of the accounts receivable, and bears all of the burdens, in the form of decreased yield by reason of later than expected prepayments, of ownership of the accounts receivable. Second, the Company bears all of the credit risk associated with the accounts receivable. While Enron ultimately bears the risk of loss due to defaults up to a certain level, which includes all expected losses, it bears that risk in its capacity as the holder of the Class A Interests in the Company and not as owner of the assets of the Company.[6] Neither Enron nor the Sellers act as guarantors of the accounts receivable, however, and the holders of interests in the Company bear all of the risk that the obligations of the Company will exceed the value of its assets. On the other hand, the Company lacks the power to dispose of the assets, except in the event of non-payment or other default, which is the third of three key indicia of a sale. The Sellers themselves,

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[5] As discussed above, the Company is not an originator.

[6] Enron will also indirectly own a 60% interest in each Secured Note.

however, have no retained interest in the assets transferred to the Company and should not be viewed as having retained ownership of the assets, which tends to undermine the argument that they merely pledged the assets. On the basis of the transfer of credit risk and prepayment risk, therefore, the transfer should be viewed as a true sale of the assets to the Company.

(8) Under section 163(j), the deduction for interest paid on a debt obligation by a domestic taxpayer to a related foreign entity may be deferred and ultimately denied. The Secretary of the Treasury is directed to issue regulations under section 163(j) as appropriate to prevent avoidance of that section. The legislative history of section 163(j) indicates the regulations should be issued recharacterizing back-to-back loans through third parties as direct loans to related parties. H. R. Rep. No. 101-247, at 1246-47. If the Company were disregarded for federal income tax purposes, the FASIT regular interests might be treated as debt instruments issued by the Seller to Enron and Cherokee.

(a) No regulations have been issued in final form to date. The existence of the Company should not be disregarded under general conduit principles. *See, e.g., Addison International, Inc. v. Comm'r*, 90 T.C. 1207, 1221 (1988), *aff'd*, 887 F.2d 660 (6th Cir. 1989) (corporation formed to qualify as a domestic international sales corporation may not be disregarded as a conduit, even though disqualified, and is imbued with business purpose); *Jet Research, Inc. v. Comm'r*, 60 T.C.M. 613 (1990) (same).

(b) Under regulations proposed in 1991, the IRS may disregard entities created with a principal purpose of avoiding the rules of section 163(j). Prop. Reg. § 1.163(j)-1(f). The regulations would be retroactive to 1989 if finalized in their current form. The principal purpose of the arrangement is to create a revolving securitization vehicle for accounts receivable generated by the Sellers. The obligors on the accounts receivable are not related to Cherokee and section 163(j) would not apply if they were transferred directly to Cherokee and the income on the accounts receivable were treated as interest. Only the interest paid on the Enron Debt and the Seller Debt would be subject to section 163(j) if transferred directly to Cherokee. The Enron Debt and the Seller Debt is used only for the purpose of making up for shortfalls in the amount of accounts receivable, which primarily occur due to prepayments during the month. Under the expected economic scenarios, (i) in most months, no Enron Debt or Seller Debt will be acquired at the beginning of the month, and (ii) a substantial portion of the accounts receivable are expected to be paid on or about the 25th of such month. Consequently, the anti-abuse rule in the proposed regulations should not be applicable to disregard the Company, because no principal purpose of the transaction is to avoid section 163(j).[7]

(c) The Secretary of the Treasury is instructed to issue regulations to prevent the abuse of the FASIT rules "through transactions which are not primarily related to securitization of debt instruments by a FASIT." Section 860L(h). No such regulations have yet been issued. More importantly, as noted above, the principal purpose of the arrangement is to securitize accounts receivable generated by the Sellers. Therefore, the existence of the Company will not be disregarded under the FASIT anti-abuse rule.

(d) For purposes of section 864 and 956, income from the acquisition of trade receivables from related parties is treated as if it were interest on a loan to the obligor on the receivable. Regulations suggest that if a FASIT were to acquire receivables and issue regular interests to a party related to the Seller, the FASIT would be disregarded. Treas. Reg. § 1.864-8T(c)(3)(iv), Example 2. The regulation is not applicable for purposes of section 163(j). Even if it were applicable, the obligors under the receivables are unrelated to Cherokee and section 163(j) would not apply to deny or defer a deduction for the deemed interest payments on the receivables.

(9) Under section 881(a), a withholding tax of 30% is imposed on certain income, including interest income, of foreign corporations received from sources within the United States. If this rule were applicable to the payments on the Secured Notes to Cherokee,[8] the "interest" paid would be subject to a 30% tax, unless otherwise excluded.[9] For the reasons set forth below and in paragraph 10, the interest payments on the Secured Notes should not be subject to withholding tax.

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[7] As noted above, if the transfer of the accounts receivable were not respected as a sale to the Company, the Company might be viewed as holding debt issued by the Sellers and secured by the accounts receivable. In that event, the section 163(j) anti-abuse rule might apply. Even in that event, however, the principal purpose for the arrangement was to securitize the accounts receivable.

[8] Cherokee is a corporation for U.S. federal income tax purposes.

[9] The Secured Notes are principal only regular interests and therefore do not provide for payments of "interest." References to interest payments herein relate to the discount on the Secured Notes that is deductible to the FASIT or the holder of the ownership interest.

(a) As discussed above, the Secured Notes have terms to maturity of less than one month and are FASIT regular interests. For U.S. federal income tax purposes, a FASIT regular interest is treated as a debt instrument. Section 860H(c)(1). Because the terms of the Secured Notes are less than one year, all of the interest payable on the Secured Notes will be original issue discount. *See* Treas. Reg. § 1.1273-1(c)(5). Original issue discount is subject to withholding tax only to the extent provided in section 881(a)(3). For purposes of section 881, however, original issue discount on obligations with terms to maturity of less than 183 days are not subject to withholding tax. Section 871(g)(1)(B). Consequently, the interest income on the Secured Notes should not be subject to withholding tax.

(b) Even if the interest on the Secured Notes were not excepted from the withholding tax under the short-term obligation exception, "portfolio interest" -- including interest on obligations issued in registered form such as the Secured Notes[10] -- is generally not subject to withholding tax unless it is received by a "10-percent shareholder" or unless it is received by a controlled foreign corporation from a related person. Section 881(c).

(i) In the case of an obligation issued by a corporation, a 10-percent shareholder is any person that owns 10 percent or more of the total combined voting power of all classes of stock of such corporation. Section 871(h)(3)(B)(i). In the case of an obligation issued by a partnership, a 10-percent shareholder is any person that owns 10 percent or more of the capital or profits interest in such partnership. Section 871(h)(3)(B)(ii). It is not clear whether the owner of the FASIT ownership interest or the FASIT itself is the issuer of the regular interests for federal income tax purposes. If the Secured Notes are treated as issued by the ownership interest holder, a corporation, Cherokee is not a 10-percent shareholder. The rules, however, provide only that the FASIT regular interests will be treated as liabilities of the holder of the ownership interest for purposes of determining the holder's taxable income. Section 860H(b)(1). It might be argued that the FASIT is the issuer of the Secured Notes. In that case it is not clear how the 10-percent shareholder rule would be applied. A FASIT is not treated as a corporation or a partnership for federal income tax purposes, section 860H(a), so the definition set forth in section 871(h)(3)(B) is not directly applicable. That provision suggests that a 10-percent shareholder has some form of

[10] The portfolio interest exception applies to interest paid on certain obligations in registered form with respect to which the issuer receives a statement that the holder is not a United States person. Section 881(c)(2)(B).

ownership interest in the issuer. The FASIT rules themselves were intended to provide a statutory securitization vehicle to provide tax certainty in situations where it was difficult under the traditional tax analysis to clearly identify interests in the securitization vehicle as debt or equity. Under the FASIT rules, all interests designated as regular interests are treated as debt for all purposes, section 860H(c)(1), and only a single interest is treated as an ownership interest, section 860L(a)(1)(C), which is subject to specific tax accounting rules. Section 860H(b). On the basis of this statutory scheme, Cherokee should not be viewed as having an equity interest in the Company and should not be a 10-percent shareholder.

(ii) As stated above, the portfolio interest exception also does not apply to interest received by a controlled foreign corporation from a related person, as defined in section 864(d)(4). Section 881(c)(3)(C). Cherokee is a controlled foreign corporation. Section 864(d), in general, deals with certain related party factoring transactions and section 864(d)(4) provides a definition of related parties. Under that definition of a related person, this exception to the portfolio interest exception should not apply to Cherokee and the FASIT or the ownership interest holder. [11]

(10) The exception from withholding tax for portfolio interest may not be applicable to payments of interest to the FASIT regular interest holders if the FASIT regular interests were treated as debt issued by the Sellers. *See* section 881(c)(3). Certain intermediate entities in back-to-back financing arrangements may be disregarded as conduits. Treas. Reg. § 1.881-3.

(a) An intermediate entity will not be treated as a conduit, however, unless its participation in the financing arrangement "reduces the tax imposed by section 881 (determined by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangements with the tax that would have been imposed under [Treas. Reg. § 1.881-3(d)])."[12] Treas. Reg. § 1.881-3(a)(4)(i)(A). For purposes of determining

[11] The regulations under section 864(d)(4) provide authority to disregard certain intermediate parties, discussed in paragraph 8(d) above. Treas. Reg. § 1.864-8T(c)(3)(iv). The cross reference to section 864(d)(4) in section 881(c)(3)(C) should not make these regulations applicable to the Company. The regulations deal with the meaning of indirect acquisitions and not the meaning of "related persons," which is defined in a different section of the regulations, at Treas. Reg. § 1.864-8T(b)(2).

[12] The participation of the intermediate entity must also be pursuant to a "tax avoidance plan." Treas. Reg.
(footnote continued on next page...)

the amount of tax reduction, the "financing entity" (Cherokee in this case) may "claim the benefits of any income tax treaty under which it is entitled to benefits." Treas. Reg. § 1.881-3(d)(2) cross-referencing Treas. Reg. § 1.881-3(a)(3)(ii)(C). Because Cherokee is entitled to an exemption from withholding tax under the U.S.-Netherlands treaty, the interposition of the Company does not reduce withholding taxes that would otherwise be payable and the Company is not a conduit. Therefore, the existence of the Company will not be disregarded under section 881.

(b) If a taxpayer takes a return position that any treaty of the United States overrules or modifies any provision of the Code to reduce the amount of tax owed, the taxpayer must disclose such return position. Treas. Reg. § 301.6114-1(a). Because Cherokee will not be relying primarily on a treaty-based exception from withholding, it will not file such a disclosure.

(i) It might be argued that a taxpayer is not entitled to a treaty benefit unless it files such disclosure. We do not view this requirement as affecting a taxpayer's entitlement to a benefit under a treaty as a matter of law, but rather as a mechanism for claiming the benefit. The benefit of the treaty is not being claimed in this case, and will not be claimed unless the Company is disregarded under section 881. We believe that Cherokee is entitled to the benefit of the treaty under the terms of the treaty, and could have claimed such benefit by filing the required disclosure, so that, under the regulations, the Company is not a conduit.

(ii) It might also be argued that the taxpayer is taking a return position, that the Company is not a conduit, on the basis of a treaty and must, therefore, disclose the return position to claim the benefit. Because, however, the regulations under section 881 give the IRS discretion to disregard an entity, reliance on the treaty is contingent on the assertion of the authority to disregard the Company by the IRS. Furthermore, assuming that the terms of the transfers of assets to the Company and of the FASIT regular interests are at the market, the Company might have participated in the arrangement without the purchase by Enron or Cherokee of FASIT regular interests and is therefore, on that basis, not a conduit. *See* Treas. Reg. § 1.881-3(a)(4)(i)(C)(2). This position is

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[12](...footnote continued from preceding page)
§ 1.881-3(a)(4)(i)(B). The existence of a tax avoidance plan is determined by considering all of the facts and circumstances, including whether there is a significant reduction in tax, as determined above. Treas. Reg. § 1.881-3(b)(2)(i).

independent of any treaty benefit to the Company. Consequently, based on the contingent nature of the conduit assertion and the independent authority for avoiding conduit status, the taxpayer should not be viewed as taking a treaty-based return position and need not file a disclosure under section 6114.

Very truly yours,

Shearman & Sterling

X. TAX OPINION LETTERS
RELATING TO
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February 26, 2001

Enron Corp.
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Ladies and Gentlemen:

You have requested our opinion with respect to certain federal income tax consequences relating to (i) the formation of RMT Chiricahua V LLC, a Delaware limited liability company ("Chiricahua"), (ii) the entering into of the ISDA Master Agreement dated December 20, 2000 between Risk Management and Trading Corp. and Chiricahua and the associated confirmation dated December 27, 2000 (the "RMT Swap") and (iii) the entering into of the ISDA Master Agreement dated December 20, 2000 between RMT and Tularosa LLC, a Delaware limited liability company ("Tularosa") and the associated confirmation dated December 27, 2000 (the "Tularosa Swap") with respect to RMT's member interest in Chiricahua. Specifically, you have requested our opinion as to whether the Tularosa Swap results in a constructive sale of RMT's member interest in Chiricahua under section 1259 of the Internal Revenue Code of 1986, as amended.[1]

In connection with this opinion, we have reviewed (i) the Limited Liability Company Agreement of Chiricahua dated December 20, 2000, (ii) the Limited Liability Company Agreement of Tularosa dated December 20, 2000, (iii) the RMT Swap and (iv) the Tularosa Swap.

The Transactions

Enron North America Corp. ("ENA") enters into a variety of financial positions with third parties relating to the price of natural gas. These positions include swaps, futures contracts, options and forward contracts. ENA, in turn, enters into offsetting positions with RMT pursuant to the ISDA Master Agreement dated March 31, 1997 and the periodic confirmations executed in association with that agreement (collectively, the "ENA Master Swap"). Whether a particular position taken by RMT pursuant to the ENA Master Swap represents an asset (*i.e.*, the position is "in the money") or a

[1] All section references are to the Internal Revenue Code of 1986, as amended.

liability (*i.e*, the position is "out of the money") depends upon the terms of the position and the current and projected price of natural gas.

Chiricahua was formed on December 20, 2000. FS 360 Corp., a wholly-owned subsidiary of RMT ("FS 360 Corp.") is the managing member of Chiricahua owning a .01% interest in capital, profits and losses. RMT is also a member of Chiricahua owning a 99.99% interest in capital, profits and losses. FS 360 Corp. acquired its interest in exchange for a cash contribution of $159,982. RMT acquired its interest in exchange for a cash contribution of $159,982 and its agreement to enter into the RMT Swap, which represents offsetting positions with respect to certain of the contracts held by RMT. The RMT Swap is substantially "in the money" and represents a transfer of value by RMT to Chiricahua of approximately $1,825,512,753. The amount of the net cash payments required to be made under the RMT Swap to Chiricahua will be based upon the specific terms set forth in the associated confirmation based on the notional volumes and prices set forth therein. While it is possible on any particular payment date that a payment may be required to be made by Chiricahua to RMT, it is anticipated that a substantial net payment will be made by RMT to Chiricahua over the life of the RMT Swap. Moreover, under the terms of the RMT Swap, Chiricahua is not required to make net payments in the aggregate to RMT.

Following the execution of the RMT Swap, RMT entered into the Tularosa Swap with Tularosa. The members of Tularosa are ENA and Mangas I Corp., a wholly-owned subsidiary of ENA. Pursuant to the Tularosa Swap, RMT will be entitled to receive from Tularosa on the settlement date a fixed sum equal to the fair market value of the member interest in Chiricahua on the contract date and RMT will be required to pay to Tularosa the fair market value of the member interest in Chiricahua on the settlement date plus the amount of any distributions received from Chiricahua during the contract term. The contract date for the Tularosa Swap is December27, 2000 and the settlement date is January 2, 2002. Tularosa's obligations under Tularosa Swap are guaranteed by Enron Corp.[2]

Representations

In connection with your request for our opinion, you have made the following representations with respect to certain facts associated with the transactions. We have relied upon the accuracy of these representations in rendering our opinion on these matters.

1. Neither Chiricahua nor Tularosa will elect to be treated as a corporation for federal income tax purposes.

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2 In addition to Chiricahua, RMT and FS360 formed 13 other Delaware limited liability companies having similar capital structures and assets. RMT entered into financial contracts having terms similar to the Tularosa Swap with respect to its member interests in each of these other companies.

2. It is not expected that the transactions described above will result in a substantial reduction in the present value of the aggregate federal income tax liabilities of the Enron consolidated group or any of its members.

3. The Tularosa Swap will not be closed in a manner described in section 1259(c)(3) of the Code.

4. At the time of the execution of the RMT Swap, it was anticipated that RMT would be required to make net payments under the RMT Swap having a present value of approximately $1,825,512,753 and the possibility that RMT would not be required to make substantial payments to Chiricahua under the RMT Swap was remote.

5. The fair market value of RMT's member interest in Chiricahua is approximately
1. $1,825,672,735.

6. Following its formation, Chiricahua will engage in trading and dealing activities with respect to positions in natural gas.

Opinion and Analysis

While there is no authority directly addressing the federal income tax treatment of the entering into of a complex financial instrument similar to the RMT Swap as a capital contribution to a partnership, and therefore the matter is not free from doubt, in our opinion, the transactions described above should result in (i) a constructive sale of RMT's member interest in Chiricahua under section 1259, (ii) the recognition of gain in an amount equal to the excess of the fair market value of RMT's member interest in Chiricahua over its basis in such interest (which basis should not include any amount with respect to the RMT Swap), and (iii) an increase in RMT's basis in its member interest in Chiricahua in an amount equal to the gain recognized as a result of the constructive sale.

Section 1259(c) provides that a taxpayer will be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) enters into an offsetting notional principal contract with respect to the same or substantially identical property. Accordingly, the Tularosa Swap will result in a constructive sale of the RMT's member interest in Chiricahua if (i) such member interest constitutes an "appreciated financial position" within the meaning of section 1259(b), and (ii) the Tularosa Swap constitutes an "offsetting notional principal contract" with respect to such interest within the meaning of section 1259(d).

Section 1259(b) defines an "appreciated financial position" to mean any position with respect to "any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value." RMT's member interest Chiricahua is a partnership interest with a fair market value of approximately $$1,825,672,735. RMT's basis in its member interest, however, should only reflect the amount of cash contributed to Chiricahua and should not reflect the value of the RMT Swap held by it.

RMT acquired its interest in Chiricahua in exchange for cash and its agreement to enter into the RMT Swap. The RMT Swap is significantly "in the money" and represents an agreement by RMT to make substantial cash payments to Chiricahua over the life of the RMT Swap based on the terms set forth in the associated confirmation.

Section 722 provides that the basis of an interest in a partnership acquired by contribution of property, including money, to the partnership shall be the amount of such money and adjusted basis of such property to the contributing partner at the time of the contribution. Under section 722, if the property contributed to the partnership is an obligation of the contributing partner, the contributing partner's basis in its partnership interest is not increased to reflect the partner's obligation because the partner has no basis in its own obligation. *Gemini Twin Fund III v. Commissioner*, 62 T.C.M. 104 (1991); *Oden v. Commissioner*, 41 T.C.M. 1285 (1981); Rev. Rul. 80-235, 1980-2 C.B. 229; Tech. Adv. Mem. 8702006 (Sept. 26, 1986). Instead, Revenue Ruling 80-235 provides that "payments on the written obligation are added to the partner's basis in the partnership as the payments are actually made." 1980-2 C.B. at 230. This approach is consistent with the capital account rules promulgated under Section 704(b) of the Code. Treas. Reg. § 1.704-1(d)(2) generally provides that if a promissory note is contributed to a partnership by a partner who is the maker of such note, such partner's capital account will be increased with respect to such note only when there is a taxable disposition of such note by the partnership or when the partner makes principal payments on such note.

While there are no authorities that directly address the treatment of entering into a financial contract similar to the RMT Swap in exchange for a partnership interest, we believe it is appropriate to treat the RMT Swap in a manner similar to the contribution of a debt obligation for purposes of determining RMT's basis in its member interest in Chiricahua. Similar to the situation involving the contribution by a partner of its own note to a partnership, RMT entered into the RMT Swap as part of its contribution to Chiricahua in exchange for its interest therein. The RMT Swap represents the obligation of RMT to make cash payments to Chiricahua in the future as determined pursuant to the terms of the contract and RMT has no basis in these obligations. In addition, treating the in the money portion of the RMT Swap as being similar to a debt obligation is consistent with Treasury Regulations promulgated under section 446 relating to the treatment of notional principal contracts.[3] Treas. Reg. § 1.446-3(g)(4) provides that where parties enter into an off market swap that includes

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[3]For purposes of these rules, Treas. Reg. § 1.446-3(c)(1)(i) provides that a notional principal contract is a "financial instrument that provides for the payment of amounts by one party to another party at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts." Notional principal contracts include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, and equity swaps. Treas. Reg. § 1.446-3(c)(1)(i).

CONSEQUENTLY, RMT WOULD NOT RECEIVE ANY TAX BASIS IN ITS CHIRICAHUA PARTNERSHIP INTEREST RELATED TO THE RMT SWAP UNTIL SUCH TIME AS PAYMENTS ARE MADE ON THE RMT SWAP B/C

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a significant up-front payment, for federal income tax purposes the contract is treated as two separate transactions, an on-market swap and a loan. The up-front payment is treated as borrowed by the recipient and repaid over the life of the contract with excess proceeds from the deemed on-market swap. Applying these principles to RMT's receipt of the Chiricahua member interest would result in RMT being treated as receiving the up-front payment (*i.e.*, the member interest) in exchange for a note. ~~RMT's initial basis in the member~~ interest received in exchange for the note would have no ~~basis because~~ RMT has no basis in its own obligation. Instead, RMT would obtain basis in its partnership interest as deemed payments are received on the on-market swap and paid back to Chiricahua as repayment of its obligation under the ~~deemed~~ note. UNTIL ALL RMT PAYMENTS THEREON

Section 1259(d) defines an "offsetting notional principal contract" to mean an agreement which includes (i) a requirement to pay all or substantially all the investment yield (including appreciation) on property for a specified period, and (ii) a right to be reimbursed for all or substantially all of any decline in the value of such property.

The Tularosa Swap falls within the definition of an "offsetting notional principal contract" under section 1259(d) with respect to RMT's member interest in Chiricahua. The net effect of the Tularosa Swap is that RMT is required to pay all the investment yield (including appreciation) on its member interest in Chiricahua to Tularosa and Tularosa is required to pay to RMT the amount of any decline in the value of such interest.

Section 1259(c)(3) provides that in applying section 1259, there shall be disregarded any transaction (which would otherwise be treated as a constructive sale) during the taxable year if such transaction is closed before the end of the 30th day after the close of such taxable year, the taxpayer holds the appreciated financial position throughout the 60-day period beginning on the date such transaction is closed and at no time during such 60-day period is the taxpayer's risk of loss with respect to such position reduced by reason of a circumstance which would be described in section 246(c)(4) if references to stock included references to such position. By its terms the Tularosa Swap does not settle within 30-day period described in section 1259(c)(3) and you have represented to us that the Tularosa Swap will not be closed in a manner described in section 1259(c)(3).

Section 1259(a)(1) provides that if there is a constructive sale of an appreciated financial position that the taxpayer shall recognize gain as if such position were sold, assigned or otherwise terminated at its fair market value on the date of such constructive sale (and any gain shall be taken into account for the taxable year which includes such date). Further, section 1259(a)(2) and the legislative history of section 1259 provides that except as provided in Treasury Regulations, an appropriate adjustment in the basis of the appreciated financial position is made in the amount of any gain recognized on the constructive sale, and a new holding period of such position begins as if the taxpayer had acquired the position on the date of the constructive sale. S. Rep. No. 105-33 at 123-124 (1997).

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Applying these rules to the Tularosa Swap should result in RMT recognizing gain in an amount equal to the excess of the fair market value of its member interest in Chiricahua over its basis in such interest (*i.e.*, its cash contribution to Chiricahua).

Finally, the gain recognized as a result of the application of section 1259 to the Tularosa Swap should not be deferred under the consolidated return regulations. Treas. Reg. § 1.1502-13 provides rules for the deferral of recognition of gain or loss on sales of property between "corporations that are members of the same consolidated group immediately after the transaction." Treas. Reg. § 1.1502-1(b) defines the term "member" to mean "a corporation (including the common parent) that is included in the group, or as the context may require, a corporation that is included in a subgroup." RMT is a corporation and is a member of the Enron group. Tularosa, however, is a partnership for federal income tax purposes and therefore is not within the definition of a "member" for purposes of the intercompany transaction rules in Treas. Reg. § 1.1502-13.[4]

Our opinion is based upon the existing provisions of the Internal Revenue Code of 1986, as amended, regulations (and administrative pronouncements) promulgated or proposed thereunder, and interpretations thereof by the Internal Revenue Service and the courts, all as of the date hereof, all of which are subject to change with prospective or retroactive effect, and our opinion could be adversely affected or rendered obsolete by such change.

This opinion is given to you by us solely for your use and is not to be quoted or otherwise referred to or furnished to any governmental agency (other than the Internal Revenue Service in connection with an examination of the transactions contemplated herein) or to other persons without our prior written consent.

Very truly yours,

Vinson & Elkins

VINSON & ELKINS L.L.P.

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[4]It should be noted that Treas. Reg. § 1.701-2(b) provides that under certain circumstances the existence of a partnership can be disregarded and its assets and activities will be treated as being owned and conducted by the partners. The application of Treas. Reg. § 1.701-2(b) requires that the partnership in question be "formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal income tax liability in a manner that is not consistent with subchapter K." The transactions described above will accelerate the recognition of income and you have represented to us that the transaction will not result in a substantial reduction in the present value of the tax liability of the Enron consolidated group or any of its members. Accordingly, the anti-abuse provisions of Treas. Reg. § 1.701-2(b) should not apply.

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(2) Last corresp.
(3) Forward to Weil

Draft: December 17, 2001

Privileged and Confidential
Attorney – Client Communication

Enron Corp.
1400 Smith Street
Houston, Texas 77002

Re: Tax Consequences of the Liquidations of the Chiricahua LLCs

Ladies and Gentlemen:

You have requested our opinion regarding certain federal income tax consequences of the liquidations of a series of limited liability companies owned by affiliates of Enron Corp. ("Enron"). Specifically, you have requested our opinion as to ability of the Enron consolidated group to recognize a loss on the liquidations and the effect the liquidations will have on the net operating loss position of the Enron consolidated group.

Background

Enron North America Corp. ("ENA"), a wholly owned subsidiary of Enron has historically entered into a variety of financial positions with third parties relating to the price of natural gas and other commodities. These positions include swaps, futures contracts, options and forward contracts. It was ENA's normal practice to enter into offsetting positions with its wholly-owned subsidiary Risk Management and Trading Corp. ("RMT") pursuant to an ISDA Master Agreement dated March 31, 1997 and the periodic confirmations executed in association with that agreement (collectively, the "ENA Master Swap").

On December 20, 2000 RMT and FS 360 Corp., a wholly-owned subsidiary of RMT ("FS 360 Corp.") formed 14 Delaware limited liability companies -- RMT Chiricahua I-XIV, (the "Chiricahua LLCs"). FS 360 Corp. is the managing member of each of the Chiricahua LLCs owning a .01% interest in capital, profits and losses. RMT owns a 99.99% interest in the capital, profits and losses of each of the Chiricahua LLCs. FS 360 Corp. acquired its interest in each Chiricahua LLC in exchange for a cash contribution to such entity. RMT acquired its interest in each Chiricahua LLC in exchange for a cash contribution and its agreement to enter into an ISDA Master Agreement dated December 20, 2000 between RMT and the Chiricahua

LLC and the associated confirmation dated December 27, 2000 (the "RMT Swaps"), which represented offsetting positions with respect to certain of the contracts held by RMT. Each of the RMT Swaps were substantially "in the money" at the time of execution and represented a transfer of value by RMT to the Chiricahua LLCs of approximately $__________ in the aggregate. The amount of the net cash payments required to be made under each of the RMT Swaps to a particular Chiricahua LLC was based upon the specific terms set forth in the associated confirmation based on the notional volumes and prices set forth therein. While it was possible on any particular payment date that a payment would be required to be made by the Chiricahua LLC to RMT, it was anticipated that a substantial net payment would be made by RMT to each Chiricahua LLC over the life of the RMT Swaps. Moreover, under the terms of the RMT Swaps, none of the Chiricahua LLCs were required to make any net payments in the aggregate to RMT in excess of the amounts actually received by such entity from RMT.

Following the execution of the RMT Swap, RMT entered into an ISDA Master Agreement dated December 20, 2000 between with Tularosa LLC, a Delaware limited liability company ("Tularosa") and an associated confirmation dated December 27, 2000 (the "Tularosa Swap") with respect to RMT's membership interest in each Chiricahua LLC. The members of Tularosa are ENA and Mangas I Corp., a wholly-owned subsidiary of ENA. Pursuant to the Tularosa Swap, RMT was entitled to receive from Tularosa on the settlement date a fixed sum equal to the fair market value of the RMT's membership interests in the Chiricahua LLCs on the initial contract date and RMT was required to pay to Tularosa the fair market value of the membership interests in the Chiricahua LLCs on the settlement date, plus the amount of any distributions received from the Chiricahua LLCs during the contract term. The contract date for the Tularosa Swap was December 27, 2000 and the settlement date was January 2, 2002. Tularosa's obligations under the Tularosa Swap were guaranteed by Enron Corp.

In our letter dated February 26, 2001, we analyzed the federal income tax treatment of the transactions described above (the "2000 Transactions") and concluded that while there was no authority directly addressing the federal income tax treatment of the entering into of a complex financial instrument similar to the RMT Swaps as a capital contribution to a partnership, and therefore the matter was not free from doubt, in our opinion, the 2000 Transactions should result in (i) a constructive sale of RMT's membership interests in the Chiricahua LLCs under section 1259 of the Internal Revenue Code of 1986, as amended[1], (ii) the recognition of gain in an amount equal to the excess of the fair market value of RMT's membership interests in the Chiricahua LLCs over its basis in such interests (which basis should not include any amount with respect to the RMT Swap), and (iii) an increase in RMT's basis in its membership interests in the Chiricahua LLCs by an amount equal to the gain recognized as a result of the constructive sale.

In reaching these conclusions, we reasoned that it would be appropriate to treat the RMT Swap in a manner similar to the contribution of a partner's own debt obligation to a partnership for purposes of determining RMT's basis in its membership interests in the Chiricahua LLCs. RMT would not receive any tax basis in its membership interests in the Chiricahua LLCs related

[1] Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended.

to the RMT Swap until such time as payments are made on the RMT Swap because RMT had no basis in its own obligation.

Under this approach, following the execution of the Tularosa Swap, RMT's basis in each Chiricahua LLC membership interest would equal the amount of its cash contribution, plus the gain recognized as a result of the constructive sale. That basis would be adjusted upward to reflect additional contributions made to such Chiricahua LLC by RMT (including payments under the RMT Swap), as well as RMT's allocable share of income from the Chiricahua LLC, and would be adjusted downward to reflect distributions by Chiricahua to RMT (including payments under the RMT Swap) and RMT's allocable share of Chiricahua's losses.

With respect to the 2000 Enron consolidated federal income tax return, you have advised us as follows:

- Enron reported a net operating loss ("NOL") carryforward at the beginning of the year of $[3.0] billion.
- Enron reported a net operating loss of $[2.0] billion for 2000, excluding the gains from the 2000 Transactions.
- Consistent with this approach discussed above, Enron reported the 2000 Transactions as resulting in the recognition by RMT of $[5.25] billion of capital gain.
- The gain from the 2000 Transactions was offset by the losses generated in 2000 and the NOL carryforwards from prior years. Accordingly, the taxable income of the Enron consolidated group for 2000 was [$50,000,000].

Since the consummation of the 2000 Transactions several significant developments have occurred affecting the transactions described above. First, and most notably, on December 2, 2001, Enron Corp. and several of its affiliates, including ENA, filed for protection under Chapter 11 of the Bankruptcy Code. Second, although the RMT Swaps required periodic payments to be made by RMT and the Chiricahua LLCs on the dates set forth in the RMT Swaps, no such payments have been made. Instead, since the execution of the RMT Swaps amounts owed by RMT to the Chiricahua LLCs have accumulated and have been treated as an unsecured receivable from RMT. [Third, RMT's ability to satisfy its obligations to Chiricahua has deteriorated. Virtually all of RMT's assets derive their value from unsecured claims or commitments from ENA or Enron. RMT's assets consist of receivables from ENA and Enron, its rights against ENA under the ENA Master Swap and its rights against Tularosa under the Tularosa Swap. Tularosa's ability to make payments under the Tularosa Swap are principally supported by an Enron guarantee. As a result of Enron and ENA's current financial position and bankruptcy filings it is unlikely that RMT will have sufficient assets to make the remaining payments under the RMT Swap or make full payments on the receivables to Chiricahua.]

In light of these circumstances, RMT and FS360, the members of each of the Chiricahua LLCs, liquidated the Chiricahua LLCs on December __, 2001. You have advised us that the only assets held by the Chiricahua LLCs at the time of their liquidation were receivables from RMT, the RMT Swaps and cash.

Tax Consequences of the Chiricahua Liquidations

The tax consequences of the liquidations of the Chiricahua LLCs will depend primarily upon RMT's basis in its the Chiricahua LLCs and the character of the assets distributed in the liquidations. Section 731(a)(1) of the Code provides that gain shall not be recognized to a partner as a result of a distribution from a partnership except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. Section 731(a)(2) provides that no loss will be recognized to a partner upon receipt of a distribution from a partnership except upon a distribution in liquidation of a partner's interest in the partnership where no property other than money, unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)) is received. In that case, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of the money distributed and the basis to the distributee, as determined under section 732, of any unrealized receivables and inventory distributed. Any gain or loss recognized as a result of a distribution under section 731 shall be treated as gain or loss from the sale or exchange of the partnership interest of the distributee partner. Such gain or loss is treated as gain or loss from the sale or exchange of a capital asset under section 741 of the Code.

Section 751(c) generally defines "unrealized receivables" to include any rights (contractual or otherwise) to payment for (i) goods delivered or to be delivered to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (ii) services rendered, or to be rendered. Under section 751(c) "unrealized receivables" also includes certain recapture items. Section 751(d) defines "inventory items" to mean any property of the partnership which, on sale or exchange by the partnership (or by the distributee partner) would be property other than a capital asset and other than property described in section 1231 of the Code.[2]

As discussed above, in our letter dated February 26, 2001, we concluded that the 2000 Transactions should result in a constructive sale of RMT's interests in the Chiricahua LLCs under section 1259 and an increase in RMT's basis in its membership interests in the Chiricahua LLCs by an amount equal to the gain recognized as a result of that constructive sale. Accordingly, under this approach RMT's basis in its interest in each of the Chiricahua LLCs would equal the amount of gain recognized under section 1259 with respect to such LLC, plus the initial cash contributions made to such LLC. You have advised us that the aggregate basis of RMT in the Chiricahua LLCs under this approach is [$________________].

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[2] Section 751(d) also defines inventory items to include any property of the partnership which, if sold or exchanged by the partnership (or the distributee partner), would result in gain taxable under section 1246(a) (relating to gain on foreign investment company stock).

Under section 732(a) loss will be recognized by RMT as a result of the liquidation of the Chiricahua LLCs only if the distributed property consists solely of cash, unrealized receivables and inventory items. In the liquidation of the Chiricahua LLCs two types of assets were distributed – cash and obligations of RMT. Upon their distribution to RMT, the obligations of RMT will be extinguished. Accordingly, whether loss will be recognized on the Chiricahua liquidations will depend upon the how the obligations RMT that are extinguished in the liquidation are treated.

The effect of a distribution of a partner obligation to the obligee partner by a partnership under section 731 depends upon the manner in which the distributing partnership acquired the obligation.[3] If a partnership loans money or property to a partner and the partner's indebtedness to the partnership is subsequently cancelled, Treas. Res. § 1.731-1(c)(2) provides that the obligor partner will be deemed to have received a distribution of money or property at the time of cancellation. Rules for the treatment of the distribution of obligations acquired by the partnership from a third party are set forth in Rev. Rul. 93-7, 1993-1 C.B. 125, which holds:

> If a partnership acquires indebtedness of a partner, and the partnership distributes (in a liquidating or nonliquidating distribution) the indebtedness to the partner so that the debt is extinguished, the distribution of property rules will apply to determine the consequences for the partnership and the partner will recognize capital gain or loss to the extent that fair market value of the indebtedness differs from the basis of the indebtedness determined under section 732 of the Code.

Unfortunately, there is no direct authority addressing the tax consequences of the distribution of an obligation of a partner to the obligee partner where the obligation was incurred in exchange for interest in the partnership. Neither Treas. Reg. § 1.731-1(c)(2) nor Rev. Rul. 93-7 nor is applicable because the obligation did not result from a loan to the partner and obligation was not acquired by the partnership from a third party.

It appears that the distribution of a partner obligation received in exchange for an interest in the partnership back to the obligee partner should be viewed as a nonevent for federal income tax purposes.[4] In the circumstances covered by Rev. Rul. 93-7 and Treas. Reg. § 1.731-1(c)(2) the partner's basis in its partnership interest included, directly or indirectly, the funds used to acquire the partners note or loaned to the partner, respectively. In both of those instances treating the distribution as a distribution of money or other property is necessary to properly reflect the economic gain or loss of the partner. When a debt obligation is contributed to a partnership in exchange for a partnership interest, however, (i) the partner's basis in its partnership interest does not reflect the amount of the obligation until payments under the obligation are actually made, and (ii) the partnership has a zero basis in the obligation of the

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[3] McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners ¶ 19.02[5] (1997) ("McKee").

[4] *See* McKee at ¶ 19.02[5][c].

partner.5 Thus, treating the distribution of a contributed debt obligation back to the contributing partner as a nonevent is consistent the treatment of the contribution of the obligation.

Moreover, in the case of the Chiricahua liquidations where cash and the contributed partner obligations are the only assets distributed in the liquidation, treating the obligations as "other property" for purposes of section 731 would prevent the recognition of loss on the liquidation. Such a disallowance would be inconsistent with the rationale underlying Rev. Rul. 93-7, which holds that gain or loss should be recognized where following a partnership distribution no mechanism for the preservation of gain or loss exists. Specifically, Rev. Rul. 93-7 provides:

> when indebtedness of a partner is distributed to that partner, the debt is extinguished. Thus, just as in a situation involving the distribution of money, when debt is distributed by a partnership to its issuer, there is no mechanism for preserving gain or loss. Accordingly, current recognition of any gain or loss is appropriate. *See Cora-Texas Manufacturing Co., Inc. v. U.S.*, 222 F.Sup. 527 (E.D. La. 1963), aff'd per curiam, 341 F2nd 579 (5th Cir. 1965), which concluded that the partnership nonrecognition rules for distributions of property did not prevent the recognition of loss by a partner when a partnership distributed to a corporate partner that partner's preferred stock.

1993-1 C.B. 125.

Accordingly, although there is no direct authority addressing the distribution of partner obligations in this context, and therefore the matter is not free from doubt, in our opinion the distribution of the RMT Swap and associated receivables to RMT in the liquidation of the Chiricahua LLCs should be treated as a nonevent for federal income tax purposes and therefore RMT should be treated as receiving solely cash in the liquidations of the Chiricahua LLCs.

Assuming that the distributions of the RMT Swaps and related receivables are treated as nonevents for federal income tax purposes and RMT is treated as receiving solely cash in the liquidation of the Chiricahua LLCs, under section 731(a)(2) RMT will recognize a loss on the liquidation of each Chiricahua LLC in an amount equal to the excess of its basis in its LLC interest over the amount of cash distributed. Under section 731(a) in loss recognized will be

5 Section 722 provides that the basis of an interest in a partnership acquired by contribution of property, including money, to the partnership shall be the amount of such money and adjusted basis of such property to the contributing partner at the time of the contribution. Under section 722, if the property contributed to the partnership is an obligation of the contributing partner, the contributing partner=s basis in its partnership interest is not increased to reflect the partner=s obligation because the partner has no basis in its own obligation. *Gemini Twin Fund III v. Commissioner*, 62 T.C.M. 104 (1991); *Oden v. Commissioner*, 41 T.C.M. 1285 (1981); Rev. Rul. 80-235, 1980-2 C.B. 229; Tech. Adv. Mem. 8702006 (Sept. 26, 1986). Instead, Revenue Ruling 80-235 provides that Apayments on the written obligation are added to the partner=s basis in the partnership as the payments are actually made.@ 1980-2 C.B. at 230. This approach is consistent with the capital account rules promulgated under Section 704(b) of the Code. Treas. Reg. ' 1.704-1(d)(2) generally provides that if a promissory note is contributed to a partnership by a partner who is the maker of such note, such partner=s capital account will be increased with respect to such note only when there is a taxable disposition of such note by the partnership or when the partner makes principal payments on such note.

treated as a capital loss. You have advised us that under this approach the liquidation of each Chiricahua LLC resulted in a capital loss and that the total aggregate capital loss recognized as a result of the Chiricahua liquidations equals [$5.0 billion] (the "Chiricahua Capital Loss").

Section 1212(a)(1) provides that if a corporation has a net capital loss for any taxable year, the loss may be carried back to each of the three taxable years preceding the loss years but only to the extent such loss does not increase or produce a net operating loss for the taxable year to which it is being carried back.

You have asked us to apply the capital loss carryback rules in section 1212 to the Chiricahua Capital Loss assuming that there are no other capital gains or losses during the 2000 and 2001 tax years of the Enron consolidated group other than the gains recognized on the 2000 Transactions and the Chiricahua Capital Loss.

Example 4 and Example 5 of Treas. Reg. § 1.1212-1(a)(3) provide relevant guidance to the application of these rules in this context. Example 4 provides:

Year	**Operating Income or Loss (Exclusive of Capital Gain or Loss)**	**Capital Gain or Loss**
1967	($20,000)	$24,000
1968	$20,000	-0-
1969	$20,000	-0-
1970	($25,000)	($20,000)

The net capital loss of $20,000 for 1970 is carried back to 1967 and applied against the $24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year only to the extent of $4,000, the maximum amount to which the 1970 capital loss carryback can be applied without producing a net operating loss for 1967. The unused $16,000 balance of the 1970 net long-term capital loss can be carried forward to 1971 and subsequent taxable years.

Example 5 provides:

Year	Operating Income or Loss (Exclusive of Capital Gain or Loss)	Capital Gain or Loss
1967	-0-	-0-
1968	($20,000)	-0-
1969	-0-	$24,000
1970	$20,000	($24,000)

> The net capital loss of $24,000 for 1970 is carried back to 1969 and applied against the $24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year to the extent of $24,000. The application of the capital loss carryback is not limited as it was in Example (4) because such carryback neither increases nor produces a net operating loss, as such, for 1969. The $20,000 net operating loss for 1968 is then carried forward to 1970 to eliminate the $20,000 of operating income for that year.

Assuming that there are no other capital gains or losses during the 2000 and 2001 tax years of the Enron consolidated group other than the gains recognized on the 2000 Transactions and the Chiricahua Capital Loss, under section 1212 Enron will be entitled to carry back the Chiricahua Capital Loss to 2000 to the extent of $3.25 billion (*i.e.*, the excess of the $5.25 billion capital gain recognized as a result of the 2000 transactions over the taxable loss of the Enron Consolidated Group of $2.0 billion for 2000 calculated without regard to the gain recognized from the 2000 transactions).

Finally, the above discussion assumes that the 2000 Transactions are respected and are treated in the manner described in our letter dated February 26, 2001. However, because (i) the parties to the 2000 Transactions were related, (ii) RMT and Chiricahua did not follow the terms of the RMT Swap, and (iii) the Chiricahua LLCs have failed to engage in other trading operations for their own account as originally contemplated, there is a risk that the IRS could assert that the 2000 transactions should be disregarded. Moreover, the Chiricahua liquidations increase this risk because the liquidations resulted in putting RMT in a position very similar to where it would have been had the 2000 transactions never occurred.

Even if the IRS were successful in such a challenge, however, in our opinion there should not be an adverse effect on the Enron tax position. If the 2000 Transactions were disregarded, Enron would not recognize gain under section 1259 in 2000 as a result of those transactions and would not recognize loss as a result of the Chiricahua liquidations. The net effect would be that Enron would have a net operating loss of [$2.0 billion] for 2000 and would have a net operating loss carryforward at the beginning of 2001 of [$5.2 billion].

Our opinion is based upon (i) our understanding of the relevant facts surrounding the 2000 Transactions and the Chiricahua Liquidations as set forth herein and in our letter dated February 26, 2001, and (ii) the existing provisions of the Internal Revenue Code of 1986, as amended, regulations (and administrative pronouncements) promulgated or proposed thereunder, and interpretations thereof by the Internal Revenue Service and the courts, all as of the date hereof, all of which are subject to change with prospective or retroactive effect, and our opinion could be adversely affected or rendered obsolete by such change.

This opinion is given to you by us solely for your use and benefit, and is not to be quoted or otherwise referred to or furnished to any governmental agency (other than the Internal Revenue Service in connection with an examination of the transactions contemplated by the rescission agreement) or to any other person without our prior written consent.

Very truly yours,

XI. TAX OPINION LETTERS

RELATING TO

PROJECT VALHALLA

C L I F F O R D
C H A N C E
P Ü N D E R

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To:

Enron Corp.
1400 Smith Street
Houston, Texas 77025
USA

May 2, 2000

Project Valhalla

Ladies and Gentlemen,

We have acted as German legal advisers to Enron Corp. ("**Enron**") in connection with the promissory note issued by Deutsche Bank AG ("**Deutsche Bank**") to Enron (the "**Promissory Note**"), the financing of Rheingold GmbH ("**Rheingold**") by Enron and Deutsche Bank and the purchase of preferred shares (the "**Preferred Shares**") in Risk Management & Trading Corp. ("**RMT**") by Rheingold (the "**Transaction**") with effect as of May 2, 2000 (the "**Closing**").

<u>Scope</u>

This opinion is given as to German law (not including unpublished case law) as in effect, enforced and interpreted as of the day hereof only.

In giving this opinion we have examined copies of the documents listed in the annex to this letter (the "**Transaction Documents**"), together with such other documents as we have considered necessary or desirable in order to give this opinion.

Capitalized terms used in this letter and not defined in it are defined in the annex to this letter.

Assumptions

In rendering this opinion, we have relied upon, without independent verification, the following assumptions:

(A) the capacity, power and authority of each party to enter into and perform under the Transaction Documents;

(B) the due execution and delivery of the Transaction Documents by each party thereto;

(C) that those of the Transaction Documents which are not expressed by their terms to be governed by German law, and the rights and obligations created thereby, are valid and binding under the laws by which they are expressed to be governed;

(D) that in such cases where the execution of a document by a natural person acting for and on behalf of a legal person affects the disposition of property, the power to make such disposition is not limited by applicable public or private law other than applicable German public or private law;

(E) the authenticity of all documents submitted to us as originals;

(F) the conformity with their respective original documents of all documents submitted to us as photocopies and the authenticity of the originals of such photocopied documents;

(G) that all filings necessary for the valid and enforceable creation and / or maintenance of rights have been or will be duly made;

(H) that there are no other agreements between the parties to the Transaction which would expand, modify or otherwise affect the respective rights, duties and obligations of all parties set forth in the Transaction Documents which would have an effect on the opinions rendered herewith;

(I) that all Transaction Documents available to us in draft form only have been or will be executed in all material respects in the same form as presented to us;

(J) dividends on the Preferred Shares will qualify for the participation exemption under the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes (the "**Treaty**");

(K) that the activities of RMT consist of various hedging transactions with other group companies, such as entering into options, futures, financial futures, foreign exchange transactions, etc., as well as inter-company loans in order to use excess cash;

(L) that for U.S. tax purposes, RMT is part of a consolidated group with Enron and other Enron subsidiaries; that in the process of the group consolidation, RMT's income is set-off in part by the elimination of certain inter-company charges within the group, and in part by losses or loss carry-forwards of Enron or other group companies; and that RMT will become a party to a tax allocation agreement (the form of which is used by the Enron consolidated group) which provides for compensation payments for the differences in the tax effects for each group company caused by the consolidation;

(M) that there are no other exemptions or other special tax effects applicable for the U.S. taxation of RMT;

(N) that Rheingold will have no income other than the distributions on the Preferred Shares, potential capital gains from the sale of the Preferred Shares and a small amount of investment income;

(O) that Valhalla will engage in no other activities than those contemplated under the Transaction Documents; and

(P) that the Transaction will be unwound by

- Rheingold exercising a put option over the Preferred Shares (the "**Rheingold Put Option**"), thereby selling the Preferred Shares to Valkyrie for the original U.S. Dollar ("**USD**") issue price or the current USD amount which is equivalent to the original Euro issue price, whichever is higher,
- Rheingold redeeming the Note for the original USD issue price or the current USD amount which is equivalent to the original Euro issue price, whichever is higher,
- Deutsche Bank exercising the put option under the Put Option Agreement, or Valkyrie exercising the call option under the Call Option Agreement,
- Rheingold being merged into Valhalla, and
- Valhalla liquidating at a time after Valkyrie either actually, or, by reason of having a single owner and no longer qualifying as a partnership for U.S. tax purposes, has been dissolved

(the "**Unwind**").

We have reviewed the Transaction Documents for Enron. In rendering the opinions expressed herein, we have relied solely upon our review of these Documents and have made no independent verification of the factual matters set forth in such Documents. Accordingly, save as expressly provided in this opinion, no opinion is given as to matters of fact and it is assumed that there are no facts which would affect the conclusions in this opinion.

Opinion

Based upon and subject to the foregoing, and subject to our reservations and qualifications stated below, we are of the opinion that:

1. The profit share of Rheingold from the distributions of RMT on the Preferred Shares should not be subject to German taxation based on the German foreign controlled corporation rules in the German Foreign Transactions Tax Act (*Aussensteuergesetz* – "**AStG**").

2. Rheingold should have no income subject to German trade tax other than income from the investment of its equity before the Closing or of dividends received on the Preferred Shares and not distributed as dividends on the Participation Rights ("**Investment Income**"). However, it cannot be entirely excluded that trade tax may be assessed on 50 % of the interest paid on the Note minus any other deductible expenses incurred by Rheingold.

3. The Unwind will not cause any German income tax to be imposed on Rheingold or Valhalla other than withholding tax on retained Investment Income. In the case that the Euro depreciates against the USD between the Closing and the Unwind, withholding tax of 5 % will be incurred on any cash distributed to Enron in excess of the Euro amount of Valhalla's registered share capital.

4. Rheingold will be a German resident for German tax purposes as long as it maintains its seat or principal place of management in Germany.

5. The Preferred Shares should be treated as equity for German tax purposes.

Reservations and qualifications

1. German controlled foreign corporation rules

1.1 Foreign controlled corporation

For German tax purposes, the profits of a foreign corporation are attributed to a German shareholder irrespective of whether such profits are distributed or retained if:

- (a) German shareholders hold more than 50 % of the share capital or the voting rights of a foreign corporation which earns passive income, or

  (b) one German shareholder holds 10 % or more of the share capital or the voting rights in a foreign corporation which earns passive investment income, and

- the passive income or passive investment income, respectively, exceeds certain *de minimis* thresholds and

- such passive income or passive investment income, respectively, is subject to a low tax burden in the country of the foreign corporation.

A German shareholder is protected by the Treaty against German taxation if the foreign corporation is located in the United States, if the German shareholder holds 10 % or more of the shares in the foreign corporation and if the distributions of the foreign corporation are treated as dividends in the United States as the country of residence of such foreign corporation. However, this protection does not apply with regard to

- passive investment income,

- which is more than 10 % of the total passive revenues of the foreign corporation or more than DM 120,000 and,

- subject to a low tax burden in the country of the foreign corporation.

As a consequence, the share of Rheingold in the profits of RMT will be subject to German taxation with no participation exemption available if and to the extent that

- 10 % or more (or more than DM 120,000) of RMT's passive income is passive investment income, and
- such income is subject to a low U.S. tax burden.

1.2 Passive investment income

Passive investment income is income from holding, administration, maintenance or appreciation in value of cash, receivables, securities, share or similar assets, unless the taxpayer proves that such income is

- connected to activities which generate active income, or
- received from a subsidiary in which the foreign corporation holds a share of 10 % or more, or
- remuneration for services rendered by the foreign corporation which is considered an arm's length price under German transfer pricing rules.

According to a public ruling of the German tax administration, passive investment income includes interest and dividend income as well as income from financing leases, factoring, "financial innovations" (structured financial products), futures and financial futures. Although the application of the AStG to some of these activities is disputed in the legal literature, all German tax officers are bound by the ruling. Therefore, although disputable in court, for planning purposes it must be assumed that the tax administration will treat all income from the financing activities listed in the ruling as passive investment income.

As a consequence, most, if not all, of RMT's income may be treated as passive investment income. Based on the information available to us, we are not able to determine the exact amount of such passive investment income.

1.3 Low tax burden

A foreign company's income is subject to a low tax burden if it is subject to income tax in the country of its seat or management at an overall rate of less than 30 %.

The relevant tax burden is not necessarily the actual tax paid. In principle, the tax administration considers first the general corporate income tax rate applicable in the particular country, state and local community, and any tax exemption or rate reduction for any relevant kind of income or corporation. The current U.S. corporate income tax rate of 35 % (plus state tax and local tax, if any) is principally sufficient to provide for a tax burden which is not a low tax burden for this purpose.

Even if the general corporate income tax burden is 30 % or higher and no specific exemption applies, but there is an indication that under the relevant foreign tax laws the amount of income included in the tax base is significantly smaller than it would be under the equivalent German tax laws, then an individual calculation of the tax base according to German corporate income tax laws is made. For this determination it is disregarded if the tax base is decreased by losses from other sources or by a loss carry-forward or loss carry-back. It is also disregarded if the foreign tax burden was decreased by a third country foreign tax credit or the deduction of a third country foreign tax imposed on the relevant foreign corporation. On the other hand, dividend income which is tax exempt based on a participation exemption or for which the foreign corporation can claim a tax credit for taxes imposed on the entity making the distribution (indirect tax credit) is automatically considered to be subject to a low tax burden. In the case that the foreign corporation receives different classes of income, only some of which are eligible for an exemption or tax reduction, the tax burden must be determined for each class of income separately.

There is no specific statutory rule nor administrative guidance regarding the effects of the consolidation within a group of companies. To our knowledge, there is also no case law regarding this question. However, it is the tax burden which is principally applicable to the relevant kind of income in the country of the foreign corporation, which is decisive for the application of the AStG. The set-off between income and losses from different sources is to be ignored. Although the statute does not provide explicitly whether this applies also to income and losses within a group of companies, consolidation is a concept which is also used in German tax law in the case of a so-called "*Organschaft*" which is different in detail from the U.S. consolidated group but which still uses similar concepts. One difference is that of the treatment of minority shareholders which, under U.S. consolidation rules, can participate in the tax benefits provided by losses with regard to losses which they do not have to bear. However, these potential benefits are normally, and specifically in the case of the Enron group, excluded by the compensation under the tax allocation arrangements within the group. Therefore, economically, each group company bears the tax burden attributable to its own income. In particular, in cases where income and losses are set off between group companies within the same country which are subject to the same general level of tax burden, there should be no basis for the application of the AStG in these circumstances.

The same reasoning applies for the reduction of the tax base for U.S. tax purposes caused by the elimination of certain inter-company income. As the German consolidation within an *Organschaft* follows similar rules, it can be expected that the German tax administration will accept these corrections as resulting from consolidation procedures sufficiently similar to German rules that they will not decrease the tax burden.

Therefore, we consider it unlikely that the German tax administration will consider the income of RMT as subject to a low tax burden based on the effects of the group consolidation. However, as there is no explicit guidance by the statute, the tax administration or the tax courts, it cannot be entirely excluded that the German tax administration will treat the effects of the consolidation as a reduction in the tax burden. However, in view of the compensation under the tax allocation arrangements within the Enron group, we consider this unlikely and believe that there is a very good chance to win any potential argument about this issue.

2. <u>German trade tax</u>

2.1 General rules on exempt dividends and interest deduction

As a German corporation, Rheingold is subject to German trade tax, a local income tax which is administered by the same authorities as the corporate income tax, but the tax rate of which is set by the municipality in which the business premises are located. The tax base is in principle the net income of each fiscal year as determined for corporate income tax purposes but with some additional items to be deducted from or added to the tax base.

One of the items added to the tax base is 50 % of any interest paid on long term loans and previously deducted from the tax base. If an interest payment is non-deductible as expense directly connected to exempt dividends, then the add-back of 50 % of such interest does not apply. This is expressly stated in the German trade tax regulations (*Gewerbesteuer-richtlinien*). Although German tax regulations do not have the force of law and do, therefore, not bind the courts, they are official guidelines for the tax administration and must be followed by all tax officers.

2.2 Deemed non-deductible expenses

As it has been disputed for some time in which circumstances expenses can be considered as directly connected to exempt dividends, a new provision was added to the German corporate income tax act last year, which stipulates that for all exempt foreign source dividends an amount equivalent to 5 % of the dividends received is deemed to be the amount of expenses directly connected to the exempt dividends (Sec. 8b para. 7). The German Federal Ministry of Finance has recently issued a public ruling which outlines its interpretation of this new section (the "**Ruling**"). The Ruling, like tax regulations, does not have the force of law but must be followed by all officers of the tax administration.

According to the Ruling, Sec. 8b para. 7 is to be applied not only for corporate income tax purposes but also for trade tax purposes if a dividend is exempt based on a tax treaty. In all circumstances, 5 %, and only 5 %, of the exempt dividends received in any year is to be added back to the tax base as non-deductible expense after the gross amount of the dividends has been deducted from the net income shown in the financial statements. This means that, on the one hand, 5 % is added back even if the total amount of all expenses is less than this amount and, on the other hand, that any expenses exceeding the amount of 5 % of the dividends are deductible even if directly connected to the exempt dividends. For corporate income tax purposes, this has the effect that for a German corporation which has no other income than exempt dividends, there is no taxable income nor loss if the actual expenses are exactly 5 % of the amount of dividends received in any given year. If the expenses are lower, then the German tax administration will assess taxable income in the amount of the difference. If the expenses are higher, there will be a loss which can be carried back to a limited degree or forward indefinitely.

As the interest expenses Rheingold will incur match 5 % of the dividend income it is expected to have each year, there should be a small amount of tax loss each year based on any other expenses that Rheingold will incur, such as rent, management fees etc.

With regard to the exact effects of Sec. 8b para. 7 on the trade tax assessment at the present time, there is no clear guidance from the German tax administration or the tax courts. According to the trade tax regulations mentioned above, the 5 % deemed non-deductible expense should decrease the amount deductible as exempt dividend and, to the extent that the non-deductible expense is interest, the 50 % add-back should not apply. However, the trade tax regulations are older than Sec. 8b para. 7 and, therefore, do not necessarily reflect the view of the tax administration on the new deemed non-deductible expense. Systematically there should be no add-back of any interest for which the taxpayer has not received an effective deduction. Therefore, it is reasonable to take the position on Rheingold's tax return that there is no income (other than Investment Income) for Trade Tax purposes. However, it cannot be entirely excluded that the tax administration may consider the deemed non-deductible expense as a separate item totally unrelated to actual expenses. Only in that case, it could be argued that the interest expense is deductible and, therefore, 50 % of the interest must be added back to the tax base. For Rheingold this would result in additional taxable income for trade tax purposes in the amount of 50 % of the interest paid on the Note.

3. Foreign exchange gains or losses

3.1 Euro depreciated against USD between Closing and Unwind

If the Euro depreciates against the USD, the price received for the Preferred Shares when the Rheingold Put Option is exercised as well as the principal to be paid back upon redemption of the Note will still be the same USD amounts as paid initially, but those will each represent a higher amount in Euro. Rheingold must use Euro for its financial statements and for the calculation of its income tax base. Therefore, it will show a profit in the amount of the difference in the original Euro price paid for the Preferred Shares and the Euro price received upon putting the Preferred Shares to Valkyrie, and a loss in the amount of the difference between the original Euro amount received for the Note and the Euro amount paid upon its redemption. However, since this profit will be considered as capital gain realized upon the sale of shares which qualifies for the participation exemption under the Treaty, the resulting income is exempt from corporate income tax as well as from trade tax.

When the Participation Rights are put to Valhalla by Deutsche Bank, Valhalla pays the initial USD price and, therefore, in Euro more than the amount of equity initially contributed to Rheingold. In the merger between Rheingold and Valhalla, Valhalla will incur a corresponding merger loss which will set-off most of the profit in Rheingold in the financial statements. For tax purposes, however, the tax exempt income of Rheingold is carried over to Valhalla and the merger loss is deducted from any capital reserve (paid in capital in addition to the registered share capital, so-called "EK 04"). If there is no or not a sufficient capital reserve, a negative capital reserve is created.

When the excess cash is distributed to Enron, there is no corporate income tax but a 5 % withholding tax will be applied since all distributions are deemed to be made out of distributable income first before any (even a negative) capital reserve is considered, unless the distribution is made in liquidation. Upon liquidation, the registered share capital can be paid out first and will, therefore, be protected.

3.2 Euro appreciated against USD between Closing and Unwind

If the Euro appreciates against the USD between the Closing and the Unwind, the amounts paid for the Preferred Shares and the redemption of the Note will be the USD amounts representing the original Euro prices. As Rheingold must account for its income or loss in Euro, no income or loss will be incurred.

When the put is exercised, Valhalla will acquire the Participation Rights for an amount which in Euro is lower than the equity originally contributed for the Participation Rights. In the merger between Rheingold and Valhalla, Valhalla will, therefore, show a merger gain which is shown in the financial statements as profit, but which for tax purposes will be added to the capital reserve.

When the excess cash is distributed to Enron, any amount paid out of the capital reserve will be considered repayment of paid-in equity and will, therefore, not trigger any withholding tax.

4. <u>German tax residence</u>

In principle, in order to remain a German tax resident, it is sufficient for Rheingold to maintain its seat <u>or</u> principal place of management in Germany.

For German tax purposes, the seat of a GmbH is in principle the place specified as seat in the corporate documents (*Gesellschaftsvertrag*). However, if this specification is only fictitious, i.e. if the relevant GmbH does not plan to have an active office in the specified location, then the choice of the seat is disregarded as a sham and the principal place of management is then considered to be the actual seat of the company instead. Furthermore, under German conflict-of-law rules, the principal place of management is considered to be determinative for the law applicable to the relevant entity. Therefore, if a GmbH formed and registered in Germany has its principal place of management outside of Germany, it may lose its qualification as a legal entity and, therefore, as a corporation. The details of this theory and its consequences are largely disputed and, therefore, unclear. As the participation exemption under the Treaty applies only to <u>corporations</u>, Rheingold should not rely on the specification of its seat in its corporate documents, but should maintain its principal place of management in Germany in order to ensure that the participation exemption is applied. Furthermore, to minimize the trade tax risk (discussed above at 2.), Rheingold's business activities generally must be carried out in the office in Eschborn.

The principal place of management is in the location where the majority of the decisions are made that are important for the management of the company. This is in principle the place where the management is physically present when it receives relevant information and prepares and carries out any response. The kind of activities this includes in detail depends on the business of each individual company. In the case of Rheingold and Valhalla, all correspondence should be sent to the Eschborn office. The managing director should be present in the Eschborn office on a regular basis, i.e. at least once or better several times each year to take care of the day-to-day business, i.e. mostly controlling functions such as monitoring the cash-flows, supervising the accountants' work, reviewing of financial statements and bank statements. All activities should be documented, i.e. by itemized telephone bills, travel expenses, minutes of meetings with accountants, Deutsche Bank representatives, etc. The managing director must also be prepared to come to the Eschborn office whenever there is a problem or crisis, or at least to send a representative. Generally, it is not necessary (or sufficient) to hold shareholder meetings in the relevant location. However, in the case of Valhalla the shareholder meetings for Rheingold should be held in Eschborn, as this will be the principal business activity of Valhalla until the Unwind.

5. <u>Preferred Shares</u>

Under German tax law, preferred shares are treated as equity if the profit distributions on such shares qualify for dividend treatment pursuant to Sec. 20 para.1 no.1 of the German Income Tax Act (*Einkommensteuergesetz* – **"EStG"**). Pursuant to the definition in Sec. 20 para.1 no.1 EStG, this is the case for dividends and other income from shares or profit participation rights which carry the right to the profits and liquidation proceeds of a corporation.

There is no clear guidance on the interpretation of what exactly constitutes a participation in the liquidation proceeds. The Federal Tax Court has held that an actual participation in the liquidation proceeds is necessary. However, the German tax administration does not apply this case law other than to the individual cases actually decided by the tax courts and considers it sufficient that the shares or profit participation rights are not redeemable before the liquidation of the corporation. Therefore, the tax administration may in some cases treat participation rights as equity for tax purposes, which would be classified as debt by the tax courts. However, the Preferred Shares include the right to participate to a limited extent in the liquidation proceeds of RMT.

Furthermore, there is no published case law or other guidance as to any required minimum participation either in amount or as a percentage of the funds invested. Although this means in principle that even the smallest participation should be sufficient, the tax administration could still disregard the participation as economically insubstantial under general anti-abuse rules. However, this would only be likely in extreme cases. We consider the participation in the liquidation proceeds under the Preferred Shares as too substantial to constitute such an extreme case and, therefore, the preferred shares should be treated as equity for German tax purposes.

6. Further qualifications

- This opinion is based on the facts existing on the date hereof of which we are aware and the opinions set forth herein shall not be deemed to relate to facts and conditions prevailing, or laws and regulations in effect, at any time after the date hereof.

- We do not purport to be experts on any laws other than the laws (not including unpublished case law) of the Federal Republic of Germany as in effect, enforced and interpreted on the date hereof.

- This opinion is limited by the effect of any applicable bankruptcy, reorganization, insolvency, moratorium and other similar laws including, without limitation, court decisions of general application, statutory or other laws regarding fraudulent or preferential transfers, relating to, limiting or affecting the enforcement of creditors' rights generally, save as expressly set out otherwise herein.

C L I F F O R D
C H A N C E
P Ü N D E R

- We express no opinion on the commercial value of the Transaction including without limitation whether any alternative structure or investment to those referenced herein may provide for a higher value or more beneficial tax treatment to any party in any jurisdiction.

- This opinion does not include any statement on the validity or enforceability of any agreement or legal relationship with regard to the Transaction.

Reliance

This opinion is addressed only to the addressee set out above in connection with the Transaction, and may not be communicated or delivered to any other person other than the addressee (and its U.S. legal advisers) or used for any other purpose without our prior written consent.

This letter and the opinions expressed herein are issued under and shall be interpreted and applied solely in accordance with the laws of the Federal Republic of Germany. The courts in Frankfurt am Main, Federal Republic of Germany, shall have exclusive jurisdiction regarding any disputes arising under or in accordance with this letter or the opinions expressed herein.

Very truly yours,

(Jutta Schneider)
Clifford Chance Pünder

CLIFFORD
CHANCE
PÜNDER

Opinion Project Valhalla
ANNEX

Transaction Documents

1. **Series 1 Non-voting Preferred Stock Certificate of Designations, Preferences and Rights of Risk Management & Trading Corp.** dated May 2, 2000 issued by RMT. *Delaware Law.*

2. **Series 2 Voting Preferred Stock Certificate of Designations, Preferences and Rights of Risk Management & Trading Corp.** dated May 2, 2000 issued by RMT. *Delaware Law.*

3. **Agreement on Participation Rights** (*Genussrechtsvertrag*) dated as of May 2, 2000 between Rheingold as issuer, Valhalla GmbH ("**Valhalla**") as holding and DBOFD as investor. *German Law.*

4. **Subscription and Procurement Agreement** dated as of May 2, 2000 between Valhalla as holding and Rheingold is issuer. *German Law.*

5. **Call Option Agreement** dated as of May 2, 2000 between Enron Valkyrie, LLC ("**Valkyrie**") and Deutsche Bank as Investor. *German Law.*

6. **Put Option Agreement** dated as of May 2, 2000 between Deutsche Bank as Investor and Valhalla. *German Law.*

7. **Promissory Note** dated May 2, 2000 issued by Deutsche Bank as maker to Enron as payee and accepted by Valkyrie, Valhalla and Rheingold. *New York Law.*

8. **Enron Guarantee** dated as of May 2, 2000 between Enron as guarantor, Deutsche Bank as counterparty, Valkyrie, Valhalla and Rheingold. *New York Law.*

9. **Note** dated May 2, 2000 issued by Rheingold to Enron. *New York Law.*

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September 12, 2000

Enron Corp.
1400 Smith Street
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Attorney-Client
Privileged Communication

Re: Project Valhalla Financing Transaction

Ladies and Gentlemen:

You have requested our opinion concerning certain United States federal income tax consequences of a financing transaction involving the creation of U.S. and German limited liability companies, the purchase and sale of preferred shares, the issuance of participating debt and various other related transactions.

Our opinion is based upon: (i) the Subscription and Procurement Agreement between Valhalla GmbH ("Valhalla") and Rheingold GmbH ("Rheingold"), each a German limited liability company; (ii) the Participation Agreement among Rheingold, Valhalla and Deutsche Bank AG, Frankfurt, a German corporation ("Deutsche Bank"); (iii) the Put Option Agreement between Deutsche Bank and Valhalla; (iv) the Call Option Agreement between Deutsche Bank and Enron Valkryie, LLC, a Delaware limited liability company ("Enron Valkyrie"); (v) the Amended and Restated Articles of Association of each of Valhalla and Rheingold; (vi) the Certificates of Designations, Preferences and Rights for Series 1 Non-Voting Preferred Stock and Series 2 Voting Preferred Stock of Risk Management & Trading Corp., a Delaware corporation ("RMT"); (vii) the Securities Purchase Agreement between RMT and Rheingold; (viii) the Company Agreement of Enron Valkyrie, LLC (the "Valkyrie LLC Agreement"); (ix) the Enron Guaranty by Enron Corp. ("Enron") in favor of Deutsche Bank; (x) a letter agreement regarding the U.S. tax characterization of the transactions executed by Enron and Deutsche Bank AG, New York Branch ("DBNY"); (xi) the Promissory Note issued by DBNY to Enron (all such agreements are referred to collectively as the "Agreements"); and (xii) our assumptions as to the existence of certain material facts. Capitalized terms not defined herein have the meanings set forth in the Participation Agreement or in the referenced agreement.

Based on the initial and continuing accuracy of all of such facts, documents and assumptions, and as more fully described herein, it is our opinion that for U.S. federal income tax purposes (i)

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Valhalla and Rheingold should be treated as entities disregarded as separate from their owners (ii) the transactions contemplated by the Agreements should be treated as a loan from Deutsche Bank to Enron Valkyrie with respect to which deductible interest payments are made, and (iii) and RMT should continue to be includible in the Enron Group (as defined below).

FACTS

A. Parties to the Transaction

1. Enron Valkyrie

Enron Valkyrie is a newly-formed Delaware limited liability company, the members of which are Enron and Enron Diversified Investments Corp., a Delaware corporation ("EDIC"). EDIC is a member of the affiliated group of corporations filing a consolidated federal income tax return of which Enron is the common parent (the "Enron Group"). Enron contributed $67.5355 million in exchange for a ninety-five percent member interest and EDIC contributed $3.5545 million in exchange for a five percent member interest in Enron Valkyrie. Enron Valkyrie is classified as a partnership for U.S. federal income tax purposes. Under the Enron Valkyrie LLC Company Agreement, all items of income, gain, loss, deduction and credit are allocated in accordance with the members' respective interests in Enron Valkyrie.

2. *Risk Management & Trading Corp.*

RMT is a Delaware corporation, all of the outstanding stock of which ("RMT Common Stock") is indirectly owned by Enron. RMT is a member of the Enron Group and is engaged in the business of hedging and trading financial instruments and commodities in the United States.

3. Valhalla and Rheingold

Valhalla and Rheingold are newly-formed German limited liability companies that are wholly-owned by Enron Valkyrie. Enron Valkyrie contributed $71.09 million to Valhalla in exchange for all of the common shares of Valhalla. Valhalla, in turn, contributed $71.09 million to Rheingold in exchange for all of the common shares of Rheingold. Rheingold obtained additional capital through a loan from Enron of $106.63 million and issued a note to Enron evidencing such indebtedness with interest payable at 7.7 percent annually (the "Rheingold Note"). In order to address certain German tax and accounting issues, the note provides for repayment of the greater of (i) the EURO equivalent of $106.63 million at the exchange rate on the date of issuance, or (ii) the EURO equivalent of $106.63 on the day the note is repaid. Rheingold has the right under the Rheingold Note to prepay all or any portion of the principal amount of the loan. Each of Valhalla and Rheingold has filed an election to be treated as an entity disregarded from its owner for United States federal income tax purposes.

4. *Deutsche Bank*

Deutsche Bank is a German corporation that is engaged in the banking and financial services business. Deutsche Bank is a resident of Germany for German tax purposes and is eligible for the benefits of the Income Tax Treaty Between the United States and Germany (the "Treaty").

B. *The Financing Transaction*

Following the formation of Enron Valkyrie, Valhalla and Rheingold, as described above, the parties undertook a series of transactions on or about the same date in order to facilitate a borrowing by the Enron Group from Deutsche Bank and an offsetting loan to DBNY (the transactions are referred to together as the "Financing Transaction").

1. The Subscription and Procurement Agreement

Valhalla and Rheingold entered into a Subscription and Procurement Agreement (the "Subscription Agreement") pursuant to which Valhalla agreed to procure a subscriber for, or to subscribe for, certain participating debt rights in Rheingold, referred to as *Genussrechte* (the "Participation Rights"). The subscription price for the Participation Rights was $2 billion.

2. The Participation Agreement (Genussrechtsvertrag)

Rheingold, Valhalla and Deutsche Bank entered into an Agreement on Participation Rights (*Genussrechtsvertrag*) (the "Participation Agreement") pursuant to which Rheingold issued to Deutsche Bank, and Valhalla waived its rights to subscribe for, the Participation Rights. Under German law, the holder of such Participation Rights has no voting rights and generally has the rights of a creditor. However, the Participation Rights have the following terms: (i) they participate with the common stock in distributions made by Rheingold to the extent of their ratable share of Rheingold's capital; (ii) for the first five years, the Participation Rights are entitled to a minimum distribution, payable each December, at the rate of 7.7 percent (the "Minimum Distribution"), contingent on Rheingold's having sufficient distributable profits; (iii) they participate in liquidation proceeds to the extent of their ratable share of Rheingold's capital; and (iv) they have a fixed maturity of 35 years. Because the amount paid by Deutsche Bank for the Participation Rights represents approximately 98 percent of the capital in Rheingold, the interest in the Participation Rights entitles the holder to 98 percent of any distributions on common shares and a 98 percent interest in the proceeds of a liquidation of Rheingold. There is no requirement under German law that distributions be made with respect to the common shares and it is assumed that no such distributions will be made. In addition, after the expiration of the initial five-year period, no Minimum Distribution is required to be paid with respect to the Participation Rights.

The Participation Agreement requires Deutsche Bank to provide to Rheingold or its agent at closing and from time to time thereafter upon request, any forms, certificates or documents that may be required or reasonably requested by Rheingold to allow it to make payments under the Participation Agreement free of withholding except for certain specified German withholding taxes. At the closing, Deutsche Bank delivered to Rheingold a properly completed Form W-8 BEN executed by an authorized person for Deutsche Bank.

3. *The Put Option Agreement*

Deutsche Bank and Valhalla entered into a Put Option Agreement (the "Put Agreement") pursuant to which Valhalla granted Deutsche Bank the right to sell its Participation Rights to Valhalla upon the occurrence of a "Put Circumstance." The Put Agreement provides that a Put Circumstance occurs: (i) when any Interim Distribution provided for in the Participation Agreement or any payment under the Enron Guaranty is not paid within five business days of the date when due; (ii) if there is an amendment to, or change (including any proposed change) in, the law or regulations of Germany or the United States or any political subdivision or taxing authority thereof or therein, or any official administrative pronouncement or judicial decision interpreting or applying such laws or regulations, or any other activities of the taxing authorities of Germany or the United States which amendment or change is effective or which pronouncement, decision or action is announced on or after the "Effective Date" (as defined in the Participation Agreement), that in the opinion of a nationally recognized tax counsel, would result in Deutsche Bank or any of its Affiliated Companies suffering a loss greater than $250,000 per annum with respect to the Participation Rights or related agreements; (iii) there is a material breach of a representation or warranty, or a failure to comply with any undertaking or provision, of the Agreements by Valhalla, Rheingold or Enron that is not remedied within five business days; (iv) Valhalla, Rheingold or Enron shall generally not pay its debts as they become due, or otherwise shall become bankrupt or insolvent; (v) at any time it becomes or will become unlawful for, or a breach of the Articles of Association (or similar constitutional documents) of, or otherwise in excess of the powers of, Deutsche Bank to perform or comply with any of its obligations under the Put Agreement or the Participation Agreement; (vi) the senior, unsecured and otherwise unsupported long-term obligations of Enron or Deutsche Bank are downgraded by Standard & Poor's corporation ("S&P"); (vii) on December 15 of 2000 through 2004 and on the fifth anniversary of the Effective Date; or (viii) an amendment to, or change in, regulatory or accounting rules under United States or German generally accepted accounting principles that would cause Deutsche Bank to suffer any loss in excess of $250,000 or force Deutsche Bank to significantly change the presentation of this transaction on its consolidated financial statements.

The Put Agreement provides that the "Put Right" shall arise on the date on which a Put Circumstance occurs and shall last for the following 90 days. The exercise of the Put Right must be made by written notice (the "Put Notice") specifying a business day on which the exercise of the Put Right shall become effective. The date so specified shall be within the period commencing on the fifth business day following Valhalla's and Guarantor's receipt of the Put Notice and ending on the 60th day after receipt of the Put Notice. The Put Price will be equal to (i) $2 billion plus (ii) the difference between the Minimum Distribution that would be payable (without regard to "Distributable Profits" as defined in the Participation Agreement) for the period from the Effective Date through the last day of the fiscal year immediately preceding the year in which the Put Right is exercised and the amount actually paid by Rheingold, plus (iii) the difference between the Minimum Distribution that would be payable (without regard to "Distributable Profits" as defined in the Participation Agreement) for the current fiscal year up to the date the Put Price becomes due and the amount actually paid by Rheingold, less (iii) any distribution on the Participation Rights in excess of the Minimum Distribution. Any portion of the Minimum Distribution paid by Valhalla (rather than Rheingold) as part of the Put Price may result in a taxable gain to Deutsche Bank, which in turn will require Valhalla to pay an additional amount to compensate Deutsche Bank for German taxes imposed. For this reason, it is understood that the entire amount of the Minimum Distribution will be paid by Rheingold prior to the date the Put Price becomes due.

4. The Call Option Agreement

Enron Valkyrie and Deutsche Bank entered into a Call Option Agreement (the "Call Agreement") pursuant to which Deutsche Bank granted Enron Valkyrie the right to acquire the Participation Rights subject to the conditions precedent that (i) one or more of the "Call Circumstances" has occurred, (ii) Enron Valkyrie exercises the Call Right by written notice in accordance with the Call Agreement, (iii) the Participation Rights have not been sold and assigned to Valhalla, and (iv) the Call Price has been paid in full. In the Call Agreement, Deutsche Bank represents that other than with Affiliated Companies (direct and indirect 10 percent shareholders of Valhalla and companies in which Valhalla or such shareholders have an interest of at least 10 percent of the votes or capital) of Enron Valkyrie, it has not and will not enter into any contractual arrangement with respect to the sale, assignment, pledge or other transfer of the Participation Rights. In addition, Deutsche Bank further agrees in the Call Agreement that it will not transfer the Participation Rights or any interest therein other than to Valhalla, to Enron Valkyrie, or to an affiliate of Deutsche Bank upon the prior written consent of Enron Valkyrie and Enron.

The Call Agreement provides that a Call Circumstance occurs: (i) if there is an amendment to, or change (including any proposed change) in, the law or regulations of Germany or the United States or any political subdivision or taxing authority thereof or therein, or any official administrative pronouncement or judicial decision interpreting or applying such laws or regulations, or any other activities of the taxing authorities of Germany or the United States which amendment or change is effective or which pronouncement, decision or action is announced on or after the Effective Date, that in the opinion of a nationally recognized tax counsel, would result in, or would increase the risk or likelihood of Valhalla, Enron or any of their Affiliated Companies suffering a loss greater than $250,000 per annum with respect to the Call Agreement, the Participation Agreement or related agreements; (ii) there is a material breach of representation or warranty, or a failure to comply with any undertaking or provision of, the Agreements, by Deutsche Bank that has not been remedied; (iii) it becomes unlawful or otherwise in excess of the powers of Rheingold or any Affiliated Company to issue the Participation Rights, to perform or comply with any obligations under any documents issued in connection with the transactions, issuing the Participation Rights or performing its obligations would require Rheingold or any Affiliated Company to fail to comply with a direction or instruction from a regulatory body, or there is a change in circumstances that is reasonably expected to result in RMT not having sufficient earnings and profits to pay a.dividend to Rheingold, as a result of which Rheingold would not have sufficient Available Distributable Profits to pay the Minimum Distribution; or (vi) there is a significant and material adverse change in the prevailing economic climate ("Material Change"). A Material Change is defined to include, but not be limited to, the following circumstances, which may have occurred prior to the Exercise Date or which occur on or after the Exercise Date: (x) the 3 Month US$-LIBOR has decreased by more than 150 basis points during any 180 day period since the 4th anniversary of the Effective Date; (y) the 3 Month EURIBOR has decreased by more than 125 basis points during any 180 day period since the 4th anniversary of the Effective Date; or (z) the countervalue of EURO/US-$ has changed by more than EURO 0.06 during any 180 day period since the 4th anniversary of the Effective Date. Enron has determined that one of the foregoing Material Changes is virtually certain to occur.

The Call Agreement provides that the Call Right arises on the day a Call Circumstance occurs and continues for as long as the Call Circumstance exists. The exercise of the Call Right must be made by written notice (the "Call Notice") and must specify a business day on which the exercise of the Call Right will become effective. The date so specified must be within the period commencing on the fifth business day following Deutsche Bank's receipt of the Call Notice and ending on the 60th day after receipt of the Call Notice. The Call Price will be equal to (i) $2 billion, plus (ii) the difference between the Minimum Distribution that would be payable (without regard to "Distributable Profits" as defined in the Participation Agreement) for the period from the Effective Date through the last day of the fiscal year immediately preceding the year in which the Call Right is exercised and the amount actually paid by Rheingold, plus (iii) the difference between the Minimum Distribution that would be payable (without regard to "Distributable Profits" as defined in the Participation Agreement) for the current fiscal year up to the date the Call Price becomes due and the amount actually paid by Rheingold, less (iv) any distribution on the Participation Rights in excess of the Minimum Distribution. Any portion of the Minimum Distribution paid by Enron Valkyrie (rather than Rheingold) may result in a taxable gain to Deutsche Bank, which in turn will require Enron Valkyrie to pay an additional amount to compensate Deutsche Bank for German taxes imposed. For this reason, it is understood that the entire amount of the Minimum Distribution will be paid by Rheingold prior to the date the Call Price becomes due.

5. *Investment in RMT Preferred Shares*

Rheingold used the funds from (i) the capital contribution by Valhalla of $71.09 million, (ii) the loan from Enron in the amount of $106.63 million, and (iii) the purchase of the Participation Rights by Deutsche Bank for $2 billion to purchase two classes of preferred stock of RMT. Pursuant to a Securities Purchase Agreement with RMT, Rheingold purchased 1,979,740 shares of Series 1 Non-Voting Preferred Stock in the amount of $1,979.74 million (the "Series 1 Preferred Stock") and 197,980 shares of Series 2 Voting Preferred Shares in the amount of $197.98 million (the "Series 2 Preferred Stock"). The Series 1 Preferred Stock and the Series 2 Preferred Stock are referred to collectively herein as the "RMT Preferred Stock." It is assumed that (i) the value of the Series 1 Preferred Stock will not at any time represent more than 75 percent of the total value of the outstanding stock of RMT; (ii) the aggregate value of the RMT Common Stock and the Series 2 Preferred Stock will not at any time represent less than 25 percent of the total value of the outstanding stock of RMT; (iii) the value of the Series 2 Preferred Stock will not at any time represent less than 5 percent or more than 20 percent of the value of the voting shares of RMT including the RMT Common Stock and the Series 2 Preferred Stock; and (iv) the dividend rate on the Series 1 Preferred Stock represents a market rate for such dividend.

The Series 1 Preferred Stock is non-voting, non-participating (except to the extent of its fixed 7.54048 percent dividend), and is not convertible into any other class of RMT stock. The Series 2 Preferred Stock has voting rights representing 10 percent of the total voting power of RMT and is non-participating (except to the extent of its fixed 7.54048 percent dividend). Upon liquidation, the holders of the Series 1 Preferred Stock and Series 2 Preferred Stock are entitled to receive the price paid for each share ($1000), plus any accrued but unpaid dividends, plus a liquidation premium that accrues at the rate of .2 percent per year not to exceed $25 per share. Neither the Series 1 Preferred Stock nor the Series 2 Preferred Stock is subject to mandatory redemption rights nor do they provide for a redemption premium. RMT has loaned all or a portion of the proceeds from the sale of the RMT Preferred Stock to Enron and will use the remainder of the proceeds (if any) in its trading operations.

On the Effective Date, Enron Valkyrie granted to Rheingold the right to put the RMT Preferred Stock to Enron Valkyrie at a price that is the greater of (i) the original issue price of the RMT Preferred Stock, or (ii) the U.S. dollar equivalent of the original Deutschmark price on the date the put is exercised (the "Internal Put"). The Internal Put to Enron Valkyrie by Rheingold has been executed solely to avoid a mismatch of foreign exchange gains and losses for German tax and accounting purposes.

6. *Enron Guaranty*

Pursuant to the Enron Guaranty, Enron has provided to Deutsche Bank a guaranty of the performance of certain obligations of its affiliates in connection with the Financing Transaction.

Specifically, Enron has guaranteed (i) Valhalla's obligation to pay the Put Price pursuant to the Put Agreement, and (ii) Enron Valkyrie's obligation to pay the Call Price pursuant to the Call Agreement.

7. *Promissory Note From Deutsche Bank AG, New York Branch*

In connection with the transactions described above, Enron loaned to DBNY $1.950 billion pursuant to the terms of a Promissory Note (the "Promissory Note"). The Promissory Note requires DBNY to make annual Coupon Payments that consist of a fixed interest rate component and a variable component equal to the value on the coupon payment date of certain options designated by Enron at the beginning of the relevant coupon period. The Promissory Note is due and payable on May 2, 2005 or on the occurrence of any Required Payment Event under the Promissory Note. Required Payment Events under the Promissory Note include, among other events, the exercise of the Put Right pursuant to the Put Agreement, exercise of the Call Right pursuant to the Call Agreement, a downgrade of either Enron's or Deutsche Bank's credit rating below certain prescribed levels and a failure of Enron and DBNY to agree annually on the designation of options related to the variable component of the Coupon Payment. The Promissory Note further contains a contractual agreement between Enron and DBNY to set off their respective obligations under the Enron Guaranty and the Promissory Note.

8. *Tax Characterization Letter Agreement*

At the closing of the Financing Transaction, Enron and DBNY executed a letter agreement acknowledging that solely for United States federal income tax purposes, the transactions would be treated as an extension of credit by Deutsche Bank to Enron Valkyrie and that payments of the Minimum Distribution would be treated as payments of interest by Enron Valkyrie on the indebtedness. The parties further agreed not to take, or allow their affiliates to take, any position for United States federal income tax purposes that is inconsistent with the foregoing characterization.

9 *Unwind of Financing Transaction*

The parties intend that the Financing Transaction will remain outstanding for a period of up to five years after the Effective Date. At the present time, the parties contemplate that the Financing Transaction will be terminated through a series of steps designed to minimize or eliminate various U.S. and German tax consequences including foreign currency gains and losses. Such steps and the associated tax and legal consequences will, however, be reevaluated at the time the transaction is terminated. The series of steps described below assumes that (i) either the Put Right or Call Right has been exercised, and (ii) the Promissory Note has been repaid by Deutsche Bank.

First, Rheingold will pay all Minimum Distributions payable for the period up to the date of payment of the Put Price or Call Price. Enron will contribute to Enron Valkyrie the funds necessary to repay the principal amount of the Participation Rights plus any additional amounts necessary to satisfy the terms of the Internal Put. For purposes of German tax law, the funds will be transferred to Rheingold, and thereafter, the RMT Preferred Stock will be treated as owned by Enron Valkyrie. The Put Price or the Call Price will be paid to Deutsche Bank by the appropriate party.

At some point following the repayment of the Participation Rights, Enron will purchase EDIC's interest in Enron Valkyrie. Although the Rheingold Note will merge out of existence for U.S. tax purposes, for German tax purposes, Rheingold will be required to make a payment to Enron in satisfaction of the Rheingold Note. This may require Enron to make a "contribution" to its division, Rheingold, of the funds necessary for repayment of such note. Depending on the state of the U.S. tax law at that time, prior to the purchase of EDIC's interest and the deemed dissolution, it may be necessary or advisable to cause RMT to redeem the RMT Preferred Stock with a note payable to Enron Valkyrie in the face amount of the RMT Preferred Stock.

Rheingold and Valhalla will be liquidated under German law pursuant to mergers that should be treated as tax-free for German tax purposes. Amounts, if any, remaining to be distributed to Enron upon the mergers may be subject to a German withholding tax. Enron Valkyrie may either be dissolved in accordance with Delaware law or remain as a division of Enron.

AUTHORITIES AND ANALYSIS

A. Ownership of the Participation Rights

The issue of whether a putative purchaser of property is considered the owner of such property for tax purposes has been addressed in case authorities and in published rulings of the Internal Revenue Service. In the proposed transaction, Deutsche Bank purports to purchase a right to participate in the profits of Rheingold similar to the rights of an equity owner. However, whether Deutsche Bank actually owns such an interest for tax purposes or has merely made a loan to Rheingold significantly affects the tax consequences of the Financing Transaction, including the entity classification of Rheingold and the taxes imposed on payments made to the various parties in the transaction.

1. Entity Classification

The classification of an entity as an association taxable as a corporation, a partnership or an entity disregarded from its owner is determined under rules set forth in Treasury Regulation § 301.7701. Treasury Regulation § 301.7701-2(b) describes the types of domestic business entities that are classified as corporations and sets forth a list of specific foreign business entities that must be classified as corporations. An entity not classified as a corporation under the provisions of Treasury Regulation §301.7701-1(b) (an "eligible entity") can elect its classification for federal tax purposes pursuant to Treasury Regulation §301.7701-3. A domestic eligible entity that does not file an election will be (i) a partnership if it has two or more members, or (ii) disregarded as an entity separate from its owner if it has a single owner.

A foreign eligible entity that does not elect otherwise will be (i) a partnership if it has two or more members and at least one member does not have limited liability; (ii) an association if all members have limited liability; and (iii) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability. Treasury Regulation §301.7701-3(b)(2). A foreign eligible entity may elect to be classified other than as provided above by filing the appropriate form. Treasury Regulation §301.7701-3(c)(1).

Under the foregoing regulations, Enron Valkyrie, as a domestic eligible entity with two members, will be classified as a partnership for federal income tax purposes. A German GmbH is not an entity classified as a corporation under §301.7701-2(b) and therefore, each of Valhalla and Rheingold is eligible to elect to be classified as an entity disregarded from its owner. As a result of these elections, for U.S. federal income tax purposes, Valhalla and Rheingold would be considered German branches of Enron Valkyrie notwithstanding that Enron Valkyrie, Valhalla and Rheingold will be treated as separate entities under German law. However, disregarded entity status will be available to Rheingold only if it is treated as having one owner for tax purposes. As described below, the Participation Rights should not be viewed as granting Deutsche Bank an equity interest in Rheingold and therefore Rheingold's status as a disregarded entity should not be affected by reason of Deutsche Bank holding such rights.

2. Sale and Repurchase Authorities

The Participation Rights are considered equity under German tax law and indebtedness under German corporate law and the holder thereof generally has the rights of a creditor. Because the capital of Rheingold attributable to the Participation Rights represents approximately 98 percent of Rheingold's total capital, such an interest could, under a debt-equity analysis, also be recharacterized for U.S. tax purposes as an equity interest in Rheingold. Assuming such a characterization applied, Rheingold could maintain its status as a disregarded entity only if the equity interest were treated as beneficially owned by Valhalla and thus by Enron Valkyrie rather than by Deutsche Bank. In the proposed transaction, Valhalla agreed to subscribe for the Participation Rights or to procure a subscriber for those rights. Contemporaneously with Deutsche Bank's subscription for such rights, Deutsche Bank entered into both a Put Agreement with Valhalla and a Call Agreement with Enron Valkyrie. The intent of these agreements is to ensure that the Participation Rights will be repurchased by Valhalla or Enron Valkyrie not later than five years after the original issuance of such rights.

The question of whether a purported sale and repurchase of property effects a transfer of beneficial ownership to the purchaser or is merely a collateralized loan has been addressed in a number of published rulings of the Internal Revenue Service and in case authorities. The principal published ruling addressing this issue is Rev. Rul. 74-27, 1974-1 C.B. 25, which involved the purchase by a bank of tax-exempt securities from its customers under "purchase and resale" agreements. In the ruling, the bank agreed to purchase the securities and the customer agreed to repurchase such securities on or before a certain date. If the customer failed to accept delivery and make payment for the securities, the bank was entitled to sell the securities and apply the proceeds to the contract price. If the proceeds were insufficient to satisfy the contract price, the customer remained liable for the difference. If the bank failed to deliver the securities and accept payment therefor, the customer had the right to "buy in" the bank's interest without further notice to the bank. The ruling holds that the bank did not purchase the securities and thus was not entitled to treat income from the transactions as tax-exempt interest excludable from income. Rather, the "purchase and resale" agreements merely effected loans of money by the bank upon collateral security and amounts charged with respect to such loans represented taxable interest.

In analyzing the treatment of the transactions in Rev. Rul. 74-27, the Internal Revenue Service articulated the following five-part test for determining whether a purchase and resale agreement is treated as a loan: (1) that the identical securities that are sold are required to be held for repurchase by the purported seller; (2) that if the seller refuses to repurchase the securities, the purported purchaser may sell the securities and apply the proceeds to the purchase price, and either credit the seller for the excess or hold the seller liable for the deficiency; (3) that the seller is legally bound both to repurchase the securities and pay any deficiency remaining unpaid after the application of the proceeds of sale (the seller not having a mere option to repurchase); (4) that the seller agrees to pay interest at a stipulated rate upon the amount advanced by the purchaser; and (5) that the value of the securities may or may not equal the amount advanced by the purchaser.

The Internal Revenue Service addressed a similar situation in Rev. Rul. 79-108, 1979-1 C.B. 75, which involved a "reverse repurchase" agreement. In the ruling, a city transferred U.S. Treasury Notes for 300x cash to a securities dealer who retransferred the notes to the city at the end of a specified period for the same amount of cash and retained the interest that accrued on the notes during the period. The ruling holds that the transaction was a loan and the dealer never owned the Treasury Notes; therefore the interest was earned by the city and not by the dealer. The ruling states that the essence of the transaction is that the interest income on the Treasury Notes was earned by the city and assigned to the dealer in consideration for the dealer's loan to the city of 300x. In other words, the interest income earned by the dealer was derived from its loan to the city and not from the U.S. Treasury Notes.[1]

[1] To the same effect is Rev. Rul. 77-59, 1977-1 C.B. 196, in which the Internal Revenue Service held that a real estate investment trust (REIT) that purported to purchase U.S. Treasury obligations from a bank under an agreement to resell the obligations to the bank on a fixed date at the purchase price plus the current rate of interest for such obligations, did not own the U.S. Treasury obligations. Rather the assets of the REIT were the bank's obligations to repay the funds to the REIT.

The courts have similarly analyzed the issue of beneficial ownership in transactions involving purported purchases and resales. In *American National Bank of Austin v. United States*, the Fifth Circuit held that a bank holding municipal bonds for various dealers did not demonstrate ownership of the bonds, and thus, the bank was required to report the interest payments received under the bonds as part of the bank's taxable income.[2] In the case, the bank used its own funds to purchase municipal bonds from the issuing authority for the successful bidder. The bank held the bonds until the bidder-dealer sold the bonds to its customers, usually resulting in the bank's holding the bonds for no longer than thirty days. The bank never refused to transfer the bonds to the bidder-dealer once the dealer had paid the book value of the bonds plus the bank's costs. During the period that the bank held the bonds, interest accrued and was paid to the bank. The bank took the position that it was the owner of the bonds for U.S. federal income tax purposes and therefore was entitled to exclude the interest from tax under section 103(a)(1) of the Code.[3] The court concluded that the bank could not be the actual owner of the bonds because (i) the bank did not control the disposition of the bonds even when in its possession, (ii) the bank received a fixed percent of interest for its services and did not share in the profits generated by the sale to customers, and (iii) the bank incurred no risk other than the risk that the dealer would not be able to dispose of the bonds or take possession of the bonds from the bank.[4]

In contrast, in *Citizens National Bank of Waco v. United States*, the Claims Court found that an actual sale of municipal bonds had occurred.[5] As in the financing cases, the bank had the right to demand that the customer reacquire the bonds for an amount equal to the bonds' par value plus the accrued interest. However, the parties agreed that the bank was not required to resell the bonds and in fact had the right to sell the bonds while they were in the bank's possession. In addition, the bank had the right to retain any profits made on such sales to third parties. The bank collected the interest paid on the bonds during the period in question and did not report such interest as part of its gross income under section 103(a)(1) of the Code. The court held that the transaction was a sale with economic substance and not a loan.

In situations in which the property subject to a sale and repurchase arrangement is an equity interest, the courts nonetheless have applied a similar analysis. In *Comtel Corp. v. Commissioner*, the Second Circuit found that a purported purchaser of stock, a new corporation (Comtel Corp.) created by a hotel corporation (Zeckendorf) and other "Investors", did not actually own the stock but

[2] 421 F.2d 442 (5th Cir. 1970).

[3] References to "section" or to the "Code" are to the Internal Revenue Code of 1986, as amended (or to an earlier version of such statute) unless otherwise noted.

[4] *Id.*

[5] 213 Ct. Cl. 236 (1977).

rather was merely providing short-term financing for Zeckendorf.[6] Under an agreement, Zeckendorf bought the shares of a public company and immediately sold them to Comtel for the same purchase price, retaining an exclusive option to repurchase the stock for the same price plus interest costs, expenses, and an additional lump sum payment of $600,000. Zeckendorf's shares of Comtel were subordinated to the payment rights of the other Investors with respect to their Comtel stock and Zeckendorf guaranteed the Investors the return of their investment plus interest and expenses.

The Court found that the transaction was a financing rather than a sale because (i) Zeckendorf at all times sought to acquire the stock and never surrendered ownership of its shares to Comtel; (ii) the objective of the Investors in Comtel was to make a high yield, risk-free investment, not purchase a hotel corporation; (iii) Comtel could not sell, dispose of or pledge the stock while Zeckendorf's option was outstanding; (iv) the profits generated by the transaction were not due to the appreciation in the value of the Comtel stock but were due to the fixed option price set by the parties; (v) Zeckendorf could exercise the option by paying a sum which appeared to the court to represent the equivalent of interest and compensation for financing services on a purchase-money mortgage[7]; and (vi) Zeckendorf was, for all practical purposes, compelled to exercise its repurchase option or risk losing its capital investment in Comtel due to the terms of the subordination agreement.[8]

3. *Applicability of Section 1058 to Sale-Repurchase Transactions*

Section 1058(a), dealing with securities lending transactions, provides that in the case of a taxpayer who transfers securities (as defined in section 1236(c)) pursuant to an agreement which meets the requirements of section 1058(b), no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer. Section 1236(c) defines a security as any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

An agreement meets the requirements of section 1058(b) if it (i) provides for the return to the transferor of securities identical to the securities transferred; (ii) requires that payments be made to the transferor of amounts equivalent to all interest, dividends and other distributions which the

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[6] 376 F.2d 791, 792 (2d Cir. 1967).

[7] *See also Commercial Capital Corp. v. Comm'r*, 27 T.C.M. 897, [43] (U.S.T.C. 1968) (stating that the situation where stock transferred to a corporation would be returned to the transferring party subject to a put is more like a secured loan arrangement where "a deed, absolute on its face, is coupled with an agreement to reconvey upon payment of a stipulated sum, [resulting in a] transaction [that] is nothing more than a mortgage.")

[8] *Id.* at 794-5.

owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor; (iii) does not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and (iv) meets other requirements prescribed in regulations. Proposed Treasury Regulation § 1.1058-1(b)(3) provides that in order to meet the requirement that risk of loss or opportunity for gain not be reduced, the agreement must provide that the lender may terminate the loan upon notice of not more than five business days.

The Senate Committee Report underlying section 1058 states that the provision is intended to clarify existing law by providing that no gain or loss is recognized by the owner of securities when the owner transfers securities for the contractual obligation of the borrower to return identical securities.[9] The Report additionally states that "the committee does not intend to change the tax treatment of 'repurchase agreements' in which loans of money collateralized by securities are structured as sales and repurchases of securities. See, for example, Rev. Rul. 77-59, 1977-1 C.B. 196."

4. Application of Authorities to Financing Transaction

In the Financing Transaction, Deutsche Bank purchased an interest that purports to entitle it to participate in the profits of Rheingold. However, for the reasons described below, the substance of the arrangement should be a five-year loan bearing a fixed rate of interest with repayment of the principal guaranteed by Enron.

The Participation Rights have a term of thirty-five years and entitle the holder to participate in distributions including preferred "Minimum Distributions" at the rate of 7.7% and distributions on common shares. However, Minimum Distributions are payable for only five years, and during that time and thereafter, no additional dividends are required to be paid on the common shares of Rheingold. There is no intention on the part of Enron to cause Rheingold to distribute dividends on its common shares. Moreover, in the event that any such distributions were made, there would be a corresponding reduction in the Put Price and the Call Price. Thus, at the end of five years, Deutsche Bank will no longer be assured of any return on its $2 billion investment. As a result of these provisions, Deutsche Bank's profit participation is effectively limited to the yearly Minimum Distribution for five years.

At the time Deutsche Bank subscribed for the Participation Rights, it obtained the right under the Put Agreement to require the purchase of the Participation Rights by Valhalla for an amount equal to the purchase price of the rights plus the amount of any unpaid Minimum Distributions. Should any distributions actually be made with respect to the common shares of Rheingold, such

[9] S. Rep. No. 762, 95th Cong. 2d Sess. 5-9.

amounts (in excess of the Minimum Distribution) as are received by Deutsche Bank will reduce the Put Price and thus will be treated as a repayment of principal (*i.e.*, the purchase price). The payment of the Put Price was guaranteed by Enron and therefore repayment is assured even if Rheingold has no funds. The Put Right can be exercised based on a number of circumstances as well as on December 15 of each year for the first five years. Although Deutsche Bank is not required to exercise the Put Right, there are certain factors that will compel exercise of the put by the end of the fifth year including (i) the Minimum Distribution will no longer be payable after five years, and (ii) the offsetting financing arrangement between Deutsche Bank and Enron (*i.e.*, the Promissory Note) will be terminated. It is understood that, absent exercise of the Put Right, the termination of the offsetting loan will result in adverse credit and regulatory consequences to Deutsche Bank. Thus, the Put Right is virtually certain to be exercised. Moreover, under the terms of the Put Agreement, Deutsche Bank does not have the potential for loss of its investment as would an equity investor and its only risk of recovering its investment plus a fixed return is Enron's creditworthiness.

As the holder of the Participation Rights, Deutsche Bank also is entitled to share in the liquidation proceeds of Rheingold pro rata based on its proportionate share of the capital of the company. Thus, the Participation Rights would appear to grant Deutsche Bank the potential to share in an increase in value of the company. However, at the time the Participation Rights were acquired, Deutsche Bank also granted a call option to Enron Valkyrie pursuant to which Enron Valkyrie can "purchase" the Participation Rights for an amount equal to the price paid by Deutsche Bank plus the amount of any unpaid Minimum Distributions (less any distributions in excess of the Minimum Distributions). The Call Right can be exercised on the occurrence of a number of Call Events, one of which is virtually certain to occur. Thus, if the value of Rheingold increases such that upon a liquidation Deutsche Bank would be entitled to amounts in excess of it purchase price for the Participation Rights plus the Minimum Distributions (and the Put Right is not exercised), Enron can ensure that a liquidation does not occur while the Participation Rights are held by Deutsche Bank by having Enron Valkyrie exercise its Call Right. The Call Agreement also provides that Deutsche Bank cannot transfer the Participation Rights other than to Valhalla, Enron Valkyrie, or to an affiliate of Deutsche Bank provided it has obtained the prior written consent of Enron and Enron Valkyrie. Thus, Deutsche Bank does not have the right of an owner to alienate property and as a result, has no possibility of realizing a profit through a sale to a third party.

The agreements described above indicate that (i) Deutsche Bank has no right to a return on its investment except for a fixed minimum return payable only for the first five years; (ii) Deutsche Bank is assured of not suffering a loss on the Participation Rights as Valhalla is required to purchase the Participation Rights and the Put Price is guaranteed by Enron; (iii) Deutsche Bank cannot share in any increase in value in Rheingold as Enron Valkyrie's Call Right effectively precludes Deutsche Bank's ability to realize on such an increase; and (iv) Deutsche Bank cannot sell the Participation Rights except pursuant to the Put Right or Call Right and thus cannot realize a profit on its investment through a sale to a third party. Accordingly, Deutsche Bank's ownership of the Participation Rights should not be treated as an equity interest in Rheingold. Rather, the transaction should be treated as a financing requiring the payment of interest at the rate of 7.7 percent and repayment of principal at the end of five years unless demand for repayment or the right to repay is exercised at an earlier time. Such a characterization is consistent with the letter agreement executed by Enron and Deutsche Bank describing such characterization and the delivery by Deutsche Bank of the Form W-8 BEN indicating an exemption from U.S. withholding tax on interest payments.

It is possible that the transfer of the Participation Rights to Deutsche Bank could be viewed as a loan of the Participation Rights (*i.e.*, a security) subject to section 1058. In such case, the agreements would meet some but not all requirements of section 1058 and the proposed regulations inasmuch as the agreements do not specifically require Deutsche Bank to pay over the equivalent of dividends earned with respect to the underlying securities (presumably earnings attributable to the RMT Preferred Stock). However, even if the transaction does not technically meet the requirements of section 1058, as indicated in the Senate Report, it should nonetheless be treated as a financing and not as a sale if it meets the relevant tests under the sale and repurchase authorities.

The transaction taken in its entirety alternatively could be viewed as merely producing a fee earned by Enron equal to the difference between the amount of interest paid with respect to the Participation Rights and the amount of interest received on the Promissory Note. Regardless of the characterization, the spread between the interest paid and received will be included in income in the Enron Group's consolidated federal income tax return.

B. Inclusion of RMT in the Enron Group

A corporation will be included in an affiliated group, as defined in section 1504(a) of the Code, only if stock in such corporation meeting the requirements of section 1504(b) is owned directly by one or more other members of the group. The ownership of stock meets the requirements of section 1504(b) if it possesses at least 80 percent of the total voting power of the stock of such corporation and has a value equal to at least 80 percent of the total value of the stock of such corporation. Section 1504(a)(4) provides that for purposes of this test, the term "stock" does not include any stock which (i) is not entitled to vote,[10] (ii) is limited and preferred as to dividends[11] and does not participate in corporate growth to any significant extent,[12] (iii) has redemption and

[10] The IRS ruled in Rev. Rul. 69-126, 1969-1 C.B. 218, that preferred stock that has the right to vote in the election of directors constitutes voting stock. *Cf.* Rev. Rul. 71-83, 1971-1 C.B. 268 (which held that preferred stock that had no voting rights except with respect to certain changes in the articles of incorporation or the corporation's rights to create additional stock that was senior to or on parity with the preferred stock was not voting stock for purposes of section 1504, as it existed prior to amendment in 1984).

[11] *See* Rev. Rul. 79-21, 1979-1 C.B. 290. The ruling held that participating preferred stock, which was entitled to receive not only a preferred dividend priority over common stock but was also entitled to participate with common stock in further distributions, was not limited and preferred as to dividends for purposes of section 1504.

[12] *Cf.* Treasury Regulation § 1.305-5(a), which contains similar language. The regulation provides that for

liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption premium), and (iv) is not convertible into another class of stock. In describing these requirements, the legislative history underlying section 1504(a)(4) states as an example that preferred stock carrying a dividend rate materially in excess of a market rate when issued would not be ignored for consolidation purposes.[13]

Except for the RMT Preferred Stock owned by Rheingold (and thus by Enron Valkyrie), all of the stock of RMT is owned by members of the Enron Group. The Series 1 Preferred Stock (i) has no voting rights (except as required under Delaware corporate law which does not include the right to vote for the election of directors), (ii) is entitled to preferred dividends limited to a rate of 7.7 percent, (iii) has redemption and liquidation rights equal to the issue price of the stock plus any accrued but unpaid dividends and a liquidation premium accruing at the rate of .2 percent per year, and (iv) is not convertible into another class of stock of RMT. The Series 1 Preferred also bears a dividend rate that represents a market rate. Because of these features, the Series 1 Preferred Stock should not be taken into account in determining whether the stock ownership requirements of section 1504(a) are met. Although the Series 1 Preferred Stock will represent a substantial portion of the total equity in the company, the RMT Common Stock and the Series 2 Preferred Stock will represent not less than 25 percent of the overall value of the company and, thus, will have a significant interest in the underlying profits and assets of RMT. Moreover, there is no indication in the statute or legislative history that Congress intended to impose limitations on the amount of preferred stock that could be excluded under section 1504(a)(4).

Section 1504(a) does not specify what constitutes a reasonable redemption or liquidation premium. However, the Internal Revenue Service indicated in a private ruling that the rules of section 305 with respect to redemption premiums may be analogous.[14] Since the issuance of that ruling, the regulations under section 305 have been revised and there currently are no additional authorities interpreting the meaning of reasonable for purposes of section 1504(a)(4). However, Treasury Regulation § 1.305-5(b)(1), as amended, provides that constructive distribution treatment will not result if a redemption premium does not exceed a *de minimis* amount, as determined under the principles of section 1273(a)(3). Section 1273(a)(3) provides that if the amount of original issue discount with respect to a debt instrument is less than 1/4 of 1 percent of the stated redemption price at maturity multiplied by the number of years to maturity, the original issue discount will be treated

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purposes of section 305(b)(4), the term "preferred stock" generally refers to stock which, in relation to other classes of stock outstanding enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent.

[13] H. Conf. Rep. No. 861, 98th Cong. 2d Sess. 833 (1984).

[14] In a 1987 ruling, the IRS applied the safe harbor provisions of former Treas. Reg. §1.305-5(b). PLR 8753005 (Sept. 30, 1987). Pursuant to section 6110(k)(3), a private letter ruling may not be used or cited as precedent except by the taxpayer to which it was issued.

as zero. By analogy, the Series 1 Preferred Stock provides for a liquidation premium of .2 percent per year not to exceed $25 per share. Thus, such premium is less than the amount generally regarded as *de minimis* and, therefore, should be treated as reasonable.

The Series 2 Preferred Stock has voting rights and thus will be taken into account in determining whether RMT is a member of the Enron Group. However, the voting rights of the Series 2 Preferred Stock represent only 10 percent of the total voting power of all of the stock of RMT. In addition, the Series 2 Preferred Stock has and will have a value not less than 5 percent nor more than 20 percent of the total value of the voting shares of RMT. Accordingly, following the issuance of the RMT Preferred Stock, RMT should continue to be includible in the Enron Group.

C. Taxability of Dividends on the RMT Preferred Stock

Section 243 provides that a corporation, in computing its taxable income, may deduct a certain percentage of amounts it receives as dividends from a domestic corporation subject to United States federal income taxation. One hundred percent of dividends received by a corporation may be deducted where the dividends constitute "qualifying dividends" under section 243(b). Section 243(b)(1) provides that a dividend is a qualifying dividend if it is (i) received by a corporation from another corporation that is, at the close of the day on which such dividend is received, a member of the same affiliated group and (ii) paid out of the earnings and profits from taxable years of the distributing corporation on each day of which the distributing corporation and the corporation receiving the dividend were members of the same affiliated group within the meaning of section 1504(a).

Among other exceptions and limitations, section 246(c)(1)(A) disallows the deduction provided in section 243 with respect to any dividend paid on a share of stock that is held by the recipient of the dividend for 45 days or less during the 90-day period beginning 45 days prior to the dividend payment date. In the case of certain preference dividends, section 246(c)(2) provides that the deduction is disallowed where the stock is held by the recipient for 90 days or less during the 180-day period beginning 90 days prior to the dividend payment date.

Section 246A(a) provides that in the case of any dividend on debt-financed portfolio stock, the percentage of dividends eligible for the dividends received deduction under section 243 shall be reduced. Section 246A(b) provides, however, that subsection (a) shall not apply to qualifying dividends, as defined in section 243(b).

Distributions are eligible for the dividends received deduction under section 243 only if they are distributions out of earnings and profits.[15] Treasury Regulation § 1.312-6(b) provides that among

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[15] Sections 316 and 312 of the Code.

the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable under the Constitution, as well as all items includible in gross income under section 61.

Section 312 and the regulations thereunder contain no specific rules related to income attributable to payments made by one member of a consolidated group to another member of that group. Treasury Regulation § 1.1502-33(c)(2) provides that intercompany items and corresponding items are not reflected in earnings and profits before they are taken into account under Treasury Regulation § 1.1502-13. Example 1 of Treasury Regulation § 1.1502-13(g)(5) illustrates the timing and recognition of income on intercompany indebtedness:

> (a) Facts. On January of Year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year and repayment of $100 a the end of Year 5. B fully performs its obligations. Under their separate entity methods of accounting, B accrues a $10 interest deduction annually under section 163, and S accrues $10 of interest income annually under section 61(a)(4).
>
> (b) Matching rule. Under paragraph (b)(1) of this section, the accrual of interest on B's note is an intercompany transaction. Under the matching rule, S takes its $10 of income into account in each of Years 1 through 5 to reflect the $10 difference between B's $10 of interest expense taken into account and the $0 recomputed expense. S's income and B's deduction are ordinary items.

Based on the foregoing provisions of section 312 and the applicable regulations under sections 312 and 1502, interest on intercompany indebtedness should be included in income of the recipient for purposes of earnings and profits calculations consistent with the accrual of the deduction of the payor.

Section 702(a) provides that in determining his income tax, each partner shall take into account separately his distributive share of certain of the partnership's items including dividends with respect to which there is a deduction under part VIII of subchapter B (sections 241-249 of the Code). Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (a)(1) through (7) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Section 1059(a) requires a corporation that receives an extraordinary dividend with respect to a share of stock that the corporation has not held for more than two years before the dividend announcement date to reduce its basis in the stock by the amount of the nontaxed portion of the dividend. Section 1059(e)(2) provides that except as provided in regulations, the term extraordinary dividend does not include any qualifying dividend within the meaning of section 243. Treasury

Regulation § 1.1059(e)-1(a) provides that the exception for qualifying dividends does not apply to any distribution treated as an extraordinary dividend under section 1059(e)(1) (dealing with partial liquidations and non pro rata redemptions).

Section 1059(e)(3) provides that section 1059 does not apply to certain qualified preferred dividends if the taxpayer holds the stock for more than five years; if the stock is held for five years or less, the aggregate reduction will not exceed the excess, if any, of the qualified preferred dividends actually paid during the period the taxpayer holds the stock over the qualified preferred dividends that would have been paid for such period on the basis of the stated rate of return. Section 1059(e)(3)(C) defines a qualified preferred dividend as any fixed dividend payable with respect to a share of stock which provides for fixed preferred dividends payable not less frequently than annually, and is not in arrears as to dividends at the time the taxpayer acquires the stock. The term does not apply to any dividend if the rate of return of such stock exceeds 15 percent.

Enron Valkyrie will receive dividends on the RMT Preferred Stock through its German branch, Rheingold, and will allocate those dividends to Enron and EDIC under the Enron Valkyrie Agreement. Under the foregoing authorities, Enron and EDIC should be treated as if such dividends had been received directly from RMT. Therefore, assuming distributions from RMT are paid out of earnings and profits, such amounts should constitute qualifying dividends and Enron and EDIC should be entitled to exclude 100 percent of those dividends from income pursuant to section 243(b) of the Code.

Distributions from RMT will be eligible for the dividends received deduction only if they are paid out of earnings and profits. It is expected that RMT will have sufficient earnings and profits from its trading operations to support the dividends on the RMT Preferred Stock. However, even if such earnings are insufficient, interest income accrued by RMT on the intercompany loan to Enron of the proceeds from the sale of the RMT Preferred Stock will be taken into account each year and thus should increase RMT's earnings and profits available for distribution.

Enron Valkyrie should not be required to reduce its basis in the RMT Preferred Stock under section 1059 as dividends paid on such stock should constitute qualifying dividends within the meaning of section 243 (and also should constitute qualifying preferred dividends within the meaning of section 1059(e)(3)). The RMT dividends will, however, reduce the earnings and profits of RMT that will tier up to Enron under Treasury Regulation § 1.1502-33 and thus will have the effect of a downward basis adjustment (or a lesser increase in basis) in the common shares of RMT held by members of the Enron Group.

D. Deductibility of Interest Expense

Section 163 provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. Section 702(a)(8) provides that a partner shall take into account his distributive share of taxable income or loss, exclusive of items requiring separate computation. Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction or credit shall, except as otherwise provided under the relevant Code provisions, be determined by the partnership agreement. Under the Enron Valkyrie Agreement, Enron and EDIC will be allocated their respective distributive shares of interest expense paid by Enron Valkyrie. Such interest expense should be deductible by such members of Enron Valkyrie unless precluded or recharacterized by other authority.

In Notice 94-48, 1994-1 C.B. 357, the Internal Revenue Service indicated that.it would scrutinize transactions designed to produce interest deductions with respect to a related issuance of stock. The notice states that although the details of the transactions may vary, they are designed to give the issuing corporation the tax benefits of issuing debt even though the corporation actually issues stock. The transaction described in the notice involves a corporation (X) which created PRS, a partnership, to allow X to achieve its financing objectives. X contributed $20x to PRS in return for a limited partnership interest and GP contributed $5x to PRS. PRS then issued debt instruments (notes) to third-party investors for $80x. Of the $105x in capital raised by PRS, $100x was used to purchase newly issued preferred stock of X. The notice states that X intends to take the position that (a) the dividends it pays to PRS are not income to the extent that they are allocable to X because X, in effect, is paying a dividend to itself, and (b) it is entitled to deduct its distributive share of interest deductions for payments on the notes. The Internal Revenue Service indicates that it believes that the overall substance of the arrangement as to X is simply the issuance of preferred stock and thus, the deduction of interest on the notes is inappropriate. The Internal Revenue Service also notes that even if X were treated as having issued its share of the notes, the notes would be nonrecourse as to X and secured solely by the X preferred stock. Depending on all of the facts and circumstances, the notes would be economically equivalent to debt instruments that are convertible into X preferred stock at the option of X and thus would be treated as equity for federal income tax purposes.[16]

Although Notice 94-48 is broadly drafted and purports to apply to other arrangements, interest paid under the proposed transaction should not be subject to disallowance under the Notice. In contrast to the Notice, the indebtedness issued by Enron Valkyrie is not nonrecourse indebtedness secured only by the stock of RMT. Rather, should Rheingold, Valhalla or Enron Valkyrie fail to pay Minimum Distributions, the Put Price or the Call Price, respectively, Deutsche Bank has full recourse under the Enron Guaranty and offset rights under the Promissory Note. Moreover, the indebtedness arising under the Participation Rights cannot be considered payable in RMT stock or convertible into RMT stock as Deutsche Bank has no right (or obligation) to foreclose on the property held by Rheingold in satisfaction of the indebtedness.

[16] The notice cites Notice 94-47, 1994-1 C.B. 357.

Enron has agreed to guarantee the payment of the Put Price and the Call Price, which includes the payment of any unpaid Minimum Distributions. Certain authorities dealing with corporate debt indicate that where a corporation is thinly capitalized and a loan might not be made but for the guarantee of the shareholder, the loan may be considered indebtedness of the shareholder rather than the corporation. In *Plantation Patterns v. Commissioner*, the court held that purported debt of a corporation should be treated as debt of its shareholder who had guaranteed the loan.[17] The court treated payments of principal and interest by the corporation as constructive distributions to the shareholder and interest as correspondingly deductible by the shareholder.

The thin capitalization analysis as applied to a partnership generally involves the distinction between capital contributions and loans made by a partner rather than an analysis of which party is the primary obligor on indebtedness.[18] However, even if the rationale of the *Plantation Patterns* case could be applied in the partnership context to treat Enron as the primary obligor on the indebtedness, such application should have no adverse effect as all income and deductions, including interest deductions, of Enron Valkyrie will be allocated to its members under the partnership tax rules.

E. Withholding of US Tax

1. General Rules

Sections 881 and 882 of the Code impose tax at the rate of 30 percent on certain types of income including interest and dividends, which is collected through withholding at source pursuant to sections 1441 and 1442 of the Code. Under regulations currently in effect and under regulations that will become effective on January 1, 2001, no withholding is required on payments of such income to a domestic partnership provided the appropriate documentation is obtained by the payor.[19]

The 30-percent tax imposed on interest and dividends under sections 881 and 882 of the Code may be reduced or eliminated under an applicable tax treaty. Under Article 10 of the Treaty, interest derived by a resident of Germany may be taxed only in Germany. Thus, no withholding is required on payments of interest from a U.S. resident to a resident of Germany.

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[17] 462 F. 2d 712(1972).

[18] *See, e.g., Hambuechen v. Commissioner*, 43 T.C. 90 (1964).

[19] *See* Treasury Regulation § 1.1441-5(b) (effective before January 1, 2001); Treasury Regulation § 1.1441-5(b)(1) (effective on January 1, 2001).

2. *Conduit Regulations*

In certain cases, the "conduit" regulations issued under section 881 may recharacterize payments or impose additional taxes on conduit financing arrangements.[20] Treasury Regulation § 1.881-3(a)(2)(i) defines a financing arrangement as a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and the advance and receipt are effected through one or more other persons (intermediate entities), and there are financing transactions linking the financing entity, each of the intermediate entities and the financed entity. Stock in a corporation can constitute a financing transaction if the holder has the right to require the issuer to redeem the stock, or the issuer has the right to redeem the stock and based on the facts and circumstances as of the issue date redemption is more likely than not to occur.[21]

Treasury Regulation § 1.881-3(a)(2)(iii) defines a conduit entity as an intermediate entity whose participation in the financing arrangement may be disregarded in whole or in part. A conduit financing arrangement is defined as a financing arrangement effected through one or more conduit entities.[22] Treasury Regulation § 1.881-3(a)(4) states that an intermediate entity is a conduit entity with respect to a financing transaction if (i) the participation of the intermediate entity in the financing arrangement reduces the tax imposed by section 881 (determined by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would have been imposed as determined under the regulation); (ii) the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and either (A) the intermediate entity is related to the financing entity or the financed entity, or (B) the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.

Treasury Regulation §1.881-3(e), example 9, illustrates the analysis of whether tax has been reduced under section 881 or 882:

> Example 9. Reduction of Tax. (i) On February 1, 1995, FP issues debt to the public that would satisfy the requirements of section 871(h)(2)(A) (relating to obligations

[20] *See generally* Treasury Regulation § 1.881-3. These regulations were issued under authority granted to the Secretary under section 7701(l) of the Code.

[21] Treasury Regulation § 1.881-3(a)(2)(ii).

[22] Treasury Regulation § 1.881-3(a)(2)(iv).

that are not in registered form) if issued by a U.S. person. FP lends the proceeds of the debt offering to DS in exchange for a note.

(ii) The debt issued by FP and the DS note are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(1) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The holders of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Because interest payments on the debt issued by FP would not have been subject to withholding tax if the debt had been issued by DS, there is no reduction in tax under paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

3. *Application of the Withholding Rules to Dividends and Interest*

RMT will pay dividends on the RMT Preferred Stock to Rheingold which, under the analysis described above, should be treated as a German branch of Enron Valkyrie. Enron Valkyrie is a domestic partnership and, accordingly, no withholding should be required on such dividends.

The Minimum Distributions paid by Rheingold to Deutsche Bank with respect to the Participation Rights should be treated as interest paid by a U.S. partnership to a resident of Germany. Deutsche Bank provided a Form W-8 BEN to Enron at the closing of the transactions. Thus, provided Deutsche Bank continues to provide appropriate certification when necessary, no withholding of U.S. tax will be required on such interest payments.

The conduit regulations issued under section 881 should have no applicability to the Financing Transaction. The various transactions may constitute a financing transaction even though the instrument issued by RMT to Rheingold is preferred stock. However, even if the transactions were treated as subject to the rules of Treasury Regulation § 1.881-3, Rheingold (Enron Valkyrie) should not be disregarded as a conduit entity. Interest paid by Enron Valkyrie to Deutsche Bank is not subject to withholding under the Treaty. However, the same result would obtain if the interest were paid by RMT (or treated as paid by Enron under a thin capitalization analysis, as described in D, above) as each of Enron Valkyrie, RMT and Enron is a U.S. resident for purposes of payments of interest to a German resident under the Treaty. Accordingly, there has been no reduction in the tax imposed by sections 881 or 882.

F. *Certain Partnership Issues*

1. *Adjustments to Partnership Basis*

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution, increased by the amount of gain recognized under section 721(b) to the contributing partner at such time. Under section 705, a partner's adjusted basis is increased by his distributive share of taxable income of the partnership and income exempt from tax, and is decreased by losses of the partnership and expenditures of the partnership not deductible in computing taxable income and not properly chargeable to capital account.

Under section 752, an increase in a partner's share of partnership liabilities is treated as a contribution of money to the partnership, and a decrease in a partner's share of such liabilities is treated as a distribution of money. Treasury Regulation § 1.752-2(a) provides that a partner's share of a recourse partnership liability equals the portion of such liability, if any, for which the partner or a related person bears the economic risk of loss. Under Treasury Regulation § 1.752-2(b), a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership assets became worthless and the partnership liquidated, the partner or a related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner (or related person as to that partner).

Enron and EDIC should have an initial basis in their respective interests in Enron Valkyrie equal to the amount of money contributed to Enron Valkyrie and their allocable share of partnership indebtedness under the Rheingold Note. Enron's basis also should include the amount of the obligation to repay the principal amount of the Participation Rights ($2 billion), which it has guaranteed. Dividends received on the RMT Preferred Stock will result in an increase in each partner's basis in its partnership interest, and corresponding interest deductions for the Minimum Distributions and interest on the Rheingold Note will decrease basis.

2. *Unwind and Distribution of Assets*

Section 731(a) provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. Section 737(c)(1) provides that for purposes of subsection (a), the term money includes marketable securities.

Section 731(c)(2)(B) defines marketable securities to include financial instruments that are readily convertible into or exchangeable for, money or marketable securities. A financial instrument is further defined under section 731(c)(2)(C) to include stocks and other equity interests and evidences of indebtedness. Under Section 731(c)(3), however, the foregoing rules do not apply to "eligible partners" of "investment partnerships." An investment partnership is defined in section 731(c)(3)(C)(i) as any partnership provided it has never been engaged in a trade or business and substantially all of its assets have always consisted of certain items including money, stock in a corporation, and notes and other evidences of indebtedness. An eligible partner is defined in section 731(c)(3)(C)(iii) as any partner who, before the date of the distribution, did not contribute to the partnership any property other than assets described in subparagraph (C)(i).

In certain circumstances, the nonrecognition rule of section 731(a) may not apply to the distribution of property by a partnership. In Notice 89-37, 1989-1 C.B. 679, the Internal Revenue Service indicated that regulations would be issued that would provide that a partnership distribution to a corporate partner of stock in such corporate partner (or a member of the affiliated group of which such partner is a member) will be treated as a redemption by the corporate partner of such stock with property consisting of such partner's partnership interest. Therefore, the regulations would provide that section 311(b) rather than section 731(a) will apply and gain (but not loss) will be recognized.

Treasury Regulation § 1.337-3(d), which would apply to distributions that occur after March 9, 1989, was proposed in 1992. The regulation provides that a distribution to a corporate partner of stock in that partner or an affiliate is treated as a redemption or exchange by the corporate partner of its stock for a portion of the corporate partner's partnership interest equal to the value of the stock distributed. Thus, if the partnership interest has appreciated, gain (but not loss) would be recognized by the corporate partner under section 311(b). The proposed regulation has never been finalized and there is no indication when, if ever, the regulation will be finalized.

Section 732(b) provides that the basis of property distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the transaction. Section 732 and the regulations thereunder provide rules for the allocation of basis among different types of assets.

In connection with the termination of the Financing Transaction, it is anticipated that Enron will purchase the interest held by EDIC and thus, Enron Valkyrie will be treated as liquidating and distributing its assets and liabilities to Enron. Under section 731(c), neither the RMT Preferred Stock nor a note issued in redemption of such stock should be considered readily marketable or convertible or exchangeable into money or marketable securities However, even if the RMT Preferred Stock or note could be viewed as readily exchangeable for money, such a distribution should not be subject to the provisions of section 731(c). Under the rules described above, Enron Valkyrie should qualify as an investment partnership as it will not be engaged in a trade or business and will hold only cash, the RMT Preferred Stock, and possibly a note issued by RMT in redemption of such stock. Further, Enron, as a contributor of only money, should be considered an eligible partner.

Following Enron's contribution of funds to Enron Valkyrie, the repayment of the Participation Rights, and the purchase of EDIC's interest, Enron generally should have a basis in its partnership interest in Enron Valkyrie equal to the sum of (i) its initial cash investment, (ii) the cash contributed to repay the Participation Rights (an amount not less than the face amount of the RMT Preferred Stock), (iii) the principal amount of the Rheingold Note, and (iv) the amount paid for EDIC's interest in Enron Valkyrie. Thus, the value and basis of Enron's partnership interest should be approximately equal. However, because the RMT Preferred Stock has a liquidation premium that accrues each year, the RMT Preferred Stock (and thus Enron's partnership interest) could be viewed as having appreciated in value notwithstanding that the parties intend to cause the stock to be redeemed at the end of the five-year period rather than in connection with a liquidation of RMT. Therefore, if Notice 89-37 and the proposed regulations remain outstanding (or have been finalized to require gain recognition for such future appreciation), Enron should cause RMT to redeem the RMT Preferred Stock from Enron Valkyrie prior to the purchase of EDIC's interest so that the assets distributed would include a note payable from RMT rather than the RMT Preferred Stock.

As a result of the deemed liquidation, Enron's basis in its partnership interest in Enron Valkyrie would be reduced by the amount of cash distributed and the remainder of such basis would be allocated to the other assets (the note payable from RMT and the Rheingold Note). Following the liquidation, Enron would be able to offset the note payable from RMT against any outstanding intercompany indebtedness to RMT resulting from the original loan of the proceeds from the sale of the RMT Preferred Stock. Moreover, although the Rheingold Note should be treated as merging out of existence (as Rheingold would now be a division of Enron), it is assumed that for German tax and legal reasons, Rheingold will nonetheless make a payment to Enron in satisfaction of the indebtedness.

OPINION

Based on the facts, law, and analysis set forth above, it is our opinion that for U.S. federal income tax purposes:

(i) each of Valhalla and Rheingold should be treated as an entity disregarded as separate from its owner, Enron Valkyrie;

(ii) the transactions comprising the Financing Transaction, including the purchase of the Participation Rights, the Put and Call arrangements and the purchase of the RMT Preferred Stock, and the Enron Guaranty should be treated as a loan from Deutsche Bank to Enron Valkyrie;

(iii) notwithstanding the issuance of the Series 1 Preferred Stock and the Series 2 Preferred Stock, RMT should continue to be a member of the Enron Group;

(iv) the members of Enron Valkyrie should be eligible for the 100-percent dividends received deduction under section 243 of the Code with respect to dividends from RMT allocated to such members under the Enron Valkyrie Agreement;

(v) the Minimum Distributions paid with respect to the Participation Rights should be treated as interest deductible by the members of Enron Valkyrie;

(vi) dividends paid by RMT to Rheingold should not be subject to U.S. withholding tax; and

(vii) provided Enron Valkyrie continues to receive the appropriate certifications from Deutsche Bank, no withholding of U.S. federal income tax should be required on interest payments made to Deutsche Bank as Minimum Distributions.

We express no opinion as to the tax treatment of any transaction not specifically addressed in the foregoing opinion. Our opinion is based upon the existing provisions of the Internal Revenue Code of 1986, as amended, regulations (and administrative pronouncements) promulgated or proposed thereunder, and interpretations thereof by the Internal Revenue Service and the courts, all as of the date hereof, all of which are subject to change with prospective or retroactive effect, and our opinion could be adversely affected or rendered obsolete by such change.

This opinion is given to you by us solely for your use and is not to be quoted or otherwise referred to or furnished to any governmental agency (other than the Internal Revenue Service in connection with an examination of the transactions contemplated herein) or to other persons without our prior written consent.

Very truly yours,

Vinson & Elkins L.L.P.

VINSON & ELKINS L.L.P.

Houston:145293 v 4

APPENDIX D

APPENDIX D

I. MATERIALS RELATING TO THE DUTIES OF THE ADMINISTRATIVE COMMITTEE FOR THE ENRON QUALIFIED PLANS

To: Administrative Committees of Enron Corp. Tax Qualified Pension Plans

From: Patrick Mackin

Date: December 2, 1996

Subject: Fiduciary Duties of Members of Committees

Enron Crop. sponsors three separate tax qualified pension plans: the Cash Balance Plan (formerly known as the Retirement Plan); the Savings Plan; and the Employee Stock Ownership Plan ("ESOP"). Each separate plan has a separate administrative committee. Each committee is a fiduciary of the plan it administers, as is the plan sponsor, Enron Corp. Committee members are fiduciaries of the plan. This is a summary of the fiduciary duties of members of the committees.

The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), regulates the conduct of fiduciaries with respect to the benefit plans (both pension and welfare plans) for which they have investment and/or administrative responsibilities, by establishing certain basic standards of care they must follow in conducting plan business. ERISA requires that a plan fiduciary discharge his or her duties with respect to an employee benefit plan solely in the interest of the plan's participants and beneficiaries. ERISA Section 404(a)(1)

In the discharge of those duties, the fiduciary must act:

- for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan;
- with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and like aims;
- by diversifying the investments of the plan to minimize the risk of large losses, unless, under the particular circumstances, it is clearly not prudent to do so; and
- in accordance with the documents and instruments governing the plan to the extent that those documents and instruments are consistent with the provisions of ERISA.

ERISA also contains rules:

- prohibiting certain transactions by plan fiduciaries;
- for investment duties, including those regarding the voting of proxies related to plan-owned corporate shares, statements of investment policy, and an investment policy that contemplates the monitoring of the management of corporations in which the plan has invested;

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- for loans to and from plans; and
- for the provisions of other goods and services.

1. Exclusive purpose rule.

   Plan fiduciaries must discharge their duties to the plan solely in the interest of participants and beneficiaries and exclusively to provide benefits to them or to pay reasonable plan administrative costs. ERISA Section 404(a)(1)(A)(A)

   ERISA should not be read as a prohibition against decisions by an employer that have the obvious primary purpose and effect of benefiting employees but, in addition, the incidental side effect of being prudent from the employer's economic perspective. Plan fiduciaries do not violate their duties by taking action that, after careful and impartial investigation, they reasonably conclude best promotes the interests of participants and beneficiaries simply because the action incidentally benefits the employer or themselves. However, their decisions must be made with an eye fixed exclusively on the interests of the participants and beneficiaries. Donovan v. Bierwirth, (1982, CA2) 680 F2d 263, 3 EBC 1417, cert den (1982, S Ct) 459 US 1069, 74 L Ed 2d 631.

   Think of the exclusive purpose rule as a parable of hats. As a matter of circumstance and convenience, the members of each of the three separate administrative committees are the same. However, they can only wear one hat at a time. Each member has four hats: an Enron hat; a Cash Balance Plan hat; a Savings Plan hat; and an ESOP hat. When a fiduciary of one of the plans makes a fiduciary decision with respect to that plan, the fiduciary may wear only that plan's hat, not the Enron hat or the hat of another plan. The fiduciary's ERISA obligation, with respect to such decision, extends to that single plan only. The fiduciary cannot favor the plan sponsor or another plan to the disadvantage of the plan and its participants for which he makes a fiduciary decision.

   As plan sponsor, Enron Corp. is a fiduciary of its plans, but ERISA does not impose a fiduciary duty on an employer to act exclusively in the interest of its employees. Rather, an employer that is also a fiduciary may act in accordance with its own interests as employer when it is not administering a plan or investing its assets. Thus, for example, where benefits are contingent in nature, employers are free to alter or eliminate non-vested benefits unilaterally without consideration of the employees' interests. Owens v. Storehouse Inc, (1991, DC GA) 773 F.Supp. 416, 14 EBC 1550, affd (1993, CA11) 984 F2d 394.

2. Prudent man rule.

   In discharging his or her duties, a plan fiduciary must act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like

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capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. ERISA Section 404(a)(1)(B). The source of the prudent man standard is the objective prudent man test developed in the common law of trusts.

Most cases which have addressed the issue of prudence concern a fiduciary's plan investment decisions. ERISA's prudent man rule does not require that fiduciaries be expert in all matters of plan administration and investment. It does require that plan fiduciaries be competent enough to seek counsel and advice when appropriate. This is a reason why investment managers are engaged to manage the investment of assets of the Cash Balance Plan. While investment managers have their own separate fiduciary obligations, the Committee for the Cash Balance Plan (a defined benefit pension plan as distinguished from an individual account, defined contribution pension plan) cannot abdicate all responsibility to an investment manager. As would a prudent man, the Committee must review from time to time the performance of the investment managers the Committee appoints to manage plan assets. If the Committee does not have the expertise to review the performance of the investment managers, as would a prudent man, it should obtain help to conduct such a review.

3. Diversification of investments.

As a defined benefit plan, the Cash Balance Plan is subject to the diversification requirements of ERISA. A plan fiduciary must diversify plan assets to minimize the risk of large losses, unless it is clearly prudent not to do so. ERISA Section 404(a)(1)(C). In using the term "clearly prudent," Congress did not intend to establish a more stringent standard of prudence. Instead, it intended that in an action for plan losses based on breach of the diversification requirement, the plaintiff's initial burden would be to demonstrate that there had been a failure to diversify. The fiduciary would then have the burden of showing that his or her failure to diversify was prudent. Thus, the basic policy of the Act is to require diversification, and, if diversification on its face does not exist, the burden of justifying a failure to follow this general policy is on the fiduciary who engages in the conduct. H Conf Rept No. 93-1280 (93rd Cong., 2d Sess.), pp. 304, 305.

4. Duty to act in accordance with plan documents.

The fiduciary of a plan subject to ERISA must discharge his or her duties not only in the exclusive interests of beneficiaries and participants and with the diligence of a prudent person, but in accordance with the documents and instruments governing the plan. ERISA Section 404(a)(1)(D). Thus, although ERISA imposes some restrictions on plan provisions, it does permit a specific statement of an administrator's duties, and, if the plan contains such a statement, those provisions control. Offutt v. Prudential Insurance Co, (1984, CA5) 735 F2d 948.

Nonetheless, the fiduciary duty to act in accordance with plan documents does not override the fiduciary's foremost duty to serve the interests of plan participants and

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beneficiaries by adhering to the exclusive purpose rule. Kuper v. Quantum Chem. Corp, (1994, DC OH) 852 F.Supp. 1389.

5. Review of Appeals.

Part of the administration of a pension benefit plan is the review of appeals of plan participants who think that their claims have been improperly denied. Sometimes, participants disagree about the facts or what provisions of the applicable plan documents mean. Sometimes, participants simply want an exception made because of what they think are extenuating circumstances.

With respect to a committee's review of appeals of denied benefits, it is the Committee's fiduciary responsibility to administer the plan according to its terms and provisions. If there is a discrepancy in the provisions of plan documents, the written plan document controls. For example, for the Enron sponsored plans, the summary plan description of the plans, which are distributed to employees, state that in the event of such a discrepancy, the plan document controls. Each plan is established pursuant to a written plan document, and each member of the committee should have copies of and be familiar with the provisions of the plan documents.

In reviewing an appeal, the committee needs to determine what the facts are and the applicable provisions of the plan document. In most cases, the participant making the appeal will submit a written statement explaining the reasons for the appeal. The committee has the duty to administer the plan according to the provisions of the plan document. If the provisions are ambiguous, it is the committee's duty to construe the meaning of an ambiguous word or phrase. The committee should not make exceptions to the provisions of the plan.

It is important for the committee to administer the plan in a uniform and consistent manner. The committee may not administer the plan in an arbitrary or capricious manner. It cannot administer the plan in a way that is contrary to the clear meaning of the provisions of the plan. In construing ambiguities, it has to administer the ambiguity the same way in similar circumstances.

It is not the objective of the committee to deny the payment of benefits which are payable under the plan. ERISA imposes on the committee a fiduciary obligation to administer the plan in the interests of the participants. If a benefit is payable under the plan, it should be paid. When the committee meets and makes determinations with respect to a plan, it is wearing its ERISA fiduciary hat, not an Enron hat.

This fiduciary status of the committee members does not require that all claims be paid or that all appeals be favorably resolved in favor of plan participants. The plan document controls. As plan sponsor, in establishing its pension plans, Enron intended for benefits to be paid when the provisions of the plan provided for payment. If the committee starts to approve payment of benefits in situations where Enron did not intend for benefits to be

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paid, Enron has the ability to either fully terminate the plan or amend it to more clearly exclude payment of benefits in situations where Enron does not intend benefit to be paid.

This is an overview of your responsibilities as members of the committees of the Enron Corp. sponsored tax qualified pension plans. Remember that as committee members you are not wearing Enron hats. You are wearing ERISA plan fiduciary hats, and that you can only wear one hat at a time. Administer the plans according to their provisions. Make no exceptions. You job is not to make exceptions to the provisions of the plans, but to administer the plans according to such provisions.

EC 000000031

The Administration of ESOP, Cash Balance and Savings Plans

Presented by: Patrick Mackin
Prepared by: Catherine Queiroga

D-11

Types of Duties:

Duties:

Administrative | Trustee | Fiduciary

Focus: **Administration of Plans**

D-12

EC 000000910

Administrative Duties:

All Rules and Duties pertain to ESOP, Cash Balance and Savings Plans, unless noted otherwise.

(Sections XIV, XVII and XIII, respectively)

The Rules Concerning Enron Corp.:

- Appointment of Committee by Enron Corp. (Ref. 14.1, 17.1, XIII.1)
  - The Committee is the "Plan Administrator" and "Named Fiduciary"
  - Exceptions:
    - Investment of Assets of the Trust Fund, in which case the Trustee is the Named Fiduciary
    - In the ESOP, Enron Corp. shall be the "Plan Administrator" (Ref. 14.10)
- Enron Corp. to Supply Information (Ref. 14.8, 17.9, XIII.8)
  - It is Enron Corp.'s responsibility to relay full and timely information to both the Committee and the Trustee.
- Indemnification by Enron Corp. (Ref. 14.9, 17.10, XIII.9)
  - Enron Corp. will indemnify each member against any and all expenses and liabilities arising out of his/her administrative and fiduciary functions.
  - Exception: Member's gross negligence and willful misconduct.

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The Rules Concerning the Committee:

- Terms, Vacancies, Resignation, and Removal (Ref. 14.2. 17.2. XIII.2)
  - Members of the Committee will serve until written resignation, death or removal by Enron Corp.
  - Membership automatically ceases at termination of employment with Enron Corp. or with a Controlled Entity of Enron Corp.
- Officers, Records and Procedures (Ref. 14.3. 17.3. XIII.3)
  - The Committee may select officers
  - The Committee appoint a secretary, who need not be a member of the Committee.
  - The Committee shall designate person(s) authorized to sign for the Committee.
- Meetings (Ref. 14.4. 17.4. XIII.4)
  - The Committee must hold meetings at self determined intervals.
  - A majority of the members constitutes a quorum for transaction of business.
  - Resolutions by vote ('meeting' not required if all members sign a consent).

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EC 000000913

The Rules Concerning Individual Members of the Committee:

- Self-Interest of Members (Ref. 14.5, 17.5, XIII.5)
  - A member may not vote on matters where his *individual* rights to claim benefits under the Plan are directly affected.
  - Enron Corp. will appoint a temporary substitute for such member.

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- Compensation and Bonding (Ref. 14.6, 17.6, XIII.6)
  - Members shall not receive compensation.
  - Members shall furnish bond or security for the performance of theirs duties.

Third Party Administrative Services (Ref. 17.8, 14.7, XV.6 - under Fiduciary Provisions)

- Enron Corp. may engage any individual or entity, which is not an employee or a subsidiary of the Company, to perform administrative services with respect to the Plan.

- Enron Corp., not the Committee, shall be fully responsible for selecting, overseeing, monitoring, evaluating, determining fees, and replacing such service provider.

- The Committee shall have no duty or responsibility with respect to such service provider.

Powers and Duties: (Ref. 14.7, 17.7, XIII.7)

The Committee has the power to…

❶ Make and enforce written rules, regulations and bylaws.
(Cash Balance Plan Only) : Copies of these newly created rules must be delivered to the Trustee and the Employer.

❷ Interpret in its discretion all terms, provisions and conditions of the Plan, limited by the IRS Code.

❸ Correct defects, supply omissions, and reconcile inconsistencies that may appear in the Plan.

D-18

Powers and Duties (continued):

❹ Employ and compensate any number of agents the Committee deems necessary for the proper administration of the Plan.

❺ Determine eligibility questions.

❻ Determine participant's rights to benefits and prescribe distribution procedures.

❼ Prepare, file and distribute reporting and disclosure materials.

Powers and Duties:

(ESOP Only)

The Committee has the power to…

- Make a determination as to rights to a benefit under the Plan.
- Receive and review reports from the Trustee. (also applies to Cash Balance)
- Instruct Trustee in the voting of Company Stock and appoint a Voting Fiduciary.
- Select an appraiser to value the Company Stock
- Direct the Trustee as to the purchase and sale of Company Stock.
- Instruct Trustee as to Loans. (also applies to Savings Plan)
- Instruct Trustee as to the management, investment and reinvestment of the Trust Fund.

D-20

Powers and Duties:

(Savings Plan Only)

The Committee has the power to…

- Require and obtain from Enron Corp. and the Participants and their beneficiaries any data or information necessary for the proper administration of the plan.
- Instruct the Trustee as to the loans to Participants.
- Direct the Trustee as to the investment of the Trust Fund in Enron Stock or EO&G.
- Appoint investment managers.
- Direct the Trustee as to the exercise of rights or privileges to acquire, convert, or exchange Enron Stock or EO&G Stock.

D-21

Powers and Duties:

(Cash Balance Plan Only)

The Committee has the power to…

- Issue directions to the Trustee concerning all benefits that are to be paid from the Trust Fund.
- Receive and review reports from the Trustee.

D-22

Types of Duties:

Duties:

Administrative

Trustee

Fiduciary

Focus: **Trustee and Administration of Trust Fund**

D-23

Trustee Duties:

All Rules and Duties pertain to ESOP, Cash Balance and Savings Plans, unless noted otherwise.

(Sections XVI, XVIII and XIV, respectively)

D-24

The Rules Concerning:

- Appointment, Removal, and Replacement of Trustee by Enron Corp. (Ref. 16.1-2, 18.1, XIV.1(a)-(b))
  - The Trustee is the "Named Fiduciary" with respect to investment of the Trust Fund's assets.
  - Trustee may be removed on written notice by Enron Corp.
  - Successor Trustee will be appointed by Enron Corp.
  - Trustee may resign by giving a thirty days' written notice to Enron Corp.
  - NOTE:
    - Resignations and removals will be in effect only after successor Trustee is appointed and qualified.
- Trust Agreement. (Ref. 18.2, XIV.2)
  - The Company and the Trustee have entered into a Trust Agreement, which governs the administration of assets of the Plan and the duties of the Trustee.
  - This Agreement may be amended as the Company deems advisable.

D-25

The Rules Concerning (continued):

- Payment of Expenses. (Ref. 16.7, 18.3, XIV.3)
  - All expenses incident to the administration of the Plan and Trust shall be paid by the Trustee from the Trust Fund. Until paid, such expenses shall constitute a claim paramount to claims of Members and beneficiaries.
  - The Trustee shall receive compensation for services and be reimbursed for all reasonable expenses.
  - NOTE:
    - Members who already receive full-time pay from Enron Corp. or any of its operating companies shall not receive any additional compensation for serving as Trustees.
- Benefit Payments. (Ref. 18.5-6, XIV.5-6)
  - The Committee issues all directions on payable benefits to the Trustee.
  - All distributions shall be made in cash or as an annuity (Cash Balance Plan Only).
  - All benefit payments shall be provided solely from the Trust Fund.
  - Neither the Employer nor the Trustee assumes any liability for the adequacy of such payment.

D-26

The Rules Concerning (continued):

- Trust Fund Property. (Ref. 18.4, XIV.4)
  - All contributions shall be paid to the Trustee.
  - The Committee shall maintain Accounts in the name of each Participant.
  - No Participant or Member shall have any title to any specific asset in the Trust Fund upon termination or otherwise.

- No Benefits to the Employer. (Ref. 18.7, XIV.7)
  - No part of or income from the Trust Fund shall be used for any purpose other than that of:
    - Providing benefits for the Members and their beneficiaries.
    - And of defraying reasonable administrative expenses.

ESOP's Special Provisions :

- Powers of the Trustee (Ref. 16.4)
  - The Trustee shall have, hold, manage, invest, and disburse the Trust Fund as if the Trustee were its owner.
  - The Trustee may not invest the Trust Fund assets in any company security or in any Company real property which is not a "qualifying employer security" or a "qualifying employer real property".
- Investment of Trust Fund in Company Stock (Ref. 16.5)
  - The Trustee may invest up to 100% in Company Stock.
  - The Committee shall determine the extent to which the Trust Fund will be invested in Company Stock and determine the price at which this stock will be purchased or sold.
  - During periods when the Committee restricts the purchase of Company Stock, amounts that would otherwise be invested in Company Stock shall be invested in an interest-bearing account.

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ESOP's Special Provisions (continued):

- Registration of Company Stock (Ref. 16.6)
  - In the event that the disposal of Company Stock requires registration of such stock, the Company, at its own expense, shall take the necessary actions to effect such registration.
- Company Stock Valuation (Ref. 16.12)
  - The Committee may direct that appraisals of the value of Company Stock be made by an independent appraiser annually, or at more frequent intervals, as it deems necessary, in order to assess the stock's fair market value.
- Neither the Company nor any Member may Borrow from the Trust Fund (Ref. 16.4 (b))

D-29

Types of Duties:

Duties:

Administrative | Trustee | Fiduciary

Focus: **Fiduciary Provisions**

D-30

Fiduciary Duties:

All Rules and Duties pertain to ESOP, Cash Balance and Savings Plans, unless noted otherwise.

(Sections XVII, XIX and XV, respectively)

D-31

Article Controls:
(Ref. 17.1, 19.1, XV.1)

This Article shall control over any contrary, inconsistent, or ambiguous provisions contained in the Plan.

Allocation of Duties:
(Ref. 17.2, 19.2, XV.2)

- Each Fiduciary shall have only those powers given under the Plan and shall be exclusively responsible for the proper exercise of such powers.
- The Company shall appoint/remove Trustee and members of the Committee.
- The Committee shall have sole responsibility for the administration of the Plan.
- The Trust shall have sole responsibility for the administration of the Assets held under the Plan, **unless directed otherwise by written notice from the Committee (co-fiduciary).**

D-33

The Investment Manager:

(Ref. 17.4-5, 19.4-5, XV.4-5)

- The Committee may appoint subcommittees, individuals or any other agents in writing, whose acceptances shall also be in writing.
- The Committee may appoint an "investment manager" to manage, acquire or dispose of any asset of the Plan and to direct the Trustee in this regard, so long as such manager:
  - Is registered as an investment adviser, a bank, or an insurance company qualified to do business under the laws of more than one state.
  - Acknowledges in writing that he is a fiduciary with respect to the Plan.
- The Committee members and the Trustee shall not be liable for the acts or omissions of such investment manager or of any such delegatees.
- The investment manager may be removed at the Committee's sole discretion.

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Fiduciary Duty:
(Ref. 17.3, 19.3, XV.3)

- Each fiduciary under the Plan shall discharge his/her duties:
  - Solely in the interest of the Members
  - By abiding by the Reasonably Prudent Person Standard
  - By diversifying the investments as to minimize risk
  - In accordance with the Plan and applicable law

- No fiduciary shall cause the Plan or Trust Fund to enter into a "prohibited transaction".

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II. MATERIALS RELATING TO CHANGES TO THE ENRON ESOP AND CASH BALANCE PLANS

ENRON CORP

Interoffice Memorandum

To:	Distribution		
From:	Mary Joyce Mary	Department:	Corporate Benefits
Subject:	RETIREMENT PLAN CHANGES AND ESOP ACCESS QUESTIONS AND ANSWERS	Date:	January 31, 1995

Attached are the questions and answers regarding retirement plan changes and ESOP Retirement Subaccount and Special Allocation Subaccount access.

We will have a "Brown Bag" meeting on February 7, 1995 from 11:30 a.m. to 1:00 p.m. in 17C2 to review and discuss the questions and answers with Phil.

If you have any questions please call BRI at 853-7123 or 853-6069, Michael Feuerbacher at 853-6891, or me at 853-3993.

c: Phil Bazelides
Michael Feuerbacher

THESE QUESTIONS AND ANSWERS ARE FOR USE BY HUMAN RESOURCE PERSONNEL ONLY IN RESPONDING TO QUESTIONS FROM EMPLOYEES ABOUT ACCESS TO THE ESOP RETIREMENT SUBACCOUNT, HOW THE ESOP OFFSET IS DETERMINED, AND THE NEW CASH BALANCE FORMULA FOR THE RETIREMENT PLAN.

THESE QUESTIONS AND ANSWERS ARE NOT TO BE COPIED AND ARE NOT TO BE MADE AVAILABLE TO INDIVIDUALS WHO ARE NOT HUMAN RESOURCE PERSONNEL.

SOME OF THE ANSWERS IN THESE QUESTIONS AND ANSWERS ARE STILL IN THE DESIGN PHASE AND MAY CHANGE. WHILE THE ANSWERS INDICATE THE DESIGN PREFERENCES OF ENRON CORP., THE CHANGES BEING MADE ARE SUBJECT TO COMPLEX FEDERAL REGULATION AND ARE SUBJECT TO ADOPTION OF FORMAL AMENDMENTS TO THE AFFECTED PLANS BY THE COMPANY'S BOARD OF DIRECTORS AND RECEIPT OF A FAVORABLE DETERMINATION LETTER FROM THE IRS AS TO THE QUALIFIED STATUS OF THE PLANS.

January 1995

EC000020183

RETIREMENT PLAN CHANGES

Questions and Answers

1. ***Why is the Retirement Plan changing?***
   With the final allocation of the Employee Stock Ownership Plan (ESOP), Enron decided to implement a retirement plan that simplifies the Retirement Plan benefit formula and makes the benefit more portable while meeting the changing needs of Enron's workforce. This change also enables employees to take advantage of the strong performance of Enron stock in the ESOP and is projected to result in benefit improvements for approximately 97% of Enron employees for at least ten years into the future.

2. ***Why did Enron choose a 5% allocation for the cash balance formula?***
   The new 5% of pay "cash balance" formula is competitive with other companies' retirement benefits, plus it is easy for employees to understand and track the value of their retirement benefit.

3. ***How are Retirement Plan assets credited to my account under the new cash balance formula?***
   The cash balance benefit formula bases your benefit under the Retirement Plan on the value of a hypothetical account. Each member under the plan has a hypothetical account. This is not an actual individual account of the kind maintained in the ESOP and the Savings Plan, but rather cash balance accounts are nominal accounts, used essentially as a bookkeeping measure that forms the basis of the defined pension benefit under the Retirement Plan. A hypothetical employer contribution will be credited to member accounts on an annual basis. Interest credits will be credited on a monthly basis after December 31, 1996. A member's pension benefit under the cash balance formula is defined as the actuarial equivalent of a member's hypothetical account. The use of "account" is a convenient and easily understood expression for the "look and feel" of a member's cash balance defined benefit.

4. ***How much money is this new program saving Enron?***
   The Enron Management Committee made the decision to change the Retirement Plan benefit formula because the new formula better matches our vision for future workforce benefit plans. It was not a cost savings decision. Enron will receive an up-front reduction in the Retirement Plan's expense for 1995 because of the ESOP. However, for each of the next nine years, the new formula is more expensive than the old formula and for the entire 10-year period, it is slightly more expensive for Enron. Under the new formula, Enron is also expected to contribute more cash on an accelerated basis than under the old formula.

5. ***Even though EOTT is not participating in the All-Employee Stock Option Plan, are they participating in the new Retirement Plan?***
   Yes. EOTT participates in all Enron qualified benefit plans. The All-Employee Stock Option Plan is not a qualified benefit plan.

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6. *In addition to a lump sum distribution, what are the other payment options from which I can choose under the cash balance formula?*

   It is our intent to offer a lump sum distribution, Single Life Annuity, 50% Joint and Survivor, 100% Joint and Survivor, as well as a 5-, 10-, and 15-Year Certain and life annuity.

7. *Why is the 5% cash balance formula allocation put into the Retirement Plan instead of into the Savings Plan?*

   The new 5% cash balance formula represents a simplified Retirement Plan formula, which is funded by employer contributions. The Savings Plan consists entirely of employee contributions. Typically, employer contributions to a savings plan are in the form of matching contributions, which would only benefit employees who could afford to save.

8. *If someone leaves employment during 1996, what happens to their 5% cash balance allocation?*

   A pro rata 5% cash balance allocation will be placed into participants' accounts following the calendar year ending December 31, 1996. After the allocation has been made, a former employee may request a distribution of the vested cash balance account balance. Thus, employees terminating in 1996 will have their first opportunity to receive a vested cash balance distribution in the first quarter of 1997. Thereafter, terminated employees may elect to receive a vested cash balance distribution in any month.

9. *Can I roll over other qualified plan distributions into the new cash balance formula Retirement Plan?*

   No. However, active employees may roll over qualified plan distributions into the Enron Savings Plan, which currently has ten investment options.

10. *If I leave Enron, can I roll over my vested cash balance account into the Enron Savings Plan?*

    No. Only an active Enron employee may roll over a qualified plan distribution into the Savings Plan.

11. *When does the 10% tax penalty apply to distributions from the Retirement Plan (cash balance formula)?*

    The 10% tax penalty generally applies to any distribution or withdrawal received before age 59½. The 10% penalty does not currently apply if you retire from Enron on or after your 55th birthday and take a total distribution.

12. *Can employees who retire or leave employment earlier than age 55 avoid the 10% tax penalty?*

    Yes. Generally, you can elect to take an immediate annuity (regardless of age) from a qualified plan including a qualified IRA without incurring the 10% tax penalty. Also, you can elect to take a lump sum distribution from a qualified retirement plan and roll it over into another qualified plan or IRA to avoid the 10% tax penalty.

13. ***How is the Treasury Bond yield calculated?***

The interest, or yield, for a Treasury bond (which is long-term debt issued by the U.S. government) is based on economic factors at the time of issuance. The interest credit will be calculated as follows:

Assume the Treasury bond yield is 7.90% (paid twice a year). The effective annual yield would be 8.06% (7.90% $\div$ 2 = 3.95%, $[1.0395]^2$ = 8.06%). Thus, the monthly interest credit in this example would be .648% ($[1.0806]^{1/12}$ = .648%).

14. ***Does the 50% Joint and Survivor Pre-retirement Death Benefit apply to the Retirement Plan?***

The 50% Joint and Survivor Pre-retirement Death Benefit applies to accrued benefits earned prior to January 1, 1987 and to accrued benefits earned from January 1, 1987 to December 31, 1994, but only to the extent that this amount is NOT offset by the share value in the ESOP Retirement Subaccount.

Under the cash balance formula, vested benefits earned on or after January 1, 1996 can be distributed as a single lump sum payment. 100% of the account will go to the eligible survivor. We anticipate that a joint and survivor annuity may also be available.

15. ***How is the 50% Joint and Survivor Death Benefit going to work with the Prudential annuities? Does this benefit still apply in this case?***

When the InterNorth Retirement Plan was terminated on June 30, 1986, accrued retirement benefits earned under the InterNorth Plan were funded by annuities purchased through Prudential. The Pre-retirement Death Benefit providing for a 50% Joint and Survivor annuity based on the InterNorth Plan accrued benefit as of June 30, 1986 will continue to apply to married participants of the InterNorth Plan. However, participants with Prudential annuities (former InterNorth Retirement Plan participants) are still eligible for an enhanced Pre-retirement Death Benefit if death occurs after age 50 with at least 5 years of service. This benefit provides the eligible surviving spouse with 50% of the Prudential annuity.

16. ***If an employee's accrued benefit from January 1, 1987 through December 31, 1994 (the offsetable period) is in fact fully offset by the value of the employee's ESOP Retirement Subaccount, will the employee's spouse be eligible for a Joint and Survivor benefit or any form of payment under the Retirement Plan for the offsetable period?***

No. The accrued benefit for the offsetable period under the Retirement Plan is fully offset and reduced to zero. However, the shares of Enron common stock in the ESOP Retirement Subaccount at the time of an employee's death will go to the employee's surviving spouse, unless the spouse has consented to the employee's designation of a another beneficiary.

17. *How was the "Grandfathered Group" determined and why is the Special Provision only extended seven years to the year 2002?*

The grandfathered group (those eligible for the Special Provision that provides the better of the old or new benefit formula for seven years) was extended to employees who are at least age 50, because they would be eligible over the next five years to elect to retire upon or after attaining age 55. The seven-year period provides the opportunity for employees who are currently age 55 or older to retire at age 62. Retirement benefits elected at or after age 62 are unreduced for early retirement.

18. *Are employees on disability eligible for the "Grandfathered Group"?*

Yes. If you are disabled as defined under the Long Term Disability Plan, you are eligible for this Special Provision.

19. *If I am eligible for the Special Provision (age 50 with five years of accrual service), will I have full access to my ESOP Retirement Subaccount in January 1996 even though I do not plan to retire before January 1, 2002?*

Yes. Everyone that is age 50 with five years of accrual service on January 1, 1995 will have full access to the ESOP Retirement Subaccount as of January 1996. However, it is Enron's intention that these employees will have the same phased-in access to the vested shares in their ESOP Special Allocation Subaccount as all other employees.

20. *If I die or become disabled, is there immediate 100% access to the ESOP Retirement Subaccount and the Special Allocation Subaccount?*

Yes, 100% access to the ESOP Retirement and Special Allocation Subaccount is provided in the event of death or disability (as defined under the Long Term Disability Plan).

21. *On what date will my ESOP offset be calculated from my ESOP Retirement Subaccount balance?*

A separate offset will be calculated for each 20% portion of your ESOP Retirement Subaccount as the amounts become accessible to you. The intent is that the first ESOP offset will be calculated on the shares accessible from the Retirement Subaccount as of January, 1996. The second ESOP offset calculation will be based on shares accessible from the Retirement Subaccount as of January 1997; the third as of January 1998; the fourth as of January 1999; and the fifth as of January 2000.

Note: The specific day in January will probably be the closing price on the first trading day of the year.

22. *What happens to the dividends on the shares in the ESOP Retirement Subaccount?*

Currently, dividends on shares in the ESOP Retirement Subaccount are being credited to participant accounts. We are reviewing other alternatives.

23. ***Will the dividends on shares in the ESOP Retirement Subaccount be used to offset accrued benefits under the Retirement Plan?***

Currently, dividends are included in the calculation of the offset of benefits earned under the Retirement Plan. This method is being reviewed; and if any changes are made, they will be communicated to you.

24. ***How do stock price changes affect the ESOP offset valuation after I have access?***

The ESOP offset is valued on the closing market stock price as of the date of access. Any price changes after the date of access, up or down, will not change the calculation of an offset determination once it has been made.

25. ***Is the 1994 five percent ESOP Special Allocation Subaccount included in the ESOP offset to the Retirement Plan?***

No. The Special Allocation Subaccount is not included in the ESOP offset, because it is in lieu of a 1995 five percent cash balance allocation.

26. ***Why is the ESOP Special Allocation Subaccount not as "portable" as the new 5% cash balance account?***

The ESOP Special Allocation Subaccount allocation is in lieu of any benefit accrual for 1995 under the Retirement Plan. However, because this ESOP Subaccount is still part of the ESOP, it makes sense to have the same access as the ESOP Retirement Subaccount, subject to vesting.

27. ***Why wasn't there an allocation to the ESOP Retirement Subaccount on December 31, 1994?***

The value of most employees' ESOP Retirement Subaccount currently exceeds the amount of the retirement benefits accrued from January 1, 1987 through December 31, 1994 under the Retirement Plan. Also, as you may recall, the ESOP Retirement Subaccount was front-end loaded in 1987 with about 25% of salaries going into the accounts. Thus, it made sense to use the allocation in other ways that are more beneficial to employees (for instance, the 1994 Special Allocation Subaccount allocation).

28. ***What was the price used and the allocation basis for the 10% ESOP Savings Subaccount allocation and the 5% Special Allocation Subaccount Allocation?***

In 1994, the allocation to both the ESOP Savings Subaccount and Special Allocation Subaccount was based on the 1994 average daily closing market price of $30.788. The allocation basis for the Savings Subaccount was annual 1994 base compensation while for the Special Allocation Subaccount it was December 1994 base compensation annualized.

29. ***Was the full 5% Special Allocation net of dividends allocated to my account?***

No. We estimate that the shares allocated will be approximately 4.4% - 4.6%, net of dividends. The difference will be made up in the cash balance allocation in 1996.

30. ***Why was the ESOP Retirement Subaccount 100% super-vested and not the ESOP Savings Subaccount or the Special Allocation Subaccount?***

When Enron committed to change the Retirement Plan formula to a cash balance formula, management believed that to assist in the transition all employees should be 100% vested in the Retirement Plan benefit earned as of December 31, 1994. Since the ESOP Retirement Subaccount coordinates with the Retirement Plan benefit, the ESOP Retirement Subaccount was also 100% super-vested. The ESOP Savings Subaccount and the Special Allocation Subaccount do not coordinate with the Retirement Plan benefit and were not super-vested.

31. ***Will I receive a report showing my estimated January 1, 1987 and December 31, 1994 accrued benefit under the Retirement Plan?***

Yes. Employees should receive a statement in the second quarter of 1995 containing the estimated January 1, 1987 through December 31, 1994 accrued benefit under the Retirement Plan. Employees will also receive communication that will enable them to determine the estimated value of their ESOP Retirement Subaccount as compared to their estimated Retirement Plan accrued benefit for this time period. This will allow employees to see the excess value in their ESOP Retirement Subaccount as of December 31, 1994, if any. Until you gain access to your ESOP Retirement Subaccount, the excess value changes proportionately to changes in the market value of shares of Enron common stock in your ESOP Retirement Subaccount.

32. ***How were part-time employees' salaries valued for the 1994 ESOP allocations to the Savings Subaccount and the Special Allocation Subaccount?***

Part-time employees who worked at least 1000 hours in 1994 received an allocation to both the ESOP Savings and Special Subaccounts, based on their monthly benefit rate.

33. ***How will part-time employees' salaries be valued for the 1996 five percent cash balance allocation under the Retirement Plan?***

The new 5% cash balance annual contribution under the Retirement Plan for all employees (including eligible part-time) will be based on their monthly benefit rate.

34. ***Why are the ESOP allocations and cash balance formula allocation only based on my base monthly salary?***

It is competitive to use the monthly benefit rate as the basis for determining benefits under the qualified plans. We are committed to maintaining competitive base pay levels. In addition, employees do have an opportunity to achieve total compensation that exceeds competitive levels through incentive pay and stock-based programs.

35. ***Are the shares of stock in the ESOP Retirement Subaccount actually in the employee's name?***

No. Shares in the ESOP (including the Retirement Subaccount) have been earmarked ("allocated") for the benefit of participants, but the shares are not registered in participants' names; they are owned by the ESOP Trust until distributed to participants, at which time a change in the registered owner of the shares is made.

36. *Can I take a total share withdrawal from the ESOP at retirement age (55 or older)?*

If a participant elects to retire from active employment at retirement age and the participant is 100% vested, the participant can elect to receive a total share distribution.

37. ***Why does the ESOP Retirement Subaccount and Special Allocation Subaccount have a phased-in access period and not immediate access?***

The phased-in access period allows the accessible shares to be potentially withdrawn over a period of time, so that not all of the shares hit the market in a given year as this could have a negative impact on the stock price. In addition, this allows you to lock in the offset at multiple points in time and continue to focus on increasing the value of Enron stock through your efforts. Lastly, it was approved by the Department of Labor as an acceptable approach to winding down the ESOP offset.

38. ***Will Enron provide any investment education for employees to better understand asset management?***

Yes. Enron plans to provide investment education literature to employees as well as offer some classroom-type educational sessions.

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ESOP RETIREMENT SUBACCOUNT AND SPECIAL ALLOCATION SUBACCOUNT ACCESS

Questions and Answers

Eligibility

1. *Who is eligible for access to the ESOP in January 1996?*

<u>ESOP Retirement Subaccount</u>

If you are an active or former employee and have an ESOP Retirement Subaccount balance, you will have access to it in annual 20% increments over a five-year period beginning January 1996. Grandfathered participants, as defined in the Special Provision, can access 100% of this Subaccount in January 1996.

<u>ESOP Special Allocation Subaccount</u>

If you are an active employee and have an ESOP Special Allocation Subaccount, you will have access to your vested portion in the same annual 20% increments as the ESOP Retirement Subaccount (subject to IRS restrictions explained in questions 5, 7, and 8). Grandfathered participants (Special Provision) can only access this Subaccount in 20% increments beginning January 1996.

2. *If I terminate employment (non-retirement), when can I request a distribution of my shares?*

<u>ESOP Retirement Subaccount</u>

Just like active employees, former employees may request a distribution of their Retirement Subaccount in 20% increments beginning January 1996. The ESOP is processed on a monthly cycle. Generally, a distribution request received by the 20th of the month is processed as of the end of the month. Due to the potential volume in January 1996, a distribution request form must be received by December 1, 1995.

<u>ESOP Special Allocation Subaccount</u>

Just like active employees, former employees may request a distribution of only the <u>vested</u> shares in their ESOP Special Allocation Subaccount in 20% annual increments beginning January 1996. The ESOP is processed on a monthly cycle. Generally, a distribution request received by the 20th of the month is processed as of the end of the month. Due to the potential volume in January 1996, a distribution request form must be received by December 1, 1995. The 24-month IRS restriction does not apply to former employees.

3. *If I retire (age 55 or older), when can I request a total distribution of my shares?*

<u>ESOP Retirement Subaccount</u>

If employees elect to retire, they can request a total distribution of their shares any time after their retirement date.

<u>ESOP Special Allocation Subaccount</u>

Same.

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4. *When will I be informed as to the ESOP amount I am eligible to withdraw?*
ESOP Retirement Subaccount

You will begin to see the withdrawable amounts on your September 30, 1995 quarterly Statement of Account. This amount will not reflect 4th quarter dividends.

ESOP Special Allocation Subaccount

Same.

5. *How do I determine the number of shares I can withdraw?*
ESOP Retirement Subaccount

Because you are 100% vested in the ESOP Retirement Subaccount, you will have access of up to one-fifth (20%) of your ESOP Retirement Subaccount beginning January 1996. Grandfathered participants (Special Provision) can access 100% of the Subaccount in January 1996.

ESOP Special Allocation Subaccount

You may only withdraw the vested amount to which you have access in the ESOP Special Allocation Subaccount. If you have less than five years of service, an IRS restriction limits your withdrawal to the shares that have been allocated to your account longer than 24 months. Grandfathered participants (Special Provision) can only access this Subaccount in annual 20% increments beginning January 1996.

6. *What is the ESOP vesting schedule?*
Vesting represents your percentage of ownership in your account. Your vested shares cannot be forfeited. The process of becoming vested in shares allocated to your account depends on your years of service. The vesting schedule based on your full years of service using your anniversary date is as follows:

ESOP Retirement Subaccount

As of December 31, 1994, all active employees became 100% vested in their ESOP Retirement Subaccount.

ESOP Special Allocation Subaccount

Full Years of Service	Vested Interest
Less than 1 year	0%
1 year	25%
2 years	50%
3 years	75%
4 years or more	100%

7. *I have less than five years of ESOP participation; how do I determine the number of shares I can withdraw from the ESOP?*

ESOP Retirement Subaccount

Since this Subaccount was 100% vested on December 31, 1994, the number of shares you can withdraw from the ESOP Retirement Subaccount is simply the phased-in access amount, which is in annual 20% increments beginning January 1996 There is no IRS restriction because no allocations have been made during the prior 24 months.

ESOP Special Allocation Subaccount

The number of shares you can withdraw from the ESOP Special Allocation Subaccount is in annual increments of 20% of your vested shares.

If you have less than 5 years of participation, an IRS restriction limits your withdrawal to shares that have been allocated longer than 24 months.

Below is an example showing the number of shares that can be withdrawn on each of the first three access dates for a participant with less than 5 years of participation. The example is based on the following assumptions:

- Hire date of June 1, 1993.
- More than 2 years of service as of January 1996, therefore 50% vested.
- Less than 5 years of ESOP participation; therefore, IRS 24-month restriction applies.
- 100 shares were allocated to the ESOP Special Allocation Subaccount on December 31, 1994.

The number of shares eligible to be withdrawn in this example is determined by the following formula:

	Jan.* 1996	Jan.** 1997	Jan.*** 1998
A. Total Shares Allocated	100	100	100
B. x Vesting Percent	50%	75%	100%
C. = Vested Shares	50	75	100
D. x Available Fifth(s)	20%	40%	60%
E. = Available Shares	10	30	60
F. - Previous Withdrawals	- 0	- 0	-30
G. Available Before IRS Restriction is applied	10	30	30
H. Available After IRS Restriction is applied	0	30	30

Note: This example excludes dividends which may purchase additional shares.

* The number of shares withdrawn cannot be greater than the number of shares allocated to the account longer than 24 months because this employee has less than five years of ESOP participation. In this example, no shares are available for withdrawal in January 1996.

** By January 1997, the employee did not withdraw any shares. The employee has passed his/her third anniversary of employment (June 1, 1996) and is now 75% vested. Also, the shares allocated 12/31/94 have been allocated longer than 24 months. In January 1997, 30 shares become available for withdrawal.

*** By January 1998, the employee has already withdrawn 30 shares. Also, the fourth anniversary of employment (June 1, 1997) has passed and the employee is now 100% vested. In 1998, an additional 30 shares are available for withdrawal.

As soon as an employee reaches five years of ESOP participation, the IRS 24-month restriction no longer applies.

8. *I came to Enron through an acquisition (e.g., Tenneco, Access Energy, LRC), and service with my previous employer was recognized by Enron for ESOP vesting purposes. What effect does this have in determining the amount available for withdrawal?*

<u>ESOP Retirement Subaccount</u>

This will not have any impact on the amount you can withdraw from the ESOP Retirement Subaccount. In fact, you will be able to withdraw the accessible amount of shares by January 1996 because no allocations will have been made during the prior 24 months and this Subaccount was 100% vested on December 31, 1994.

<u>ESOP Special Allocation Subaccount</u>

The IRS restricts the withdrawable amount available for participants with less than 5 years of <u>plan participation</u>. Recognizing your prior service for vesting purposes has no effect on your years of actual participation in the ESOP. Participants with less than 5 years of ESOP participation will not be allowed to withdraw allocations made during the prior 24 months.

9. *Can I request a smaller amount than the total amount available for withdrawal?*

<u>ESOP Retirement Subaccount</u>

Yes. For example, if you are eligible to withdraw 300 shares, you may request fewer shares.

<u>ESOP Special Allocation Subaccount</u>

Same.

Alternatives

Leave in ESOP

10. *Do I have to take a distribution? What happens if I do nothing?*

ESOP Retirement Subaccount

You are not required to take a distribution. If you do not wish to take a distribution, your shares will continue to be held in the ESOP Retirement Subaccount. Leaving your shares in the ESOP may allow you to continue to benefit from the growth potential of Enron's stock. By leaving your shares in the ESOP, you have made an investment decision to invest in Enron common stock. You are, however, required to withdraw all your shares by April 1 of the year following the year you reach age 70 1/2.

ESOP Special Allocation Subaccount

Same.

Transfer to the Enron Corp. Savings Plan

11. *How do I roll over my ESOP Retirement Subaccount and Special Allocation Subaccount to the Enron Corp. Savings Plan, and when will my Savings Plan account be credited with the shares?*

ESOP Retirement Subaccount

As an active employee, you may withdraw shares from the ESOP and request that they be transferred directly to the Enron Corp. Stock Fund in the Enron Corp. Savings Plan. To do this, on the ESOP Distribution Request Form, you elect a rollover of shares to the Enron Corp. Savings Plan by the 20th of any month. Due to the potential volume in January 1996, a distribution form must be received by December 1, 1995. The shares transferred to the Savings Plan will be credited to your account in the Enron Corp. Stock Fund using the closing market price of the shares on the day the Savings Plan Trustee receives the shares. This will also be the same day the shares are transferred out of the ESOP at the closing market price. It is anticipated that the transfer will be made as of the first trading day in 1996.

ESOP Special Allocation Subaccount

Same.

12. *Can I place my ESOP distribution directly into any investment fund in the Enron Corp. Savings Plan?*

ESOP Retirement Subaccount

No. Any shares transferred from the ESOP to the Savings Plan will be deposited in the Savings Plan's Enron Corp. Stock Fund. After the shares of stock are credited to the Enron Corp. Stock Fund account, you may request a transfer to any of the other Savings Plan investment funds. Savings Plan fund transfers can be done on a daily basis via the BRI Administration Phone Line (1-800-316-7526).

ESOP Special Allocation Subaccount

Same.

13. *I am not currently a participant in the Enron Corp. Savings Plan; can I open an account for an ESOP rollover without making monthly contributions to the Savings Plan?*

ESOP Retirement Subaccount

Yes. If you are an active employee, you may enroll in the Enron Corp. Savings Plan at any time. It is not necessary to make a monthly contribution to the Enron Corp. Savings Plan if you elect to roll over shares from your ESOP Subaccount into the Enron Corp. Savings Plan.

ESOP Special Allocation Subaccount

Same.

14. *If I elect a rollover to the Enron Corp. Savings Plan, how soon can I apply for a loan? How much can I borrow?*

ESOP Retirement Subaccount

You may borrow from your Enron Corp. Savings Plan account any time after the ESOP rollover has been credited to your account. By submitting the ESOP Distribution Request Form to BRI by the **20th** of any month (by the 1st of December 1995 due to the potential volume in January 1996), your rollover will be credited to your Savings Plan account usually by the end of the first week of the following month.

You may borrow up to 50 percent of your Savings Plan account balance up to a maximum of $50,000 and you are allowed to have two loans at one time. However, the $50,000 limit is further reduced by the highest previous loan balance outstanding during the 12-month period ending on the date that a loan application is made (even though the previous loan may have been repaid). Non-home loans can be repaid over a period of one to five years. Loans for the purchase or construction of a home can be repaid over a period of up to fifteen years. To find out how much you can borrow from the Savings Plan and to initiate a loan, call the BRI toll-free phone line 1-800-316-7526.

ESOP Special Allocation Subaccount

Same.

15. *After transferring the ESOP to the Enron Corp. Savings Plan, can I use the ESOP to pay off an existing Savings Plan loan(s)?*

ESOP Retirement Subaccount

No. Loans must be repaid through after-tax payroll deductions or by personal check. Amounts received as a rollover are placed in the plan on a tax-deferred basis and cannot be used to pay off a loan. You could elect to receive an ESOP withdrawal (subject to ordinary income taxes and the 10 percent excise tax, if applicable) and use the proceeds to pay off your Savings Plan Loan(s).

ESOP Special Allocation Subaccount

Same.

16. *Will a rollover to the Enron Corp. Savings Plan count toward the 1995 IRS before-tax annual contribution maximum of $9,240?*

ESOP Retirement Subaccount

No. The IRS annual maximum does not apply to rollovers.

ESOP Special Allocation Subaccount

Same.

17. *If I roll over ESOP shares to the Enron Corp. Savings Plan and later wish to withdraw some of this rollover amount from the plan, is it subject to hardship withdrawal rules?*

ESOP Retirement Subaccount

No. There are no restrictions placed on withdrawals of rollovers to the Savings Plan. However, the withdrawal of the rollover amounts from the Savings Plan is subject to ordinary income taxes and 10 percent excise tax, if applicable.

ESOP Special Allocation Subaccount

Same.

Rollover Shares to an IRA

18. *How do I perform a rollover (direct transfer) to my IRA?*

ESOP Retirement Subaccount

On the ESOP Distribution Request Form, you must provide the name and address of the institution holding your IRA along with your IRA account number. A stock certificate will be mailed to the institution.

ESOP Special Allocation Subaccount

Same.

19. *Can my ESOP distribution be wire transferred directly into my IRA?*

ESOP Retirement Subaccount

No. Distributions will be in the form of stock certificates.

ESOP Special Allocation Subaccount

Same.

20. *How many times can I direct a transfer from a qualified plan to an IRA in one calendar year?*

ESOP Retirement Subaccount

There is no limit to the number of times that you can direct a transfer from a qualified plan to an IRA in any given year.

ESOP Special Allocation Subaccount

Same.

Withdraw Shares From ESOP

21. *Will I receive a stock certificate, or can I ask that my shares be sold?*

ESOP Retirement Subaccount

If you are an active employee, you may not elect a cash distribution. You will receive a stock certificate only. Partial shares are distributed in cash, which is subject to tax withholding. When you receive your stock certificates, you may elect to hold the certificates or sell them yourself through your local broker, through BRI, or through PaineWebber, our All-Employee Stock Option Plan Administrator.

ESOP Special Allocation Subaccount

Same.

22. *Can I request to receive part of the distribution in cash and the remainder in stock?*

ESOP Retirement Subaccount

No. The distribution must be in shares of stock.

ESOP Special Allocation Subaccount

Same.

23. *Will the number of shares I sell have an impact on the market price?*

ESOP Retirement Subaccount

Your single action should not affect the price of the stock. However, it is possible that a large number of shares sold at one time by many people may cause a temporary decrease in the market price.

ESOP Special Allocation Subaccount

Same.

24. ***When will I receive a distribution that was submitted in December 1995?***

ESOP Retirement Subaccount

If you request a December 1995 distribution (forms must be submitted by December 1), you should receive the stock certificate in late January 1996.

ESOP Special Allocation Subaccount

Same.

25. ***If I elect to withdraw my ESOP balances, who will send the distribution to me?***

ESOP Retirement Subaccount

A stock certificate will be mailed to you from the transfer agent, First Chicago Trust Company of New York. If you have a question about a certificate, contact a BRI representative at 1-800-332-7979 (press one). In the Houston area, call 853-7979 (press one).

ESOP Special Allocation Subaccount

Same.

Election Process

26. ***How do I elect a distribution on the first access date, January 1996?***

ESOP Retirement Subaccount

If you wish to request a distribution payable in January 1996, complete an ESOP Distribution Request Form, which will be mailed to you in October 1995 along with your ESOP quarterly statement of account. Forms returned to BRI **by December 1, 1995**, will be processed by December 31, 1995, and you will receive your stock certificate in late January 1996.

ESOP Special Allocation Subaccount

Same.

27. ***If I do not request a distribution in December 1995, when will I next be allowed to request a distribution?***

ESOP Retirement Subaccount

If you do not request a distribution in December 1995, you may request a distribution any month thereafter by returning your form to BRI by the 20th of the month.

ESOP Special Allocation Subaccount

Same.

28. *If I wait until January 1997, can I withdraw two-fifths (40%) of my vested ESOP Retirement Subaccount and Special Allocation Subaccount?*

ESOP Retirement Subaccount

Yes. Any amount that you do not withdraw will be added to the future amounts available for withdrawal.

ESOP Special Allocation Subaccount

Yes. Any amount that you do not withdraw will be added to the future amounts available for withdrawal. The withdrawal amount may be subject to the 24-month IRS restriction as mentioned in the answer to question 7.

29. *Is it possible to receive some of my ESOP distribution as a withdrawal and some as a rollover to either the Enron Corp. Savings Plan or an IRA?*

ESOP Retirement Subaccount

Yes. You may elect to receive a partial ESOP withdrawal (subject to ordinary income taxes and the 10 percent excise tax, if applicable) and/or a partial rollover to an IRA or to the Savings Plan. However, **only one of these transactions can be processed per month.**

ESOP Special Allocation Subaccount

Same.

30. *If I want to make a change after I have returned the Distribution Form, what do I do?*

ESOP Retirement Subaccount

You can obtain another form from BRI and ask that your original form be returned to you. The replacement form must be received by BRI no later than the 20th of any month (December 1, 1995, for a January 1996 distribution).

ESOP Special Allocation Subaccount

Same.

Tax Issues

31. ***Can I choose whether or not to have taxes withheld from my distribution?***

ESOP Retirement Subaccount

- If you elect stock, shares will not be sold for tax withholding. However, the total amount of any fractional shares (which you would have received as cash) will be withheld for taxes.
- Taxes will **not** be withheld if you elect a rollover of stock to the Enron Corp. Savings Plan or an IRA.

Note: A distribution that you receive as shares (do not roll over) may make you responsible for payment of an estimated tax. Under the tax law, if the withholding and estimated taxes, if any, are not sufficient, you may incur penalties.

ESOP Special Allocation Subaccount

Same.

32. ***If I elect not to roll over my ESOP, but receive a distribution as shares of common stock from the Retirement Subaccount, what is the basis for my taxable income?***

ESOP Retirement Subaccount

Note: This example will illustrate the tax impact based on the following assumptions:

♦ Number of shares received at distribution in 1996	300
♦ Market price at distribution (est. at January 15, 1996)	$35.00
♦ Sell shares in 1997 at	$40.00

Note: Any distribution that you receive before age 59 1/2 is also subject to the 10 percent excise tax, **unless certain exemptions are met**. (Review the *Special Tax Notice Regarding Plan Payments*, which is available from a BRI representative.)

Tax Calculation

Market value of shares at distribution (300 shares x $35)	$10,500
Taxable income at distribution	$10,500
(Reported on 1996 income tax return)	

Upon Sale of Stock at a Later Date

Assume sold at $40 per share in February 1997

Sale proceeds: 300 shares x $40	$12,000
Less: Brokerage fee	- 24
Net amount from brokerage firm	$11,976
Less: Taxable portion at distribution	-10,500
Taxable gain from sale of stock	$ 1,476
(Reported on 1997 income tax return)	

ESOP Special Allocation Subaccount

Same.

33. ***Are there any special tax considerations I need to be aware of other than ordinary income and excise taxes?***

ESOP Retirement Subaccount

Generally, distributions are taxable as ordinary income. However, certain "lump sum distributions" may qualify for special elective treatment under section 402(d) of the Internal Revenue Code that can reduce taxes ordinarily payable. Some elections allow all or a portion of distributions attributable to a participant's pre-1974 participation in a pension plan to be treated as long-term capital gain, and other elections allow special averaging methods to be used for computing tax on the ordinary income portion.

The term "lump sum distribution" means the distribution or payment within one taxable year of the receipt of the balance to the credit of an employee which becomes payable to the recipient (i) on account of the employee's death, (ii) after the employee attains age 59 1/2, (iii) on account of the employee's separation from service, or (iv) after the employee has become disabled, from a trust which forms part of a tax-qualified pension plan.

There are complex rules and definitions regarding these elections. If you think you may be entitled to make such an election, you should seek advice from a tax advisor.

ESOP Special Allocation Subaccount

Same.

34. ***Is my distribution reported to the IRS?***

ESOP Retirement Subaccount

All distributions are reported to the IRS on a Form 1099-R at the end of each year regardless of whether you elect to receive a distribution, roll it over to an IRA, or roll it over to the Enron Corp. Savings Plan.

ESOP Special Allocation Subaccount

Same.

35. ***Am I required to report on my income tax return the ESOP distribution that I roll over to the Enron Corp. Savings Plan or to an IRA?***

ESOP Retirement Subaccount

Yes. All distributions from ESOP must be reported on Form 1040 (individual income tax return) for the year in which you receive them, including rollovers to the Savings Plan or to an IRA.

ESOP Special Allocation Subaccount

Same.

36. *If I elect not to roll over my ESOP shares but receive a distribution of shares, will I be eligible for the special income averaging?*

ESOP Retirement Subaccount

Generally no. Since the distribution does not represent a total distribution of the savings, retirement, and special allocation portions of the ESOP, the distribution will not qualify for the special averaging. However, you are encouraged to seek the advice of a tax expert if you feel this may be applicable to you.

ESOP Special Allocation Subaccount

Same.

37. *If I elect to roll over my ESOP shares to an IRA, will I be eligible for the special income averaging upon distribution from the IRA?*

ESOP Retirement Subaccount

No. If the distribution is made from an IRA, you will not be eligible for the special income averaging.

ESOP Special Allocation Subaccount

Same.

38. *If I elect to roll over my ESOP shares to a qualified plan, will I be eligible for the special income averaging upon distribution?*

ESOP Retirement Subaccount

Yes. If the distribution qualifies as a total distribution from the qualified plan, you will be eligible for the special income averaging.

ESOP Special Allocation Subaccount

Same.

Other

39. *If my ESOP account is involved in a legal proceeding, such as divorce, whom should I contact?*

ESOP Retirement Subaccount

You should contact a BRI representative at 1-800-332-7979 or (713) 853-5111.

ESOP Special Allocation Subaccount

Same.

The Enron Retirement Program Guide

ENRON CORP

EC000020295

Table of Contents

EC000020296

Introduction

This Program Guide reviews recent changes to Enron's Retirement Plan and the Employee Stock Ownership Plan (ESOP) and highlights how the Enron Corp. Savings Plan can help you save additional funds to make your retirement years more enjoyable. These benefits are designed to meet the needs of Enron's diverse workforce and the challenges of today's competitive environment. Refer to this guide in the coming months as the details of Enron's retirement program are discussed. If you have questions that are not covered here, contact your Human Resources Representative or BRI at 1-800-332-7979.

Program Highlights

Key changes to the Enron benefits include:

- Immediate 100% vesting for active employees — fully vesting the value of your Retirement Plan benefits earned through December 31, 1994, and vesting of your ESOP Retirement Subaccount as of December 31, 1994.
- Access to the ESOP Retirement Subaccount — enabling you to take advantage of the strong performance of Enron stock in the Enron Employee Stock Ownership Plan (ESOP) and benefit directly from any excess value in your ESOP Retirement Subaccount.
- A new retirement formula — representing a simplified, equitable approach to retirement benefits that are valuable and portable.
- A special transition provision — providing employees who are at least age 50 with five years of service on January 1, 1995 the better of the old or new benefit formula, if they retire on or before January 1, 2002. In addition, these employees will have full access to their ESOP Retirement Subaccounts in January 1996.

These changes are consistent with Enron's business philosophy and are reflective of benefits designed for today's changing workforce. Enron's actuary has projected that these Retirement Plan changes will result in benefit improvements for approximately 97% of Enron employees for at least ten years into the future. With the special transition provision, the majority of the remainder of the employees are at least neutral.

Enron continues to offer and encourages you to take advantage of the Enron Corp. Savings Plan, which is designed to assist you in providing added security for retirement or other financial needs by means of a regular savings program.

EC000020297

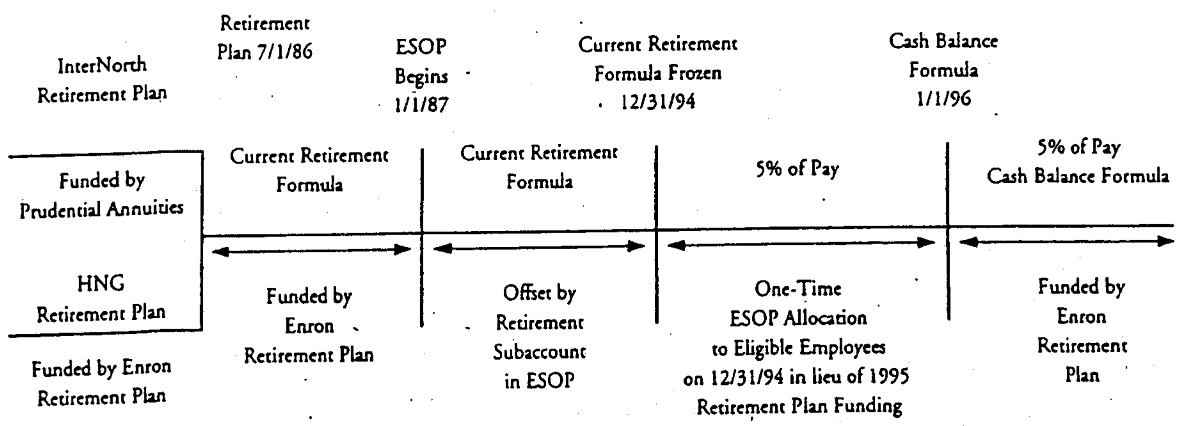
Enron Retirement Plan

Introduction

Historically, the Enron Retirement Plan has been designed to provide monthly benefits after you retire from Enron, which, together with your personal savings and any Social Security benefits you receive, help provide income during your retirement years. The intent of the plan — to provide you with retirement income security — remains unchanged. However, the way you earn benefits and your access to those benefits have been simplified.

Because the plan has changed over the years, you may have earned benefits under more than one retirement formula. Also, you may have been covered by other plans in the past (sponsored by HNG and InterNorth, for example) for which you have received credit. This section of your Program Guide discusses the evolution of the Retirement Plan — providing sample projections and combining various Enron retirement benefit sources. However, it does not cover every scenario. If you have questions concerning your situation, refer to your Enron Corp. Employee Benefit Plans and Policies handbook or contact BRI at 1-800-332-7979.

Enron Retirement Plan Timeline



Plan History

Before July 1, 1986

Before the formation of Enron in 1985, retirement benefits were provided through two separate retirement plans sponsored by HNG and InterNorth. The HNG Retirement Plan merged into the Enron Retirement Plan on July 1, 1986. Benefits earned under the InterNorth Retirement Plan before July 1, 1986 were converted to annuities to be paid by the Prudential Life Insurance Company.

From July 1, 1986 through December 31, 1986
All retirement benefits earned during this period were funded through the Enron Retirement Plan.

From January 1, 1987 through December 31, 1994
Enron introduced the ESOP in 1987. During this period, retirement benefits were funded through the Retirement Plan, the ESOP Retirement Subaccount or a combination of the two.

1995
You will receive a special ESOP allocation of 5% of your December 1994 annualized base pay (net of projected 1995 common stock dividends). This allocation is in lieu of a Retirement Plan accrual for 1995.

1996 Forward
A 5% of pay "cash balance" formula begins on January 1, 1996. Benefits will be funded through the Enron Retirement Plan.

How Benefits Are Determined Under the Current Plan and the ESOP Offset

Under the pre-1995 provisions, any benefit earned under the Retirement Plan after December 31, 1986 is offset by the value of your Retirement Subaccount in the ESOP. This approach never means a lower benefit to you — it simply means that instead of receiving the total retirement benefit from the Retirement Plan, the portion of the benefit offset by the ESOP is paid from the value of your ESOP Retirement Subaccount.

The value of your ESOP Retirement Subaccount is based on the share price of Enron stock on the date you have access to the account. Beginning January 1996, access will occur in 20% increments over five years. The value of the ESOP offset is equal to the amount of an annuity (a series of equal payments usually expressed on a monthly basis) payable when you retire that could be purchased using the value of each portion of your ESOP Retirement Subaccount to which you gain access. For purposes of this calculation, the Company has assumed that the annuity returns 8.5% per year in earnings. The ESOP offset value may be less or greater than the value of the Retirement Plan benefit earned between January 1, 1987 and December 31, 1994. If less, the Retirement Plan will pay the portion of the benefit that is not offset by your ESOP Retirement Subaccount. *If greater, the excess in your ESOP Retirement Subaccount would have been used to fund future benefits under the old formula.* With these changes, ***you keep the excess.***

Estimating the Value of the ESOP Offset

During the second quarter of 1995, you will receive information that will help you estimate the value of your ESOP Retirement Subaccount offset. In addition, you will be provided with an estimate of your Retirement Plan accrued benefit earned from January 1, 1987 through December 31, 1994. We will also explain how to determine the amount by which the value of your ESOP Retirement Subaccount offsets your Retirement Plan benefit earned from January 1, 1987 through December 31, 1994.

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Retirement Subaccount Offset Example – Excess in Year Two

Let's review an example where a Retirement Plan benefit is offset by the ESOP Retirement Subaccount through two years of access on the second access date.

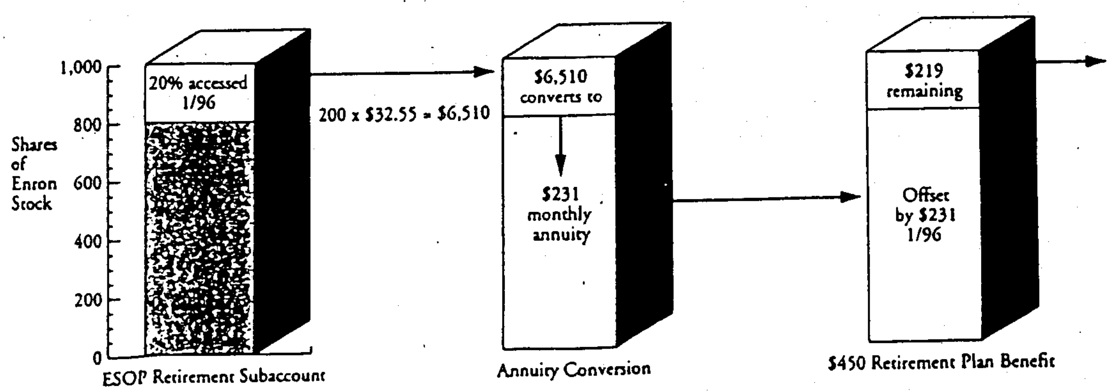
Assume that on January 1, 1995 you are 45 years old and that your earned benefit under the Retirement Plan from January 1, 1987 through December 31, 1994 is $450 per month. Also assume that you have 1,000 shares of Enron stock in your ESOP Retirement Subaccount and that the price of Enron stock is $30. You will receive a benefit from the Retirement Plan, the ESOP Retirement Subaccount or the combination of the two that equals at least $450 per month. If as of the determination date of your Retirement Plan benefit, the value of your ESOP Retirement Subaccount exceeds the amount needed to fund your Retirement Plan monthly benefit (in this example $450), you keep the excess. If less, the Retirement Plan pays the amount not offset.

Your ESOP offset is valued annually in 20% increments beginning in 1996:

First Access Date - 20%
In January 1996, you gain access to the first 20% or 200 shares (1,000 x 20%) of Enron stock in your ESOP Retirement Subaccount. On the date of access, the 200 shares are valued by multiplying the number of shares by the then current price of Enron stock. Assuming 8.5% annual growth, we can project a hypothetical price of Enron stock in January 1996 to be $32.55 per share. Therefore, the 200 shares to which you have access have a value of $6,510 ($32.55 x 200) for this example.

Using actuarial equivalency methods, we then determine that the $6,510 cash value is enough to fund a monthly annuity beginning at age 62 (the earliest you may receive full Retirement Plan benefits) in the amount of $231. Your $450 monthly benefit is then offset by this amount.

As of the first access date, 200 shares from your ESOP Retirement Subaccount have been earmarked to offset the first $231 of your $450 monthly Retirement Plan benefit. You now have 800 shares to provide for the remaining $219 ($450 - $231) monthly benefit under the Retirement Plan. The 200 shares you have earmarked on the first access date are still in the ESOP Retirement Subaccount. You now have access to these shares. Options for accessing the shares in your account are explained on page 8.



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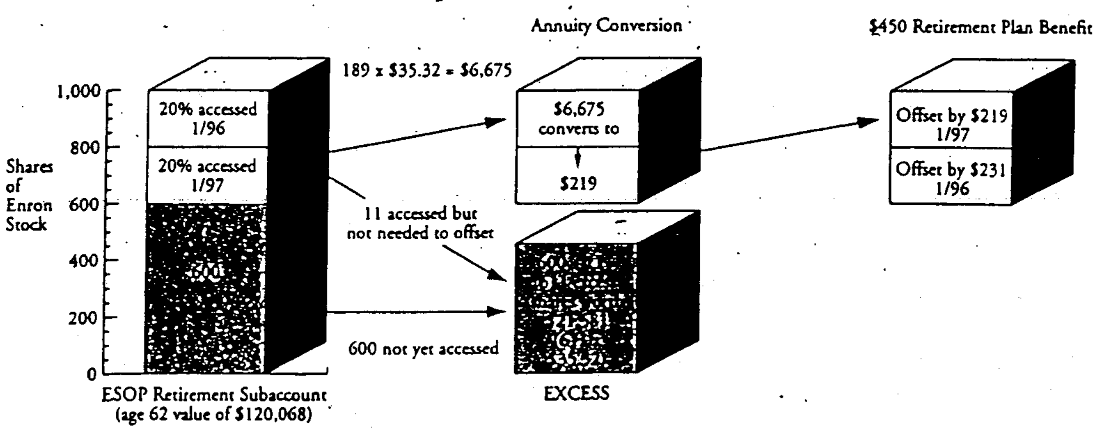
Second Access Date - 20%

In January 1997, you gain access to the second 20% or 200 shares of Enron stock in your ESOP Retirement Subaccount. Using a projected (8.5% growth) Enron stock price of $35.32 per share, we can value the second 20% of your account at $7,064 (200 x $35.32).

The $7,064 is enough to fund a monthly annuity value of $231. However, only $219 remains to be offset from your monthly Retirement Plan benefit. Therefore, instead of applying the full 200 shares, we earmark 189 shares — enough to fully offset the remaining $219 monthly benefit.



As of the second access date, your $450 monthly Retirement Plan benefit is fully offset using 389 shares from your ESOP Retirement Subaccount and you have 611 (1,000 - 389) excess shares of Enron stock worth a projected $21,581 on that date.

Because your Retirement Plan benefit has been fully offset you will not receive a monthly benefit from the Retirement Plan. However, over the next three years (by January 2000), you will gain access to the remaining 600 shares in your ESOP — meaning you will have access to the full 1,000 shares, 611 of which are excess value shares. If we project the price of Enron stock (using 8.5%) to your age 62, the 1,000 shares in your account would be worth $120,068. However, the value of the shares in your ESOP Retirement Subaccount will fluctuate with changing market conditions. Whether or not you should request a distribution of the shares to which you have access is an important investment decision (see Access and Investment Responsibility on page 7).

An example of where a Retirement Plan benefit is offset by the ESOP Retirement Subaccount through five years of access is shown in Appendix A.

EC000020301

Note: This example is an estimate only and assumes sustained stock growth of 8.5%. Actual results will depend on the performance of Enron stock. Also, for ease of calculation, dividends have not been taken into account in this example. Dividends earned on your ESOP Retirement Subaccount shares after January 1, 1995 will become accessible on a prorated basis, making all dividend shares accessible by January 2000. The example does not imply that you need to sell or withdraw your Enron shares or buy an annuity. These calculations are only used to determine if the ESOP Retirement Subaccount has enough money to offset your Retirement Plan benefit at the time of access. This example illustrates how the ESOP Retirement Subaccount is used to fund the offset Retirement Plan benefits. In this example, the value of the ESOP Retirement Subaccount is sufficient to offset earned Retirement Plan benefits. If the value of the ESOP Retirement Subaccount is not enough to offset earned benefits, the Retirement Plan pays the earned monthly benefit that is not offset. Additional examples illustrating an ESOP Retirement Subaccount excess and an ESOP Retirement Subaccount shortfall are located in Appendix A.

As illustrated in the example on pages 4 and 5, benefits earned from January 1, 1987 through December 31, 1994 are offset by the ESOP Retirement Subaccount. But how will the change to the Retirement Plan formula affect future benefits? The comparison described on the next page illustrates how your retirement benefits might be affected over the next five years — before and after the change to the Retirement Plan formula.

For purposes of this example, we'll assume that on January 1, 1995 you are 45 years old with a salary of $50,000 (which increases 4% a year) and you have 1,000 shares in your ESOP Retirement Subaccount. We will also assume that you have an earned pre-1987 Retirement Plan monthly benefit of $300, which is payable at age 62.

This example does not include the effect of any dividends paid on shares in the ESOP Retirement Subaccount.

Before 1987

Benefits earned before 1987 are not impacted by the change to the Retirement Plan formula. In this example, you have an earned pre-1987 Retirement Plan monthly benefit of $300, which is payable at age 62. Of course, you can retire earlier than age 62, and the $300 monthly benefit will be adjusted according to the early retirement reduction factors.

From January 1, 1987 through December 31, 1994

Benefits earned from January 1, 1987 through December 31, 1994 are also unaffected by the change to the Retirement Plan formula.

As explained in the ESOP Retirement Subaccount example on pages 4 and 5, benefits earned during this period are offset by the ESOP Retirement Subaccount. This means the $450 monthly benefit earned from January 1, 1987 through December 31, 1994 is reduced to zero, but remember, you still have the entire 1,000 ESOP shares. See the example on pages 4 and 5.

January 1, 1995 through January 1, 2000

Beginning January 1, 1995 the effect of the change to the Retirement Plan cash balance formula is visible. Before a change to the Retirement Plan formula benefits earned during this period would continue to be offset by the ESOP Retirement Subaccount. This means the $525 monthly benefit, payable beginning at age 62, that would have been earned after 1994 under the old formula would be reduced to zero. After a change to the formula, however, you get access to any ESOP excess value shares *and* you would earn an additional $12,215 cash balance contributions and interest over the five-year period.

And consider the difference in access to your funds. Under the old rules, you would have to wait until age 62 (the earliest you can retire with full benefits) to access both your $300 Retirement Plan monthly benefit and your ESOP Retirement Subaccount. After the change, you have phased-in access to your ESOP Retirement Subaccount beginning January 1, 1996, full access to your account by the year 2000 and access to benefits earned under the new formula when you retire or your employment with Enron terminates for any reason other than disability.

Access and Investment Responsibility

The shares in the ESOP Retirement Subaccount were originally intended to fund Retirement Plan benefits earned after December 31, 1986. With the Retirement Plan formula changing on December 31, 1994, the ESOP offset applies only to benefits earned from January 1, 1987 through December 31, 1994. If your Retirement Plan benefits can be fully offset by the ESOP Retirement Subaccount, Enron meets its Retirement Plan funding obligation for benefits earned from January 1, 1987 through December 31, 1994. In such event, at the time of your retirement you will not receive any Retirement Plan benefits from Enron for this January 1, 1987 through December 31, 1994 period. Once you have access, you become responsible for the investment and direction of your ESOP Retirement Subaccount.

When Retirement Plan benefits are offset by the ESOP Retirement Subaccount, the value of your shares of stock in your account is converted to an annuity value for comparison purposes only — no annuity is actually purchased. These annuity estimates are based on a discount rate of 8.5%. Therefore, to maintain the comparative value of your ESOP Retirement Subaccount, you need to earn at least 8.5% on any investments made with the shares to which you gain access.

Upon gaining access to the shares in your ESOP Retirement Subaccount, you may choose to:

- leave your Enron stock in the ESOP Retirement Subaccount;
- transfer your stock to the Enron Corp. Savings Plan (must be an active employee);
- roll your stock into a separate Individual Retirement Account (IRA); or
- withdraw your stock.

If you leave your stock in the ESOP, the value of your account will depend on the performance of Enron stock. If you transfer, roll over or withdraw your stock, the value of your account will depend on the investment decisions you make. Regardless of the access method you choose, the responsibility for investing your account becomes yours upon gaining access to the shares in your ESOP Retirement Subaccount. Also, there are various tax consequences depending upon how and when you access the shares in your ESOP Retirement Subaccount. For example, a 10% penalty generally applies to those who withdraw their shares before reaching age 59-1/2 and do not timely transfer them to a permitted tax deferred account or fund. However, currently the 10% penalty does not apply if you retire from Enron on or after your 55th birthday and withdraw your shares.

Other Benefits

The ESOP offset only applies to Retirement Plan benefits earned from January 1, 1987 through December 31, 1994. You will also receive the full value of any Retirement Plan benefit earned before January 1, 1987 and after December 31, 1994.

In addition, there was a one-time allocation of 5% of your December 1994 annualized base pay to a third ESOP Subaccount on December 31, 1994 in lieu of a contribution for 1995 to the Retirement Plan. This allocation is discussed in the ESOP section on pages 12 and 13.

How Benefits Will Be Determined Beginning January 1, 1996 – Cash Balance Formula

Beginning January 1, 1996, you will earn retirement benefits under a "cash balance" formula. A cash balance formula provides a simplified approach to retirement benefits — making it easy for you to understand and track the value of your benefits.

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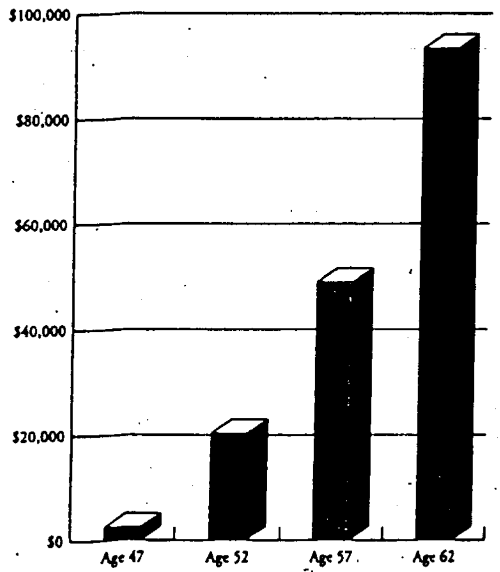
Under the new formula, you earn 5% of your monthly base pay which is credited to your account at year-end. Each month beginning in January 1997 your account is also credited with interest, based on 10-year Treasury bond yields. Your account cannot go down in value.

Your account continues to grow each year you work for Enron. Enron also provides you with a personal account statement (at least annually) so you can track the growth of your account. The statement shows how much Enron added to your account that year and how much interest your account balance earned.

Let's take a closer look at how your account might grow. Assume that on January 1, 1995 you are age 45 and earn $50,000 a year. With 5% of your pay being credited annually beginning in 1996 and interest being credited monthly beginning in 1997, just look how fast your account can grow. At age 62, you would have an additional $93,529 for retirement.



Estimate only — assumes 4% annual salary increases and 7% annualized interest credits.

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A Word On Bond Yields

Bonds are long-term debt obligations issued by companies, governments, municipalities or federal agencies. The interest — or yield — paid on these loans depends upon the amount of risk assumed by the buyer, the maturity of the loan, the loan's backing and the overall economic climate at the time of issuance. Treasury bonds, issued by the U.S. government, are considered the most important yardsticks of long-term interest rates and are therefore watched closely by credit market analysts for signs that rates might be rising or falling.

The chart below illustrates average Treasury bond yields over the last 22 years. For 1993 the yield on a ten-year Treasury bond averaged 5.87%. On December 1, 1994 the yield was quoted at 7.92%.

Estimated Treasury Bond Yields 1970-92*
(Percent Per Annum, Compounding Semiannually)

Year	10-Year Bond Yield
1970	6.46
1971	5.96
1972	6.36
1973	6.98
1974	7.36
1975	7.72
1976	6.79
1977	7.80
1978	8.87
1979	10.39
1980	12.33
1981	13.99
1982	10.65
1983	11.85
1984	11.62
1985	9.18
1986	7.56
1987	8.98
1988	9.20
1989	8.08
1990	8.22
1991	6.95
1992	6.95

* *Source: Ibbotson Associates*

EC000020306

Vesting

After five years of service, which includes your years of service to date, you are 100% vested in your Retirement Plan cash balance account. If you leave Enron for any reason and cease benefit accruals under the Retirement Plan, at any time, you can take your vested cash balance account with you. Before you complete five years of service, you have no vested interest in the Retirement Plan.

Plan Payments

How you receive payment of your vested retirement benefits under the Retirement Plan depends on whether you accrued benefits under the Retirement Plan before January 1, 1995, or whether all of your Retirement Plan benefits were earned after December 31, 1994 under the cash balance formula.

If after you become vested, your employment with an Enron employer ceases, you can elect to receive a distribution of the vested portion of your cash balance benefit through a lump sum distribution, or leave it in the Retirement Plan for later distribution. Generally, any benefit accrued under the Retirement Plan before January 1, 1995 which has not been offset will be paid in the form of a monthly payment when you become eligible and elect to receive it. The remaining part of this section of the Program Guide will focus on vested benefits earned in your cash balance account.

- If you die during employment with Enron your spouse or beneficiary may choose to receive your cash balance benefit in either a full distribution or a monthly payment for life.
- If your employment with Enron terminates and you do not elect to receive a full distribution of your cash balance account, you can elect to receive a monthly benefit, or defer any distribution until a later date.
- If you are permanently and totally disabled and eligible for and receiving either Social Security Disability Benefits under the federal Social Security Act or disability benefits under the Enron Corp. Long Term Disability Plan, you will be credited with a cash balance benefit accrual based on your annual rate of compensation that was in effect on your last day worked prior to inception of your disability. If your disability ceases and you are not re-employed by Enron, you will be entitled to receive benefit payments from the Retirement Plan as a terminated employee.

Whether to request a lump sum distribution of your cash balance account if your employment ceases involves an economic analysis. If your cash balance account stays in the Retirement Plan, it will continue to earn annual interest based credits. If you request a distribution, you can roll over the distribution to an IRA which may provide a higher rate of return if invested in a portfolio that may have more risk.

Special Provisions

All employees who are at least age 50 with five years of service on January 1, 1995 will either have the better of the old or the new benefit formula if they retire on or before January 1, 2002. In addition, these employees will have full access to their ESOP Retirement Subaccount in January 1996. In any event, of all employees who on January 1, 1995 will be age 50 or over with five or more years of service, less than 20% of this group are projected to be affected by this special provision.

Death Benefits

One of the key benefits of a cash balance formula is unrestricted access to your vested account upon death or termination of employment, representing an expanded benefit. With this change, two Retirement Plan death benefits will be eliminated effective January 1, 1995:

- The grandfathered spousal pre-retirement death benefit (providing a 50% projected age 65 Retirement Plan benefit payable immediately) for married employees hired before January 1, 1990 who die after reaching age 45 with five years of service, and
- The $5,000 Enron post-retirement death benefit.

Note: If you are eligible for the Special Provisions discussed above, you will continue to be covered under the $5,000 Enron post-retirement death benefit as long as you retire after age 55 and on or before January 1, 2002.

Enron continues to offer valuable income protection for you and your family through the Company's Survivor Benefits, such as life and accidental death and dismemberment insurance.

ESOP

There will be no ESOP allocations after December 31, 1994. All ESOP shares must be allocated as of the end of 1994. Accordingly, on December 31, 1994 two allocations occurred:

- 10% of your annual base pay to the ESOP Savings Subaccount, and
- 5% of your December 1994 annualized base pay (net of projected 1995 common stock dividends) to a third ESOP Subaccount.

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The 5% of pay allocation was made to a third ESOP Subaccount in lieu of earning a 1995 benefit under the cash balance Retirement Plan formula. You will be vested in this allocation at the rate of 25% per year of service (which includes years of service to date) and have access to this amount over a five-year period beginning in January 1996.

Net of Projected 1995 Dividends

The December 31, 1994 5% of pay allocation to a third ESOP Subaccount was made net of projected 1995 dividends. This means the dividends paid on the shares of stock you receive will be subtracted from your 5% of pay allocation. To illustrate this, let's assume you earn $30,000 a year and that on December 31, 1994 Enron stock was priced at $30. Based on a 5% of pay allocation, you would receive $1,500 ($30,000 x 5%) worth of stock, or 50 ($1,500 ÷ $30) shares. If Enron projects a per-share dividend of $0.80 payable in 1995, you would receive an additional $40 (50 x $0.80) in dividends. So, in this example, under a net of dividends allocation, you would have received $1,460 in stock on December 31, 1994 plus dividends of $40 payable in 1995 to bring you up to a full 5% of pay allocation.

1994 Stock		1995 Dividends		Total Allocation
$1,460	+	$40	=	$1,500
4.87% of pay	+	.13% of pay	=	5% of pay

This approach is consistent with the procedure of crediting interest in the year following the actual allocation.

If there were not enough shares in the ESOP for this allocation, additional contributions will be added to your 1996 cash balance Retirement Plan contribution. If there was an excess of shares after the allocation, the excess shares will be allocated to this third ESOP Subaccount.

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Adding It Up – An Example

With the changes occurring in the Enron Retirement Plan over the years, you may have earned benefits under different plans and benefit formulas — meaning the amounts and payment forms of your benefits may vary. To give you an idea of how these benefits might add up, let's review an example.

Assume you were hired by HNG in 1980. Your salary for 1995 is $50,000 and you are 45 years old. Your earned benefits from the Retirement Plan and the ESOP might look something like this at age 62:

	1 Service before 1/1/87 (before ESOP)	2 Service from 1/1/87 through 12/31/94 (ESOP)	3 Service from 1/1/95 through 12/31/95 (ESOP special allocation)	4 Service after 1/1/96 (Cash balance)	5 Total age-62 Retirement Plan benefit	
Monthly Benefit	$300	($450) fully offset	$94 or	$900 or	$1,294 and	or $300 and
Lump Sum	No option	$120,068	$9,745	$93,529	$120,068	$223,342

1 Your benefit earned before 1987 under the HNG Retirement Plan has been converted to a $300 monthly annuity, payable at age 62.

2 Your earned benefit under the Enron Retirement Plan from January 1, 1987 through December 31, 1994 is $450 per month. As illustrated in the first offset example, this benefit will be fully offset by 389 shares in your ESOP Retirement Subaccount giving you an excess of 611 shares worth $21,581 in January 1997. Again assuming 8.5% stock growth, the value of your ESOP Retirement Subaccount at age 62 is projected to be $120,068.

3 On December 31, 1994 you received a one-time allocation to a third ESOP Subaccount equal to 5% of your 1994 annualized base pay (net of projected 1995 dividends) or $2,435. Assuming 8.5% stock growth, the value of this allocation at age 62 is projected to be $9,745. Using an 8.5% annuity purchase interest rate, this is enough to purchase an immediate age-62 monthly annuity of $94.

4 In 1996, you begin to earn benefits under the new 5% of monthly base pay cash balance formula. Assuming annual pay increases of 4% and interest credits averaging 7% per year, we can project your account balance at age 62 to be $93,529. Using an 8.5% annuity purchase interest rate, this is enough to purchase an immediate age-62 monthly annuity of $900.

5 Under this example, when you retire at age 62, you will receive a monthly benefit of $1,294 ($300 + $94 + $900) plus a lump sum distribution of $120,068 or a monthly benefit of $300 plus a lump sum distribution of $223,342 ($120,068 + $9,745 + $93,529).

This example assumes that the value of shares of Enron stock attributable to the amounts in items 2 and 3 will increase at an annualized rate of 8.5%. The actual growth of Enron stock is likely to be either more or less, and the actual value of your total age 62 benefit will depend on your investment decisions regarding the shares in your ESOP Retirement Subaccount.

EC000020310

Prior Plan Participation

As previously discussed, you may have been covered by other retirement plans in the past for which you have received credit. Following is a brief summary of transitions under prior employer plans. However, this summary does not provide complete details or cover every scenario. If you have questions concerning your situation, contact BRI or your Human Resources Representative.

Chemplex

Assets of the Chemplex Retirement Plan were merged into the INI Plan on June 1, 1985. Service with Chemplex is recognized under the Enron Retirement Plan. Participants can choose between a lump sum payout or a monthly benefit for benefits earned through service with Chemplex.

Falco

Assets of the P&O Falco Pension Plan were merged into the INI Plan on June 1, 1985. Service with Falco is recognized under the Enron Retirement Plan. Participants can choose between a lump sum payout or a monthly benefit for benefits earned through service with Falco.

Florida Gas

Florida Gas adopted the HNG Retirement Plan on January 1, 1985. Annuities were purchased through Metropolitan for service prior to January 1, 1985. Through a reimbursement arrangement with Metropolitan, the Enron Retirement Plan will pay retirees for the Metropolitan annuity on the same check as the Enron Retirement Plan monthly benefit.

InterNorth

Benefits earned under the InterNorth Retirement Income (INI) Plan were annuitized through Prudential when the plan underwent a spin-off/termination June 30, 1986. The spin-off portion of the INI Plan was merged with the HNG Retirement Plan on July 1, 1986 and renamed the Enron Corp. Retirement Plan. Through a reimbursement arrangement with Prudential, the Enron Retirement Plan will pay retirees for the Prudential annuities on the same check as the Enron Retirement Plan monthly benefit.

Transwestern

Transwestern Pipeline adopted the HNG Retirement Plan on January 1, 1985. Prior service is recognized under the Enron Retirement Plan. Texas Eastern will pay for benefits earned prior to January 1, 1985. The Enron Retirement Plan pays all other benefits earned under its formula.

Enron Corp. Savings Plan

Enron provides you with an additional way to save funds for retirement — through the Enron Corp. Savings Plan. Designed to help you develop a regular savings program to supplement retirement benefits from other sources, the Plan is an attractive savings tool that allows you to:

- participate on a voluntary basis;
- maintain an individual account;
- defer paying income taxes on before-tax contributions which increases the amount you have to invest;
- save through convenient payroll deductions;
- change the amount you save every month;
- invest your contributions; and
- access your funds while employed through withdrawal or loan provisions.

Participation

If you are a full-time or eligible part-time employee, you may participate in the Savings Plan on the first day of the month following your date of hire. You need your Personal Identification Number (PIN) to enroll via the BRI Administration Phone Line (800-316-7526) before you can contribute to the Savings Plan.

When you enroll you decide:

- how much you want to contribute;
- whether you want to contribute on a before- and/or after-tax basis; and
- how your contributions will be invested.

Contributions

You may contribute from 1% to 14% of your pay on a before- or after-tax basis (up to the IRS limit). If you earn more than $66,000 a year (for 1995; this amount is indexed annually), you are considered highly compensated by the IRS and your contributions to the Savings Plan are limited to 11% with a before-tax maximum of 8%.

The Savings Plan also accepts qualified rollover contributions. If you receive a tax-qualified cash distribution from another retirement or savings plan, you may be able to transfer that amount — called a rollover contribution — to the Savings Plan and defer paying taxes on the distribution.

Other IRS and plan maximums may limit the amount you are allowed to contribute to the Savings Plan. If affected by these limits, you will be notified.

You may change your contribution percentage monthly. You may terminate (or stop) your contributions at any time.

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Investments

The Savings Plan has a variety of investment funds from which to choose, including three Enron funds and seven funds professionally managed by Fidelity Investments:

	Three-Year Performance		
	1993	1992	1991
• Enron Corp. Income Fund	6.28%	7.12%	7.68%
• Fidelity Balanced Fund	19.27%	13.47%	17.74%
• Fidelity Equity - Income Fund	21.31%	17.95%	21.65%
• Fidelity Growth & Income Portfolio	19.53%	15.46%	23.66%
• Fidelity Magellan Fund	24.66%	15.50%	23.45%
• Fidelity Growth Company Fund	16.19%	11.99%	22.99%
• Fidelity OTC Portfolio	8.33%	11.58%	22.92%
• Fidelity Overseas Fund	40.05%	11.36%	10.44%
• Enron Corp. Stock Fund – Common	28.10%	36.20%	32.50%
– Preferred	26.20%	38.10%	34.30%
• Enron Oil & Gas Stock Fund	33.60%	51.70%	(7.30%)

You may invest in any or all of these funds as long as your investment allocations are made in 1% increments and total 100%.

You may change your investment fund elections or transfer all or a part of your account balances from one fund to another on a daily basis.

We are also looking into expanding these investment fund options during 1995 to possibly include a fund with a targeted average annual return of 8.5% in order to match up with the assumed rate of return for ESOP Retirement Subaccount assets.

Account Statements

Each quarter you will receive a personal statement showing the status of your Savings Plan account. The statement will show:

- Your contributions;
- Any outstanding loan balances;
- Investment rate of return; and
- Account balances.

The statement will help you determine whether your investment choices still reflect your personal financial objectives.

Vesting Summary

Retirement Plan				Employee Stock Ownership Plan					
Benefits earned before 1995		Benefits earned after 1995		Retirement Subaccount		Savings Subaccount		5% of pay allocation to third Subaccount	
Full years of service	Vested %	Full years* of service	Vested %	Full years of service	Vested %	Full years* of service	Vested %	Full years* of service	Vested %
NA	100%	5	100%	NA	100%	Less than 1	0%	Less than 1	0%
						1	25%	1	25%
						2	50%	2	50%
						3	75%	3	75%
						4	100%	4	100%

* Includes years of service to date measured from your hire date.

Key Dates

12/31/94	1/96	1/97
Current Retirement Plan formula ceases	First Retirement Subaccount access date (20%)	Second Retirement Subaccount access 20% (total 40%)
100% vesting of Retirement Plan benefits earned to date	Cash balance formula is activated	Interest begins accruing on cash balance
100% vesting of ESOP Retirement Subaccount		
10% allocation to ESOP Savings Subaccount		
5% allocation to a third ESOP Subaccount		

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Glossary of Terms

- Access — The opportunity to choose to receive a portion of your ESOP Retirement Subaccount.
- Accrued benefit — The monthly benefit, payable for your lifetime beginning at normal retirement age (age 65), that you have earned to date based on your current pay and service.
- Actuarially equivalent benefits — Two forms of benefit payments that have the same present value, based on an interest discount assumption and a table of life expectancy rate.
- Annuity — A series of equal payments at fixed intervals.
- Cash balance — A retirement plan formula specifying consistent pay and interest credits to an individual's account. Under the Enron cash balance formula, the Company credits your account with an annual lump sum retirement benefit equal to 5% of your pay. Each month your account balance is also credited with interest based on ten-year Treasury bond yields. Under a cash balance approach to retirement, you may take your vested cash balance account balance with you if your employment terminates.
- December 1994 annualized base salary — If you are a full-time employee, your annualized base salary is your monthly base salary in December 1994, excluding overtime, times 12. If you are a part-time employee, your annualized base salary will be prorated based on the percentage of time your normal work schedule represents of a full-time schedule.
- Discount rate — The interest rate used to account for the time value of money to compute the present value.
- ESOP offset — The value of your ESOP Retirement Subaccount that is used to offset benefits earned under the Enron Retirement Plan from January 1, 1987 through December 31, 1994. This value is based on the amount of an annuity that could be purchased with the cash value of your ESOP Retirement Subaccount using an assumed discount rate of 8.5%.
- Excess — The value of your ESOP Retirement Subaccount that remains when earned Retirement Plan benefits are offset.
- Lump sum — Full payment made in one sum and at one time.
- Vesting — Earning the full rights of ownership over time.

Appendix A

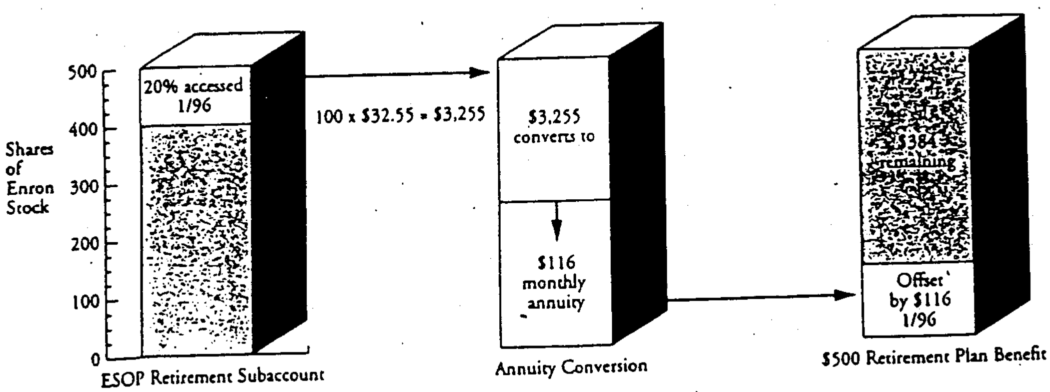
Example 1 — ESOP Retirement Subaccount Excess Realized in Year Five
Let's review another example where the Retirement Plan benefit is *offset* by the ESOP Retirement Subaccount through five years of access on the final access date.

Assume that on January 1, 1995 you are 45 years old and that your earned benefit from January 1, 1987 through December 31, 1994 is $500 per month. Also assume that you have 500 shares of Enron stock in your ESOP Retirement Subaccount and that the price of Enron stock is $30. You will receive a benefit from the Retirement Plan, the ESOP Retirement Subaccount or the combination of the two that equals at least $500 per month. If, as of the determination date of your Retirement Plan benefit the value of your ESOP Retirement Subaccount exceeds the amount needed to fund your $500 monthly benefit, you keep the excess. If less, the Retirement Plan pays the amount not offset.

Your ESOP offset is valued annually in 20% increments beginning in 1996:

First Access Date - 20%
In January 1996, you gain access to the first 20% or 100 shares (500 x 20%) of Enron stock in your ESOP Retirement Subaccount. On the date of access, the 100 shares are valued by multiplying the number of shares by the current price of Enron stock. Assuming 8.5% annual growth, we can project the price of Enron stock in January 1996 to be $32.55 per share. Therefore, the 100 shares to which you have access have a value of $3,255 for this example.

Using actuarial equivalency methods, we then determine that the $3,255 cash value is enough to fund a monthly annuity beginning at age 62 (the earliest you may receive full Retirement Plan benefits) in the amount of $116. Your $500 monthly Retirement Plan benefit is then offset by this amount.



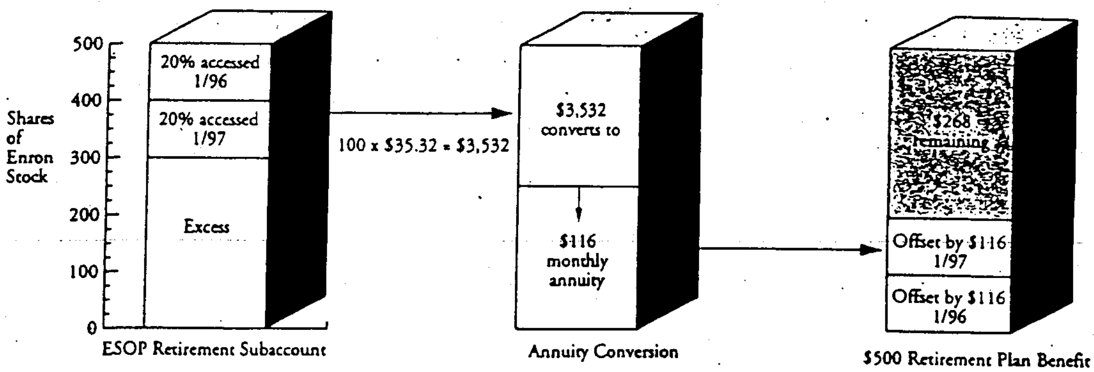
As of the first access date, 100 shares from your ESOP Retirement Subaccount have been earmarked to offset the first $116 of your $500 monthly Retirement Plan benefit. You now have 400 shares to provide for the remaining $384 ($500 - $116) monthly benefit under the Retirement Plan.

EC000020316

Second Access Date - 20%

In January 1997, you gain access to the second 20% or 100 shares of Enron stock in your ESOP Retirement Subaccount. Using a projected (8.5% growth) Enron stock price of $35.32 per share, we can value the second 20% of your account at $3,532 (100 x $35.32).

The $3,532 is enough to fund a monthly annuity value of $116. Your monthly Retirement Plan benefit is then offset by this amount.

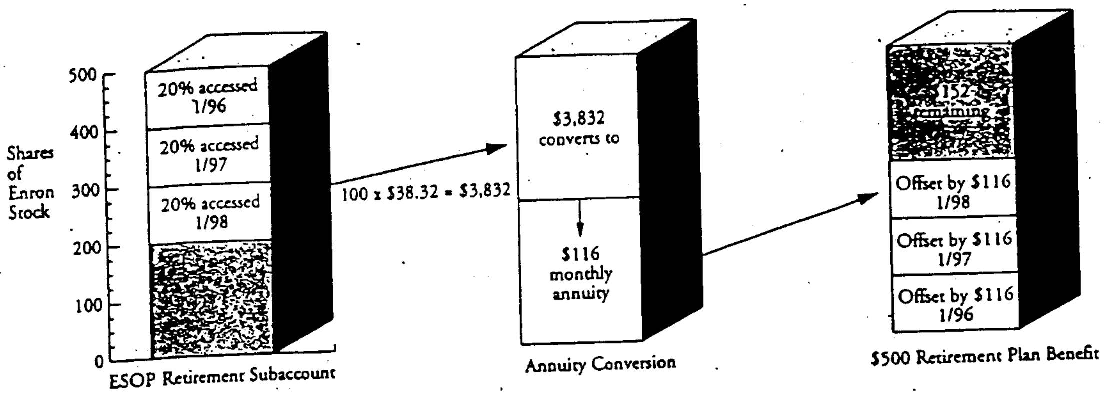


As of the second access date, another 100 shares from your ESOP Retirement Subaccount have been earmarked to offset an additional $116 of your $500 monthly Retirement Plan benefit. You now have 300 shares to provide for the remaining $268 ($384 - $116) monthly benefit under the Retirement Plan.

Third Access Date - 20%

In January 1998, you gain access to the third 20% or 100 shares of Enron stock in your ESOP Retirement Subaccount. Assuming 8.5% annual growth, we can project the price of Enron stock in January 1998 to be $38.32 per share. Therefore, the 100 shares to which you have access have a value of $3,832.

The $3,832 is enough to fund a monthly annuity value of $116. Your monthly Retirement Plan benefit is then offset by this amount.

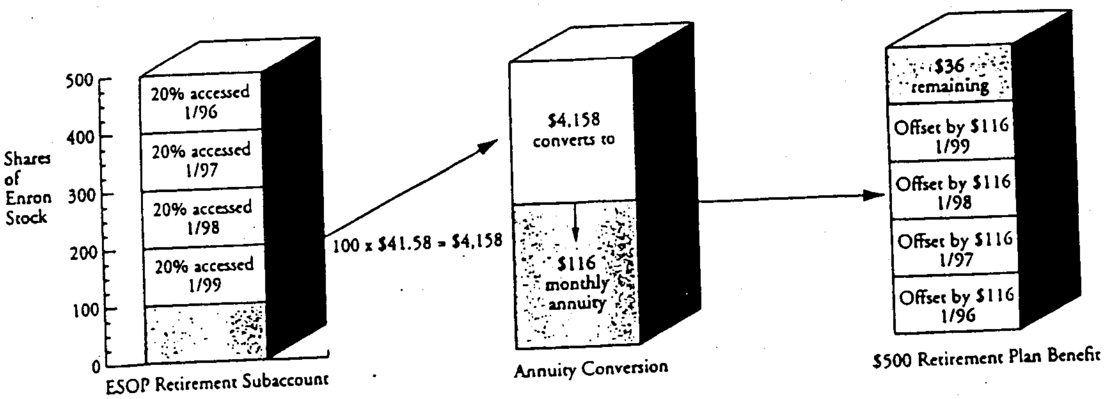


So, as of the third access date, another 100 shares from your ESOP Retirement Subaccount have been earmarked to offset an additional $116 of your $500 monthly Retirement Plan benefit. You now have 200 shares to provide for the remaining $152 ($268 - $116) monthly benefit.

Fourth Access Date - 20%

In January 1999, you gain access to the fourth 20% or 100 shares of Enron stock in your ESOP Retirement Subaccount. Assuming 8.5% annual growth, we can project the price of Enron stock in January 1999 to be $41.58 per share. Therefore, the 100 shares to which you have access have a value of $4,158.

The $4,158 is enough to fund a monthly annuity value of $116. Your monthly Retirement Plan benefit is then offset by this amount.



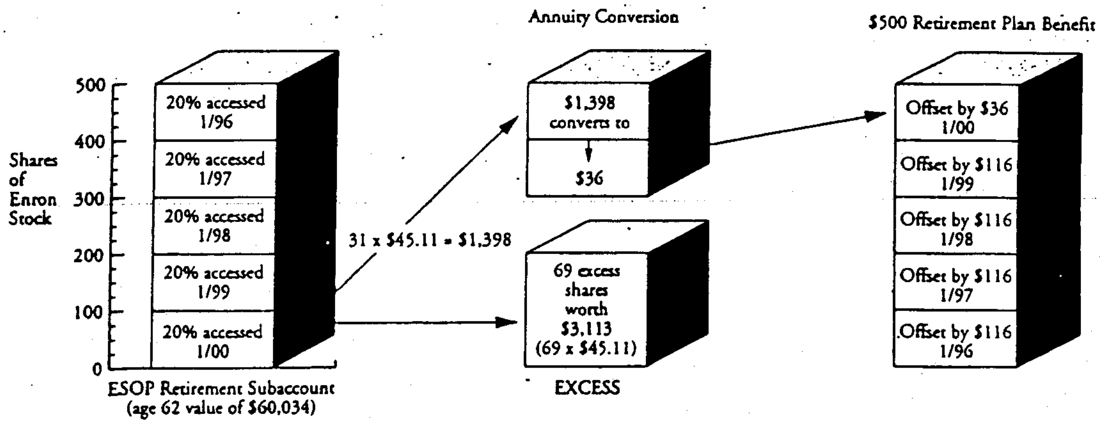
As of the fourth access date, another 100 shares from your ESOP Retirement Subaccount have been earmarked to offset an additional $116 of your $500 monthly Retirement Plan benefit. You now have 100 shares to provide for the remaining $36 ($152 - $116) monthly benefit under the Retirement Plan.

EC000020318

Fifth Access Date - 20%

In January 2000, you gain access to the final 20% or 100 shares of Enron stock in your ESOP Retirement Subaccount. Using a projected (8.5% annual growth) Enron stock price of $45.11 per share, we can value the final 20% of shares in your ESOP Retirement Subaccount at $4,511 (100 x $45.11).

The $4,511 is enough to fund a monthly annuity value of $116. However, only $36 remains to be offset from your monthly Retirement Plan benefit. Therefore, instead of applying the full 100 shares, 31 shares are earmarked — enough to fully offset the remaining $36 monthly Retirement Plan benefit.



1/1/95 assumptions:
45 years old
$500 earned Retirement Plan benefit
500 shares in ESOP Retirement Subaccount
Stock price of $30
Stock growth of 8.5%

As of the fifth access date, your $500 monthly Retirement Plan benefit is fully offset using 431 shares from your ESOP Retirement Subaccount and you have 69 (500 - 431) excess value shares of Enron stock worth $3,113.

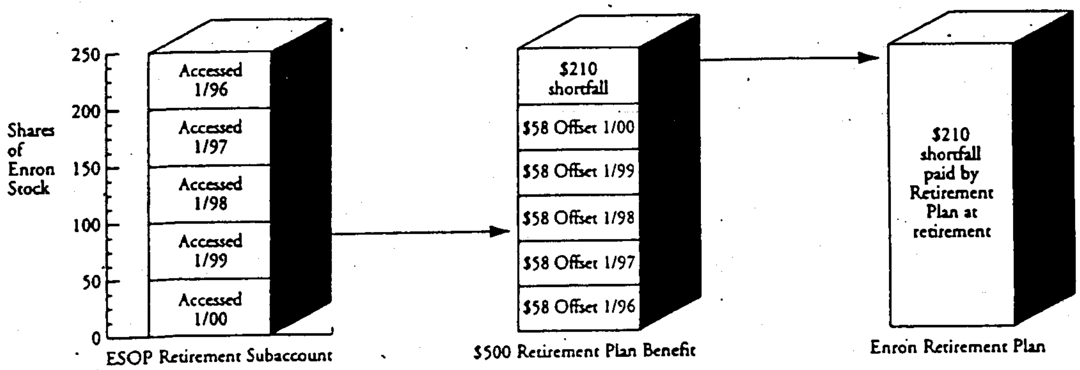
Because your Retirement Plan benefit has been fully offset, you will not receive a monthly benefit from the Retirement Plan. However, as of January 2000 in this example, over five years you have gained access to all of the 500 shares in your ESOP Retirement Subaccount. If we project the price of Enron stock to your age 62, the 500 shares in your ESOP Retirement Subaccount would be worth $60,034.

EC000020319

Example 2 — ESOP Retirement Subaccount Shortfall

The previous example illustrated how the ESOP Retirement Subaccount is used to fund or offset Retirement Plan benefits. The value of the ESOP Retirement Subaccount was sufficient to offset earned Retirement Plan benefits. If the value of the ESOP Retirement Subaccount is not enough to offset earned benefits, the Retirement Plan pays the amount of monthly retirement benefit that is not offset.

For instance, in Example 1 if there were 250 shares in your ESOP Retirement Subaccount (instead of 500) the value of your account would offset only $290 of your $500 monthly Retirement Plan benefit. In this case, the Retirement Plan would pay the remaining $210 ($500 - $290) monthly benefit at the time of your retirement (i.e., age 62).



Note: These examples are estimates only and assume sustained stock growth of 8.5%. Actual results will depend on the performance of Enron stock. Also, for ease of calculation, dividends have not been taken into account in these examples. Dividends earned on your ESOP Retirement Subaccount shares after January 1, 1995 will become accessible on a prorated basis, making all dividend shares accessible by January 2000. These examples do not imply that you need to sell Enron shares or buy an annuity. These calculations are only used to determine if the shares in the ESOP Retirement Subaccount have enough value to offset your Retirement Plan benefit at the time of access.

EC000020320

A Word on Projections

This Program Guide includes numerous examples that are intended to illustrate the potential benefits of past and future participation in Enron programs. These examples use a variety of assumptions for pay, stock performance, annuity values and interest rates. Most of the Retirement Plan examples found in this guide are based on sustained Enron stock growth of 8.5%. This rate is used for two reasons: First, 8.5% is the rate used to determine annuity purchase values at the time of ESOP Retirement Subaccount access. Once shares of stock in the ESOP Retirement Subaccount are accessed, participants need to earn at least 8.5% investment returns to maintain the full value of their accessed funds. Second, the historical investment performance of Enron stock at 8.5% is considered a reasonable rate of return for retirement projection purposes. It is important to note, however, that there is no way to project the actual performance of Enron stock and the examples found in the guide should be used for illustrative purposes only.

About this Guide

This Program Guide uses non-technical language to explain concepts related to the Enron tax-qualified pension plans which are the subject of complex federal regulation, including precise definition. Generic words and phrases have been used to describe changes to Enron retirement benefits. If this attempt at simplification is imprecise or contradicts the actual provisions of the program or any governing laws and regulations, the actual provisions of the program or the governing laws and regulations will control and take precedence over any statement in this publication.

Some of the concepts discussed in this Program Guide are proposed changes; they are still in the design stage and formal amendment of the applicable pension plans have not yet been adopted by the Enron Corp. Board of Directors. The Company reserves the right to change the design of the concepts prior to adoption of a formal amendment to the pension plans, and after adoption as may be necessary to cause the plans to meet the requirements for qualification under applicable law and regulation.

Finally, the Company reserves the right to amend or terminate the Retirement Plan at any time in accordance with applicable law or regulation.

Enron Cash Balance Plan
Benefit Examples - Calculation of the Final Average Pay Benefit

Exhibit I - Retirement or Termination after all stock is released

Facts

Date of Birth:	07/15/45
Date of Hire:	09/15/84
Non-Offsetable Benefit, 12/31/94:	$1,620.00
Offsetable Benefit, 12/31/94:	$6,109.00
Total FAP Benefit, before Offset, 12/31/94:	$7,729.00
ESOP Retirement Account Balance, 12/31/95:	800 Shares

History of ESOP Releases

	Date of Release	# of Shares Released	Share Price at Release	Market Value of Release
Release 1:	01/01/96	160.0	$31.00	$4,960.00
Release 2:	01/01/97	160.0	$34.00	$5,440.00
Release 3:	01/01/98	160.0	$34.00	$5,440.00
Release 4:	01/01/99	160.0	$37.00	$5,920.00
Release 5:	01/01/2000	160.0	$39.00	$6,240.00

Calculation of ESOP Offset Amount

	(a) Age (CM) at Release	(b) Actuarial Equiv. Annuity Factor*	(c) Market Value of Release	(c) / (b) ESOP Offset Amount
Release 1:	50 and 5 months	2.476355	$4,960.00	$2,002.94
Release 2:	51 and 5 months	2.686845	$5,440.00	$2,024.68
Release 3:	52 and 5 months	2.915227	$5,440.00	$1,866.06
Release 4:	53 and 5 months	3.163021	$5,920.00	$1,871.63
Release 5:	54 and 5 months	3.431878	$6,240.00	$1,818.25
		Total ESOP Offset Amount:		$9,583.56

Calculation of Final Average Pay Benefit at Normal Retirement

(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
$1,620.00	$6,109.00	$9,583.56

Normal Retirement Benefit = (1) + [(2) - (3), but not less than zero]

= $1,620.00

Calculation of Final Average Pay Benefit for Early Commencement at age 55

	(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
Components at Normal Retirement:	$1,620.00	$6,109.00	$9,583.56
Early Commencement Factors:	60.0000% ***	60.0000% ***	36.9950% **
Components at for Age 55 Commencement:	$972.00	$3,665.40	$3,545.44

Final Average Pay Benefit at Age 55: (1) + [(2) - (3), but not less than zero]

= $1,091.96

* From Table I
** From Table II
*** From Table III

Enron Cash Balance Plan
Benefit Examples - Calculation of the Final Average Pay Benefit

Exhibit II - Retirement before all stock is released

Facts

Date of Birth:	05/03/41
Date of Hire:	08/01/91
Non-Offsetable Benefit, 12/31/94:	$0.00
Offsetable Benefit, 12/31/94:	$3,423.00
Total FAP Benefit, before Offset, 12/31/94:	$13,491.00
ESOP Retirement Account Balance, 12/31/95:	250 Shares
Date of Retirement:	06/23/98

History of ESOP Releases

	Date of Release	# of Shares Released	Share Price at Release	Market Value of Release
Release 1:	01/01/96	50.0	$31.00	$1,550.00
Release 2:	01/01/97	50.0	$34.00	$1,700.00
Release 3:	01/01/98	50.0	$34.00	$1,700.00
Release 4:	06/23/98	100.0	$35.50	$3,550.00

Note: Retirement causes the immediate release of any unrelease amounts in the ESOP Retirement Account

Calculation of ESOP Offset Amount

	(a) Age (CM) at Release	(b) Actuarial Equiv. Annuity Factor*	(c) Market Value of Release	(c) / (b) ESOP Offset Amount
Release 1:	54 and 7 months	3.478833	$1,550.00	$445.55
Release 2:	55 and 7 months	3.774534	$1,700.00	$450.39
Release 3:	56 and 7 months	4.095370	$1,700.00	$415.10
Release 4:	57 and 1 month	4.263550	$3,550.00	$832.64
		Total ESOP Offset Amount:		$2,143.68

Calculation of Final Average Pay Benefit at Normal Retirement

(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
$0.00	$3,423.00	$2,143.68

Normal Retirement Benefit = (1) + [(2) - (3), but not less than zero]

= $1,279.32

Calculation of Final Average Pay Benefit for Early Commencement at age 57 and 1 month

	(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
Components at Normal Retirement:	$0.00	$3,423.00	$2,143.68
Early Commencement Factors:	72.5000% ***	72.5000% ***	45.2182% **
Components at for Age 55 Commencement:	$0.00	$2,481.68	$969.33

Final Average Pay Benefit at Age 55: (1) + [(2) - (3), but not less than zero]

= $1,512.34

* From Table I
** From Table II
*** From Table III

Enron Cash Balance Plan
Benefit Examples - Calculation of the Final Average Pay Benefit

Exhibit III - Termination before all stock is released

Facts

Date of Birth:	05/14/62
Date of Hire:	03/15/86
Non-Offsetable Benefit, 12/31/94:	$600.00
Offsetable Benefit, 12/31/94:	$3,615.00
Total FAP Benefit, before Offset, 12/31/94:	$4,215.00
ESOP Retirement Account Balance, 12/31/95:	916 Shares
Date of Termination:	06/12/97

History of ESOP Releases

	Date of Release	# of Shares Released	Share Price at Release	Market Value of Release
Release 1:	01/01/96	183.2	$31.00	$5,679.20
Release 2:	01/01/97	183.2	$34.00	$6,228.80
Release 3:	01/01/98	183.2	$34.00	$6,228.80
Release 4:	01/01/99	183.2	$37.00	$6,778.40
Release 5:	01/01/2000	183.2	$39.00	$7,144.80

Note: Termination does not accelerate the release of the ESOP Retirement Account.

Calculation of ESOP Offset Amount

	(a) Age (CM) at Release	(b) Actuarial Equiv. Annuity Factor*	(c) Market Value of Release	(c) / (b) ESOP Offset Amount
Release 1:	33 and 7 months	0.627205	$5,679.20	$9,054.77
Release 2:	34 and 7 months	0.680517	$6,228.80	$9,153.04
Release 3:	35 and 7 months	0.738361	$6,228.80	$8,435.98
Release 4:	36 and 7 months	0.801122	$6,778.40	$8,461.13
Release 5:	37 and 7 months	0.869217	$7,144.80	$8,219.81
		Total ESOP Offset Amount:		$43,324.73

Calculation of Final Average Pay Benefit at Earliest Possible Commencement Age (age 55)

	(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
Components at Normal Retirement:	$600.00	$3,615.00	$43,324.73
Early Commencement Factors:	60.0000% ***	60.0000% ***	36.9950% **
Components at for Age 55 Commencement:	$360.00	$2,169.00	$16,027.98

Final Average Pay Benefit at Age 55: (1) + [(2) - (3), but not less than zero]

= $360.00

* From Table I
** From Table II
*** From Table III

Enron Cash Balance Plan
Benefit Examples - Calculation of the Final Average Pay Benefit

Exhibit IV - Death before all stock is released

Facts

Date of Birth:	05/14/62
Date of Hire:	03/15/86
Non-Offsetable Benefit, 12/31/94:	$600.00
Offsetable Benefit, 12/31/94:	$3,615.00
Total FAP Benefit, before Offset, 12/31/94:	$4,215.00
ESOP Retirement Account Balance, 12/31/95:	916 Shares
Date of Death:	06/12/97
Spouse's Date of Birth:	09/18/64

History of ESOP Releases

	Date of Release	# of Shares Released	Share Price at Release	Market Value of Release
Release 1:	01/01/96	183.2	$31.00	$5,679.20
Release 2:	01/01/97	183.2	$34.00	$6,228.80
Release 3:	06/12/97	549.6	$34.25	$18,823.80

Note: Death causes the immediate release of any unreleased amounts in the ESOP Retirement Account.

Calculation of ESOP Offset Amount

	(a) Age (CM) at Release	(b) Actuarial Equiv. Annuity Factor*	(c) Market Value of Release	(c) / (b) - ESOP Offset Amount
Release 1:	33 and 7 months	0.627205	$5,679.20	$9,054.77
Release 2:	34 and 7 months	0.680517	$6,228.80	$9,153.04
Release 3:	35 and 0 months	0.703480	$18,823.80	$26,758.12
		Total ESOP Offset Amount:		$44,965.93

Calculation of Final Average Pay Benefit at Earliest Possible Commencement Age (age 55)

	(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
Components at Normal Retirement:	$600.00	$3,615.00	$44,965.93
Early Commencement Factors:	60.0000% ***	60.0000% ***	36.9950% **
Components at for Age 55 Commencement:	$360.00	$2,169.00	$16,635.15

Final Average Pay Benefit at Age 55: (1) + [(2) - (3), but not less than zero]

= $360.00

Calculation of Final Average Pay Death Benefit Payable to Spouse at Participant's Earliest Possible Commencement Age

Earliest Possible Commencement Date:	06/01/2017
Participant's Age (Nearest Birthday):	55
Spouse's Age (Nearest Birthday):	53
Benefit Payable to Participant as Single Life Annuity:	$360.00
Option Factor for 50% J&S Annuity:	0.9241
Benefit Payable to Participant as 50% J&S Annuity:	$332.64
Benefit Payable to Surviving Spouse as Single Life Annuity: (50% of the Benefit Payable to Participant as if he survived)	$166.32

* From Table I
** From Table II
*** From Table III

Enron Cash Balance Plan
Benefit Examples - Calculation of Regular and Transition Benefits

Facts

Date of Birth:	05/12/41
Date of Hire:	06/10/64
Non-Offsetable Benefit, 12/31/94:	$27,432
Total FAP Benefit, 12/31/94, before Offset:	$33,784
ESOP Retirement Account Balance, 12/31/95:	1,504 Shares
Date of Retirement:	06/01/2001
Age at Retirement:	60.00
Total ESOP Offset:	$13,402.20
Total Cash Balance Account at Retirement:	$28,765.47
Final Average Pay at Retirement:	$89,300.00
Integration Level at Retirement:	$46,130.00

Calculation of Final Average Pay Benefit for Early Commencement at age 60

Total 12/31/94 Accrued Benefit:	$33,784.00
Non-Offsetable Benefit:	($27,432.00)
Offsetable Benefit:	$6,352.00

	(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
Components at Normal Retirement:	$27,432.00	$6,352.00	$13,402.20
Early Commencement Factors:	90.0000% ***	90.0000% ***	60.1759% **
Components at for Age 59 Commencement:	$24,688.80	$5,716.80	$8,064.89

Final Average Pay Benefit at Age 60: (1) + [(2) - (3), but not less than zero]

= $24,688.80

** From Table II
*** From Table III

Calculation of Total Cash Balance Plan Benefit as an Annuity (before Transition Minimum)

Calculation of Cash-Balance Annuity

Cash Balance Account Balance at Retirement: $28,765.47

Cash Balance Annuity Conversion Factor: 10.509491 Determined by reference to Plan § 1.1(3)

Cash Balance Annuity, Payable at age 60: $2,737.09 = Account Balance divided by Annuity Conversion Factor

Net Final Average Pay Benefit

Net 12/31/94 FAP Accrued Benefit, at 60: $24,688.80

Total Cash-Balance Plan Benefit

Sum of CB Annuity and Net FAP Benefit: $27,425.89

Enron Cash Balance Plan
Benefit Examples - Calculation of Regular and Transition Benefits

Calculation of Transition Minimum

Special Sub-Account Stock Releases

Number of Shares as of 12/31/95:	83.5	- to be released over 5 years
Number of Shares Allocated, 12/31/96:	14.2	- to be released over 4 years
	97.7	

History of Special Sub-Account ESOP Releases

	Date of Release	# of Shares Released	Share Price at Release	Market Value of Release
Release 1:	01/01/96	16.7	$31.00	$517.70
Release 2:	01/01/97	20.3	$34.00	$688.50
Release 3:	01/01/98	20.3	$34.00	$688.50
Release 4:	01/01/99	20.3	$37.00	$749.25
Release 5:	01/01/2000	20.3	$39.00	$789.75
		97.7		

Offset Associated with Special Sub-Account ESOP Releases

	(a) Age (CM) at Release	(b) Actuarial Equiv. Annuity Factor	(c) Market Value of Release	(c) / (b) ESOP Offset Amount
Release 1:	54 and 7 months	3.478833	$517.70	$148.81
Release 2:	55 and 7 months	3.774534	$688.50	$182.41
Release 3:	56 and 7 months	4.095370	$688.50	$168.12
Release 4:	57 and 7 months	4.443476	$749.25	$168.62
Release 5:	58 and 7 months	4.821171	$789.75	$163.81
		Special Sub Account ESOP Offset Amount:		$831.77

Calculation of Transition Old Plan Benefit, as if Old Plan Continued to Date of Retirement

Service at Retirement:	37.0
Final Average Pay at Retirement:	$89,300.00
Integration Level at Retirement:	$46,130.00
Benefit as if Old Plan had continued to Retirement	$44,975.03

Calculation of Transition Old Plan Benefit after ESOP Offset

Offset Associated with Retirement Account:	$13,402.20
Offset Associated with Special Sub-Account:	$831.77
Total Offset for Transition Benefit:	$14,233.97

	(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
Components at Normal Retirement:	$27,432.00	$17,543.03	$14,233.97
Early Commencement Factors:	90.0000%	90.0000%	60.1759%
Components at for Age 60 Commencement:	$24,688.80	$15,788.72	$8,565.42

Final Average Pay Benefit at Age 60: (1) + [(2) - (3), but not less than zero]

= **$31,912.10** = Transition Minimum Benefit

Calculation of Total Qualified Cash Balance Plan Benefit, after Transition Minimum

Qualified CB Plan Benefit, before Transition:	$27,425.89
Qualified Plan Transition Minimum:	$31,912.10
Qualified CB Plan Benefit, After Transition:	**$31,912.10**
Increase in Benefit due to Transition Minimum:	$4,486.21 to be added to the net FAP Benefit for administrative purposes

Enron Corp. Cash Balance Plan

Annual Age 65 ESOP Offset Factors

(Divide Market Value of Stock at Release by Factor based on Age at Release to get ESOP Offset to Annual Age 65 Floor Plan Benefit)

Mortality Table: UP84, Setback 1 year (Post-Commencement Only) | Single Life Annuity Normal Form | Interest Rate: 8.50%

Age	Completed Months											
Years	0	1	2	3	4	5	6	7	8	9	10	11
15	0.137612	0.138587	0.139562	0.140536	0.141511	0.142486	0.143461	0.144435	0.145410	0.146385	0.147360	0.148334
16	0.149309	0.150367	0.151424	0.152482	0.153540	0.154597	0.155655	0.156713	0.157770	0.158828	0.159886	0.160943
17	0.162001	0.163149	0.164296	0.165444	0.166591	0.167739	0.168886	0.170034	0.171181	0.172329	0.173476	0.174624
18	0.175771	0.177016	0.178261	0.179506	0.180751	0.181996	0.183241	0.184486	0.185731	0.186976	0.188221	0.189466
19	0.190711	0.192062	0.193413	0.194764	0.196114	0.197465	0.198816	0.200167	0.201518	0.202869	0.204219	0.205570
20	0.206921	0.208387	0.209853	0.211318	0.212784	0.214250	0.215716	0.217181	0.218647	0.220113	0.221579	0.223044
21	0.224510	0.226100	0.227691	0.229281	0.230871	0.232461	0.234052	0.235642	0.237232	0.238822	0.240413	0.242003
22	0.243593	0.245319	0.247044	0.248770	0.250495	0.252221	0.253946	0.255672	0.257397	0.259123	0.260848	0.262574
23	0.264299	0.266171	0.268043	0.269915	0.271787	0.273659	0.275532	0.277404	0.279276	0.281148	0.283020	0.284892
24	0.286764	0.288795	0.290827	0.292858	0.294889	0.296920	0.298952	0.300983	0.303014	0.305045	0.307077	0.309108
25	0.311139	0.313343	0.315547	0.317751	0.319955	0.322159	0.324363	0.326566	0.328770	0.330974	0.333178	0.335382
26	0.337586	0.339977	0.342368	0.344760	0.347151	0.349542	0.351933	0.354324	0.356715	0.359106	0.361498	0.363889
27	0.366280	0.368875	0.371469	0.374064	0.376658	0.379253	0.381847	0.384442	0.387036	0.389630	0.392225	0.394819
28	0.397414	0.400229	0.403044	0.405859	0.408674	0.411489	0.414305	0.417120	0.419935	0.422750	0.425565	0.428380
29	0.431195	0.434249	0.437304	0.440358	0.443412	0.446466	0.449521	0.452575	0.455629	0.458683	0.461738	0.464792
30	0.467846	0.471160	0.474474	0.477788	0.481102	0.484416	0.487730	0.491043	0.494357	0.497671	0.500985	0.504299
31	0.507613	0.511209	0.514804	0.518400	0.521995	0.525591	0.529187	0.532782	0.536378	0.539973	0.543569	0.547164
32	0.550760	0.554661	0.558563	0.562464	0.566365	0.570266	0.574168	0.578069	0.581970	0.585871	0.589773	0.593674
33	0.597575	0.601808	0.606041	0.610274	0.614506	0.618739	0.622972	0.627205	0.631438	0.635671	0.639903	0.644136
34	0.648369	0.652962	0.657554	0.662147	0.666739	0.671332	0.675925	0.680517	0.685110	0.689702	0.694295	0.698887
35	0.703480	0.708463	0.713446	0.718429	0.723412	0.728395	0.733378	0.738361	0.743344	0.748327	0.753310	0.758293
36	0.763276	0.768683	0.774089	0.779496	0.784902	0.790309	0.795715	0.801122	0.806528	0.811935	0.817341	0.822748
37	0.828154	0.834020	0.839886	0.845752	0.851618	0.857484	0.863351	0.869217	0.875083	0.880949	0.886815	0.892681
38	0.898547	0.904912	0.911277	0.917641	0.924006	0.930371	0.936736	0.943100	0.949465	0.955830	0.962195	0.968559
39	0.974924	0.981830	0.988735	0.995641	1.002547	1.009452	1.016358	1.023264	1.030169	1.037075	1.043981	1.050886
40	1.057792	1.065285	1.072777	1.080270	1.087763	1.095255	1.102748	1.110241	1.117733	1.125226	1.132719	1.140211
41	1.147704	1.155834	1.163963	1.172093	1.180222	1.188352	1.196481	1.204611	1.212741	1.220870	1.229000	1.237129
42	1.245259	1.254080	1.262900	1.271721	1.280541	1.289362	1.298183	1.307003	1.315824	1.324644	1.333465	1.342285
43	1.351106	1.360676	1.370247	1.379817	1.389387	1.398958	1.408528	1.418098	1.427669	1.437239	1.446809	1.456380
44	1.465950	1.476334	1.486718	1.497102	1.507485	1.517869	1.528253	1.538637	1.549021	1.559405	1.569788	1.580172
45	1.590556	1.601823	1.613089	1.624356	1.635622	1.646889	1.658155	1.669422	1.680688	1.691955	1.703221	1.714488
46	1.725754	1.737978	1.750202	1.762426	1.774650	1.786874	1.799099	1.811323	1.823547	1.835771	1.847995	1.860219
47	1.872443	1.885706	1.898969	1.912232	1.925495	1.938758	1.952022	1.965285	1.978548	1.991811	2.005074	2.018337
48	2.031600	2.045991	2.060381	2.074772	2.089162	2.103553	2.117943	2.132334	2.146724	2.161115	2.175505	2.189896
49	2.204286	2.219900	2.235514	2.251127	2.266741	2.282355	2.297969	2.313582	2.329196	2.344810	2.360424	2.376037
50	2.391651	2.408592	2.425533	2.442474	2.459414	2.476355	2.493296	2.510237	2.527178	2.544119	2.561059	2.578000
51	2.594941	2.613322	2.631703	2.650084	2.668464	2.686845	2.705226	2.723607	2.741988	2.760368	2.778749	2.797130
52	2.815511	2.835454	2.855397	2.875341	2.895284	2.915227	2.935170	2.955113	2.975056	2.995000	3.014943	3.034886
53	3.054829	3.076467	3.098106	3.119744	3.141383	3.163021	3.184660	3.206298	3.227936	3.249575	3.271213	3.292852
54	3.314490	3.337968	3.361445	3.384923	3.408400	3.431878	3.455356	3.478833	3.502311	3.525788	3.549266	3.572743
55	3.596221	3.621694	3.647168	3.672641	3.698114	3.723587	3.749061	3.774534	3.800007	3.825480	3.850954	3.876427
56	3.901900	3.929539	3.957177	3.984816	4.012454	4.040093	4.067731	4.095370	4.123008	4.150647	4.178285	4.205924
57	4.233562	4.263550	4.293537	4.323525	4.353513	4.383500	4.413488	4.443476	4.473463	4.503451	4.533439	4.563426
58	4.593414	4.625951	4.658488	4.691024	4.723561	4.756098	4.788635	4.821171	4.853708	4.886245	4.918782	4.951318
59	4.983855	5.019157	5.054460	5.089762	5.125064	5.160366	5.195669	5.230971	5.266273	5.301575	5.336877	5.372180
60	5.407482	5.445785	5.484088	5.522391	5.560694	5.598997	5.637300	5.675603	5.713906	5.752209	5.790512	5.828815
61	5.867118	5.908677	5.950236	5.991794	6.033353	6.074912	6.116471	6.158029	6.199588	6.241147	6.282706	6.324264
62	6.365823	6.410914	6.456006	6.501097	6.546188	6.591279	6.636371	6.681462	6.726553	6.771644	6.816735	6.861827
63	6.906918	6.955842	7.004766	7.053690	7.102614	7.151538	7.200462	7.249386	7.298310	7.347234	7.396158	7.445082
64	7.494006	7.547089	7.600171	7.653254	7.706336	7.759419	7.812502	7.865584	7.918667	7.971749	8.024832	8.077914
65	8.130997											

Enron Corp. Cash Balance Plan

ESOP Offset Early Commencement Factors

(Multiply Age 65 ESOP Offset by Factor at Age of Commencement to get ESOP Offset at Commencement)

Mortality Table: UP84, Setback 1 year (Post-Commencement Only) Single Life Annuity Normal Form Interest Rate: 8.50%

Age	Completed Months											
Years	0	1	2	3	4	5	6	7	8	9	10	11
55	0.369950	0.373047	0.376144	0.379242	0.382339	0.385437	0.388534	0.391631	0.394729	0.397826	0.400923	0.404021
56	0.407118	0.410555	0.413992	0.417430	0.420867	0.424304	0.427741	0.431178	0.434615	0.438052	0.441490	0.444927
57	0.448364	0.452182	0.455999	0.459817	0.463634	0.467452	0.471270	0.475087	0.478905	0.482723	0.486540	0.490358
58	0.494175	0.498419	0.502663	0.506907	0.511151	0.515395	0.519639	0.523882	0.528126	0.532370	0.536614	0.540858
59	0.545102	0.549823	0.554545	0.559266	0.563987	0.568709	0.573430	0.578152	0.582873	0.587594	0.592316	0.597037
60	0.601759	0.607020	0.612281	0.617543	0.622804	0.628065	0.633326	0.638588	0.643849	0.649110	0.654372	0.659633
61	0.664894	0.670763	0.676632	0.682500	0.688369	0.694237	0.700106	0.705975	0.711843	0.717712	0.723580	0.729449
62	0.735318	0.741870	0.748421	0.754973	0.761525	0.768077	0.774629	0.781181	0.787733	0.794285	0.800837	0.807388
63	0.813940	0.821261	0.828581	0.835902	0.843222	0.850543	0.857863	0.865184	0.872504	0.879825	0.887145	0.894466
64	0.901786	0.909971	0.918155	0.926340	0.934524	0.942709	0.950893	0.959078	0.967262	0.975447	0.983631	0.991816
65	1.000000											

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Enron Corp. Cash Balance Plan

Floor Plan Benefit Early Commencement Factors

(Multiply Age 65 Floor Plan Benefit by Factor at Age of Commencement to get Floor Plan Benefit at Commencement)

Age	Completed Months											
Years	0	1	2	3	4	5	6	7	8	9	10	11
55	0.600000	0.605000	0.610000	0.615000	0.620000	0.625000	0.630000	0.635000	0.640000	0.645000	0.650000	0.655000
56	0.660000	0.665000	0.670000	0.675000	0.680000	0.685000	0.690000	0.695000	0.700000	0.705000	0.710000	0.715000
57	0.720000	0.725000	0.730000	0.735000	0.740000	0.745000	0.750000	0.755000	0.760000	0.765000	0.770000	0.775000
58	0.780000	0.785000	0.790000	0.795000	0.800000	0.805000	0.810000	0.815000	0.820000	0.825000	0.830000	0.835000
59	0.840000	0.845000	0.850000	0.855000	0.860000	0.865000	0.870000	0.875000	0.880000	0.885000	0.890000	0.895000
60	0.900000	0.904167	0.908333	0.912500	0.916667	0.920833	0.925000	0.929167	0.933333	0.937500	0.941667	0.945833
61	0.950000	0.954167	0.958333	0.962500	0.966667	0.970833	0.975000	0.979167	0.983333	0.987500	0.991667	0.995833
62	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000
63	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000
64	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000	1.000000
65	1.000000											

Table III

Enron Corp. Retirement Plan
Estimated Cash Contributions

Plan Year	1994 (Made in 1995)	1995 (Made in 1996)	1996 (Made in 1997)	1997 (Made in 1998)	1998 (Made in 1999)
Old Plan					
Minimum Contribution (assuming minimum funding)	$0	$0	$0	$13,982,000	$18,523,000
Contribution to Maintain 60% Funded Status	$1,736,000	$6,149,000	$6,989,000	$7,876,000	$8,466,000
Minimum Contribution (assuming larger of minimum or 60% Funded Status funding)	$0	$0	$0	$0	$6,660,000
New Plan					
Minimum Contribution (assuming minimum funding)	$0	$0	$1,005,000	$24,071,000	$22,207,000
Contribution to Maintain 60% Funded Status	$1,736,000	$2,353,000	$14,636,000	$14,758,000	$13,684,000
Minimum Contribution (assuming larger of minimum or 60% Funded Status funding)	$0	$0	$0	$4,293,000	$10,853,000

Plan Year	1999 (Made in 2000)	2000 (Made in 2001)	2001 (Made in 2002)	2002 (Made in 2003)	
Old Plan					
Minimum Contribution (assuming minimum funding)	$20,537,000	$17,481,000	$19,432,000	$21,019,000	
Contribution to Maintain 60% Funded Status	$9,087,000	$0	$0	$0	
Minimum Contribution (assuming larger of minimum or 60% Funded Status funding)	$18,577,000	$17,481,000	$19,432,000	$21,019,000	
New Plan					
Minimum Contribution (assuming minimum funding)	$22,176,000	$17,860,000	$18,941,000	$20,087,000	
Contribution to Maintain 60% Funded Status	$13,766,000	$8,417,000	$4,420,000	$0	
Minimum Contribution (assuming larger of minimum or 60% Funded Status funding)	$19,104,000	$17,860,000	$18,941,000	$20,087,000	

- Results estimated based on 1/1/93 valuation results
- Other Assumptions: 4% asset return in 1994; DOL assessment rate equal to 6.5% for all years (up from 5.75% for 1993); 1/1/94 Assets adjusted for accruals.

III. MATERIALS RELATING TO THE BLACKOUT PERIOD FOR THE ENRON SAVINGS PLAN

Date	Stock Price *	Comments/Actions
Mid 1997	$20.50	PGE acquired, with two-year moratorium on any plan changes. It was decided to gradually increase ENE company match starting with 50% of 2% in 1998, 50% of 4% in 1999 and 50% of 6% in 2000. This was done to move ENE to PGE match levels.
July 1998	$24.90	Original decision to RFP for new 401(k) administrator and Trustee Reason for search – PGE and ENE planned to merge the two plans; however PGE and ENE did not share the same recordkeeper. RFIs went to 33 potential vendors, 17 responded Highest 4 selected for full RFP process
August – October 1998	$25.37	RFP process in progress and resulting decision (team was made up of PGE/ENE and Watson Wyatt representatives) Site visits 10/19/1998 Fidelity was selected as vendor of choice on 10/30/1998 with a planned 7/1/99 live date.
November 1998	$28.44	Decision was reviewed for impact to Non-Qualified Deferral (NQ) Plans wherein it was determined that the recent vendor change for the NQ plans was to go live 3/99 at Northern Trust. A new recommendation was made to not move the 401(k) recordkeeping until after the PGE plan merger and ENE's Qualified and Non-Qualified plans were stabilized.
11/4/98	$28.44	Presentations were given to both the PGE and ENE's administrative committees notifying both of the recommendation. In subsequent meetings, the recommendation to stay with Northern was approved until the plans were stable. At this point, there was no more work on the move away from Northern until after the PGE plan had been merged.
7/1/99	$40.56	Completion of PGE merger into 401(k) plan Note: the PGE merger was communicated to employees via a mailed employee communication package in May 99. To total transition period was to run from May 15 – September 3. The actual blackout period was set for the time period of June 15 thru September 3rd (8 – 12 weeks). However, there was a Trust reconciliation issue that caused this black out period to extend until September 15. Enron also had a slight blackout period even though it did not have an actual Trustee or Recordkeeper change which ran from August 30th to September 3rd. (4 days)

* Historical stock price is approximated due to required reliance on nearest dividend payment dates. Prices reflect post split price of which occurred on 8/16/99. THIS DOCUMENT IS CONFIDENTIAL FOR DISTRIUBITION TO ADMIN COMMITTEE ONLY

Date	Stock Price *	Comments/Actions
July – Dec. 1999	$44.37	Major administrative changes halted due to decision to move to SAP as well as efforts to prepare for Y2K. All resources devoted to this effort.
1/4/2000	$42.50	SAP 401(k) module live for NEPCO.
January – June 2000	$64.50	Major administrative changes halted due to efforts applied for taking the full SAP benefit module live on 7/1/2000. All resources devoted to this effort.
June 2000	$64.50	Decision to outsource benefit processes with objective of reducing headcount on or before 9/1/00. This was later moved to 1/1/01. Order of priority was Pension (totally in-sourced), Health & Group (partly in-sourced), 401(k) (fully outsourced except for customer service)
7/3/2000	$68.18	SAP benefit module live.
10/2/2000	$86.44	Pension Plan fully outsourced
11/2/2000	$81.75	The outsourcing of benefits was discussed at the Administrative Committee. Information from ERISA counsel was provided to the Committee concerning the Enron's versus the Committee's role in these decisions.
November 2000	$64.75	Notified Northern Trust of Enron's intent to re-review the decision to change recordkeepers as soon as the other plans are outsourced. Northern is alerted to Enron's concern for service levels and told that weekly service meetings will begin to address service issue.
1/2/2001	$79.87	Health & Group fully outsourced

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Date	Stock Price *	Comments/Actions
January 2001	$80.00	Began internal preparation for work on the 401(k) plan. Noted that service level is at 76% in January with abandoned call rate of 2.6%. NOTE: Typical target service levels are 80% or higher. In addition to the service level concern the following is a list of other problems encountered with Northern supporting the need to reconsider the decision of moving the Trust and Recordkeeping services to alternative vendor. • NAV error discovered in 2000 that dated back to 10/99. While the dollar magnitude was only $158,000 the concern was that an NAV error occurred in both the Stable Value and Stock fund that went undetected for months and only detected by an audit. • During the PGE transition, a Trust reconciliation error was found that resulted in the blackout period having to be extended 12 more days. • Unacceptable Sr. account staff turnover. Examples include numerous staff changes at customer service and Trust officer level. • Loss of withdrawal checks • Significant difficulty during IRS audit in documentation of discrimination testing as well as proof of distributions and timeliness of response. We believe the issues faced during this audit contributed greatly to Enron's inability to get the audits closed. • Inability to accurately or effectively process 1099Rs for in-kind distributions impacting 24 participants. One participant (Leon Cernock, actually received 7 different forms before getting it corrected.) • Encountered difficulty getting timely Trust Statements during our annual external audits, which had the potential of putting the 11K filing in jeopardy. • Errors in processing employee requested transfers (example would be Neena Kirsch) • There were also system compliance difficulties; one example was the systems inability to comply with loan parameters. (Examples are Mary Celia and Joan Amero)
February 2001	$68.50	Service levels at Northern dropped to 73% and abandoned call rate was at 2.2%

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Date	Stock Price *	Comments/Actions
February – March 2001	$58.10	New RFP process began for 401(k) Hired Watson Wyatt to provide updates from their vendor databases for all vendors who had responded during the original RFI as well as identify new players. A short list of about 6 vendors received a modified RFP. The Non-Qualified Deferral Plans were included in the process. Site visits conducted
April 2001	$62.72	Northern Trust Service Level drops to 36% and the abandoned call rate jumps to 15.8%.
April – May 2001	$58.35	Vendor finalists were determined to be Hewitt and Fidelity. Fidelity was eliminated due to cost to program for the Non-Qualified Plans. Hewitt notified of intent to do business effective 10/1/01. NOTE: The original blackout period was scheduled to be 10/1 thru 10/20/2001 and original communication scheduled for 9/4. (See notes on 8/15 and September 2001 regarding the reasons for moving the transition period.)
May 3, 2001	$58.35	Mikie Rath presented the decision to move the 401(k) services to Hewitt Associates and Wilmington Trust to the Admin Committee
July 2001	$48.30	Northern Trust notified and Hewitt implementation begins. Phone call to Northern on July 6 followed by a letter dated the same day.
July 2001	$48.30	HR community notified of decision to move during All HR Lead meeting on 7/17.
8/15/2001	$40.25	Mikie Rath informed the Committee that the ESOP would be moved to a daily processing versus monthly upon the successful completion of the service transfer to Hewitt Associates. Ms. Rath also received full approval from the Committee for the removal of the EOG stock Fund.
August 2001	$34.99	Jeff Skilling left the Company
August 2001	$34.99	Timeline of transition given to HR Community • All HR Lead staff meeting 8/28 and special HR staff meeting for ENA/EBS/Networks on 8/29

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Date	Stock Price *	Comments/Actions
September 2001	$35.00	Working with ERISA counsel it was determined that an amendment was required at the October Comp Committee meeting to allow for diversification of the stock held in EOG. The result was that the Hewitt Asset Transfer could not occur on 10/1 and was then moved to 11/1/01. This resulted in the following new transition periods: 10/19 – last day for loan and distribution requests, rollovers in and the SDA Schwab funds liquidation 10/26 – at close of business (3:00 pm CST) no new transfers until 11/20.
September 2001	$35.00	Special meeting held with HR Community • ETS HR staff meeting 9/24
9/20/2001	$28.39	Letter mailed to all participants holding Schwab funds in the SDA with information on the upcoming liquidation of these funds.
Sept/October 2001	$28.39	Individual HR meetings held with Robert Jones and Gary Smith's HR groups in effort to prepare them for employee issues/questions.
10/04/01	$33.10	401(k) communication mailed to all participants in the plan. Highlighted key activity dates such as suspension of withdrawals and last day to initiate transfer activity among funds. Supplemental information was also mailed for Non-Qualified Participants.
10/10/01	$35.25	Letter mailed to all ESOP participants on transition to new providers. NOTE: no blackout for ESOP participants due to monthly processing cut off on 20th of each month. In fact, access moved to daily with move to new provider.
10/16/01	$33.84	Full account status is still available
10/16/01	$33.84	e-mail sent to all active employees 11:10pm Oct. 16 as further reminder of transition period deadlines.
10/16/01	$33.84	Enron takes a $1. billion charge for right downs and reduction to shareholder equity by $1.2 billion.
10/19/01	$26.05	At end of day, withdrawals and distributions are frozen, but transfers among funds is still available
10/19/01	$26.05	WSJ article discloses a Fastow general partnership realized more than $7 million in management fees.
10/22/01	$26.65	e-mail sent at 10:28pm on October 22 as further reminder of transition period approaching
10/22/01	$26.65	ENE announces SEC inquiry, its full cooperation and its support for Fastow
10/23/01	$19.79	All employee meeting wherein the SEC inquiry was announced to employees as well as assurance of support for Fastow.

EC 000001913

* Historical stock price is approximated due to required reliance on nearest dividend payment dates. Prices reflect post split price of which occurred on 8/16/99. THIS DOCUMENT IS CONFIDENTIAL FOR DISTRIUBITION TO ADMIN COMMITTEE ONLY

Date	Stock Price *	Comments/Actions
10/24/01	$16.41	ENE replaces Fastow as CFO
October 25, 2001	$16.35	Discussions with CO/PM on ability to stop as well as discussions with Hewitt and Northern Trust. Basis for decision was the inability to notify all participants thus giving active participants an advantage outweighed the inability to predict what would occur with the stock prices. Prior to deciding to move forward, CO touched based with two other VPs of HR as well as a Enron employee to get a sense as to the acceptance of moving forward with transition.

D-101

EC 000001914

* Historical stock price is approximated due to required reliance on nearest dividend payment dates. Prices reflect post split price of which occurred on 8/16/99. THIS DOCUMENT IS CONFIDENTIAL FOR DISTRIUBITION TO ADMIN COMMITTEE ONLY

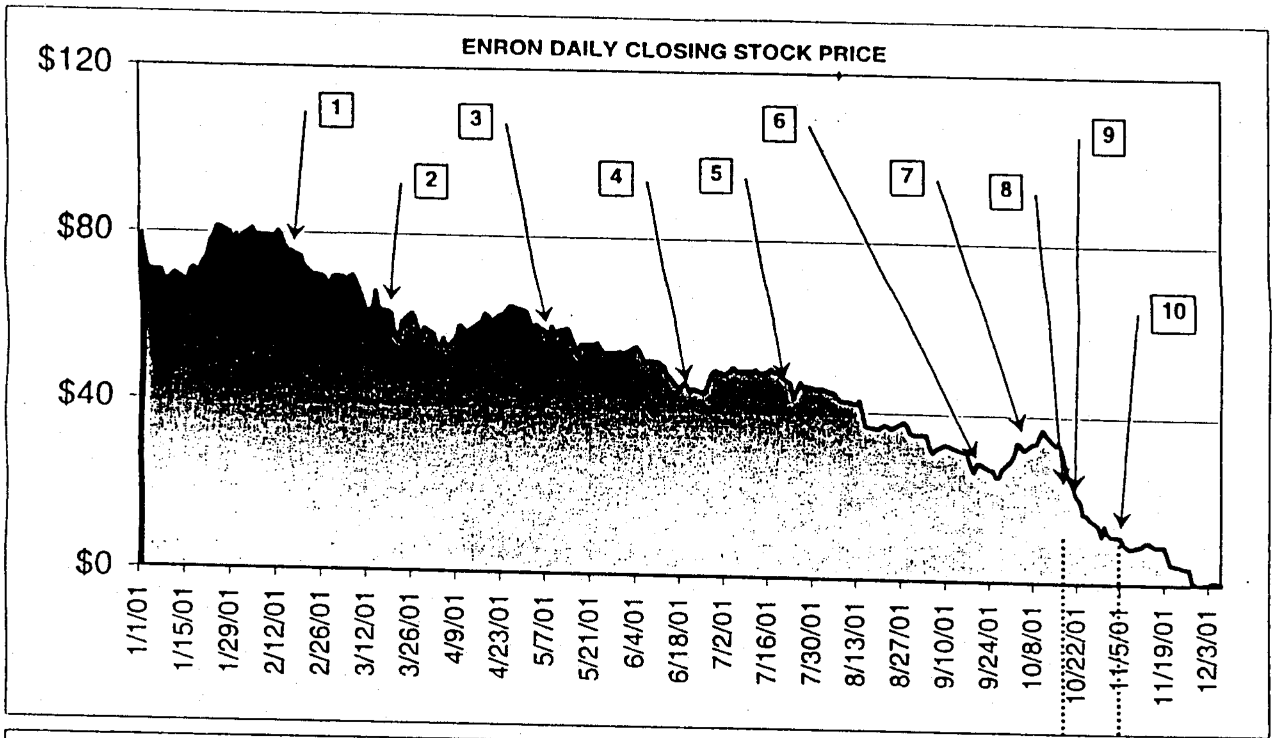
Date	Stock Price *	Comments/Actions
10/25/01	$16.35	ENE draws down $3 billion dollars from bulk of available credit lines. Fitch rating agency puts ENE on review for possible downgrade
10/26/01	$15.40	Transfer are available until close of market this day
10/26/01	$15.40	e-mail sent early morning acknowledging concern and decision to move forward with transition. A "Final Reminder" sent at noon.
10/29/01	$13.81	First day of the transition period. Benefits Dept. adds Option 6 to Benefits Service Line to take questions internally.
10/29/01	$13.81	Moody's lowers rating by 1 notch and kept Company under review for further downgrade.
10/30/01	$11.16	Discussion with Chairman for the need for weekly Administrative Committee Meetings
10/31/01	$13.90	SEC elevates to formal investigation
11/1/01	$11.99	ENE states it has secured commitment for $1 billion from JP Morgan and Citigroup. An Administrative Committee meeting was also held this date.
11/5/01	$11.17	New questions raised on another deal related to $35 million purchase by a company run by an ENE officer.
11/6/01	$9.67	Special Admin. Committee meeting held
11/07/01	$9.05	Website and phone line for updates went live
11/08/01	$8.96	Postcards mailed to all participants announcing efforts to shorten period and how to access information on web and phone line
11/09/01	$8.63	ENE announces merger with Dynegy
11/12/01	$9.24	Transition Period completed at end of day
11/13/01	$9.98	Plan is live (IVR and Web accepting transfers) and second Admin. Committee meeting held
11/14/01	$10.00	E-mail to employees to alert them to the system going live on the 13th.
11/20/01	$6.99	Admin Committee meeting held. NOTE: this was the date the scheduled end date for the black out period.

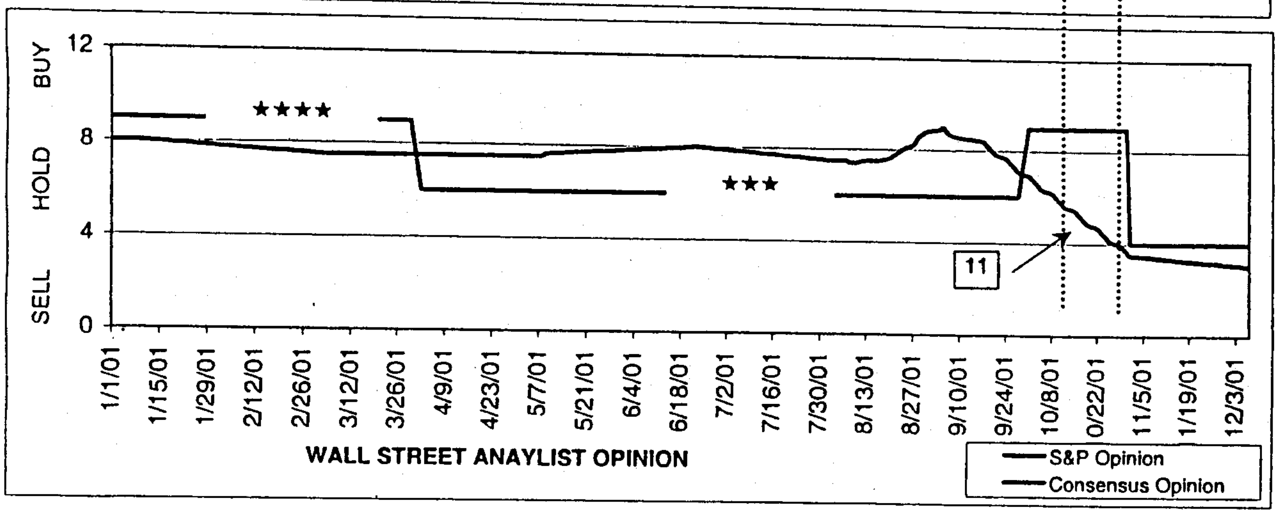
D-102

EC 000001915

* Historical stock price is approximated due to required reliance on nearest dividend payment dates. Prices reflect post split price of which occurred on 8/16/99. THIS DOCUMENT IS CONFIDENTIAL FOR DISTRIUBITION TO ADMIN COMMITTEE ONLY

D-103





TIMELINE DETAILS

1: Request for proposal for new third party adminstrator began

2: Vendor selection narrowed to two finalist

3: May 3, 2001 -- Presentation made to Administrative Committee recommending vendor.

4: Transition implimentation began

5: Human Resources community notified of transistion.

6: October 4, 2001 -- Participants notified by US mail of the transisiton and black-out

7: October 16, 2001 -- E-mail sent to all active participants as a reminder of the

8: October 22, 2001 -- E-mail sent to all active participants as a reminder of the

9: October 26, 2001 -- Two E-mails sent to all active participants as a reminder of the

9: October 26, 2001 -- Last day to trade before adminitrative black-out period.

10: November 13, 2001 -- Account access available.

11: Enron Stock remains either buy or hold by consensus investor opinion.

what's new | | what's the same

Enron Corp. Savings Plan Changes

money | **in** | *motion*

ENRON

EC000021560

What's NEW?

In late November, Hewitt Associates will become our new administrator for the Enron Corp. Savings Plan, providing improved customer service and quicker processing of your requests. Hewitt is recognized as a leader in benefit plan administration, with a reputation of providing quality service to many Fortune 500 companies.

Fund Changes

On November 20, the Fidelity Freedom™ Funds will replace the Vanguard LifeStrategy® Funds. These new funds invest in a wide variety of underlying Fidelity mutual funds to provide you with broader diversification. And speaking of diversification – all investment funds will now be listed by asset class in order of risk factor – from the least risky to the most risky.

YOUR ACCOUNT BALANCE WILL MOVE FROM THESE INVESTMENT OPTIONS		TO THESE OPTIONS WITH SIMILAR INVESTMENT OBJECTIVES
*Vanguard LifeStrategy Conservative Growth	→	Fidelity Freedom 2000
Vanguard LifeStrategy Moderate Growth	→	Fidelity Freedom 2010
Vanguard LifeStrategy Growth Portfolio	→	Fidelity Freedom 2020

*default fund

Loans, Withdrawals and Distributions

There may be a time when it is necessary for you to use a portion of your funds; so we've made it simpler for you to make withdrawals and take loans. There's an easy paperless process for in-service withdrawals and distributions (now offered on a daily basis). The loan administration fee will be $35.

EC000021561

New Website Features

- Personal Rate of Return
- Reduced Self-Directed Account (SDA) fees
- Retirement Report Card – coming soon
- **Password Hint** – No more hunting for that PIN; assign your own and use the hint to help you remember

A GREAT NEW FEATURE FOR ACTIVE EMPLOYEES

Will my finances support my long-term goals?

What funds should I invest in, and how much should I put in each fund?

In early December, Enron will offer you an online investment education and advice tool that will help turn your financial dreams into reality. The new mPower website will feature a personalized Retirement Report Card to help you quickly determine your financial readiness for the future. mPower is the nation's leading provider of online retirement planning advice. mPower takes the guesswork out of investing, and in just a few minutes can provide personalized and fund-specific answers to important questions.

WATCH FOR MORE INFORMATION ON THIS POWERFUL NEW FEATURE.

What's THE SAME?

- The same great benefit
- Easy access through the web or voice response system
- Benefit service representatives to help you when you need personal assistance
- One phone number to remember for access to your benefits

IMPROVED SELF-DIRECTED ACCOUNT SERVICES

Hewitt Financial Services, in partnership with **CSFB*direct*, will replace Charles Schwab as the brokerage firm providing this service.** Backed by Credit Suisse First Boston, CSFB*direct* offers you a comprehensive line of brokerage products, including extended-hours trading and reduced commissions for online stock trades. However, there are some minor changes that you need to be aware of listed below.

Have a Current Schwab Account? READ ON!

At 3:00 PM CST on October 19, your Schwab Personal Choice Account will be frozen until 8:00 AM CST on November 20 when the transition period ends.

Don't Panic!

Your holdings as of market close on October 19 will NOT be liquidated! They will remain invested and moved **in kind** to CSFB*direct*.

Schwab Mutual Funds No Longer Available

If you are invested in Schwab's family of mutual funds, you must choose an alternative investment before the transition period begins. If you do not choose an alternative, your funds will be liquidated and transferred to the Money Market Fund and will remain there until the transition period ends.

SDA Contribution Allocations No Longer Allowed

Effective November 20, all contribution allocations must be made among the core funds. If you have not changed your allocation by 3:00 PM CST on October 26, your funds will be allocated to the Fidelity Freedom 2000 Fund.

Current Schwab account holders will receive a Welcome Kit in November. For information visit **www.hewitt.csfbdirect.com**

To establish online access to your CSFB*direct* account, you must call 1-800-890-3200 after November 12.

EC000021563

TRANSITION ACTION ITEMS

Your fund balances will remain invested during the transition.

ask...

During the transition period, you will NOT have access to your funds. Your fund balances will remain invested in the market based on your fund choices as of 3:00 PM October 26. All activity must be completed by the dates shown below.

why...

Fund balances of approximately $1.4 billion for 24,000 participants will be moved and balanced. Each record must be correct for every account, i.e. before-tax, after-tax, company match, etc. Once the records are balanced, investment returns and November payroll contributions will be added.

october 19
3:00 PM CST

Last Date For:

- Loan Requests
- In-Service Withdrawals & Distributions
- Hardship Withdrawals
- Loan Payoffs
- Rollovers into the Plan
- SDA Schwab Fund Liquidation

october 26
3:00 PM CST

Last Date For:

- Investment Fund Balance Transfers/Allocation Changes
- Contribution Rate Changes

november 20
8:00 AM CST

TRANSITION ENDS...

Savings Plan system opens with all the great new features!

EC000021564

No Excuses...

The Savings Plan is a great benefit provided by Enron. It allows you to save for the future by making contributions directly from your paycheck on a pre-tax basis—before any federal or state income taxes are deducted. The company match...it's like receiving free money!

For complete details on the Plan, refer to the Money-in-Motion guide on the Enron Intranet site or contact a Benefits Service Representative.

CONNECT

1 **Internet**
Access your Savings Plan through
enron: benefits.enron.com
home: http://resources.hewitt.com/enron

2 **Voice Response System**
Access your Savings Plan 24/7 by calling (800) 332-7979, option 3. Benefits Service Representatives are available Monday through Friday, 8:30 AM to 5:00 PM CST.

EnronBenefits...*keeping pace with your lifestyle*

2001

Rath, Mikie

From:	Enron Announcements/Corp/Enron@ENRON on behalf of Corporate Benefits@ENRON
Sent:	Tuesday, October 16, 2001 11:10 PM
To:	All Enron Employees United States Group@ENRON
Subject:	To: All Domestic Employees who Participate in the Enron Corp. Savings Plan

Mark your calendar--
the Enron Corp. Savings Plan is moving to a new administrator!

In preparation, here are a few things you need to remember.

For **All** Savings Plan participants, **Friday, October 19 at 3:00pm CST** will be the last day to:

- Request a loan or a loan payoff so that funds can be allocated or distributed in time.
- Request a withdrawal (In-service or Hardship).

For **SDA** Participants, **Friday, October 19 at 3:00pm CST** will be your last day to:

- Make trades in your Schwab SDA brokerage account so that we can move your holdings in-kind.
- Re-invest any Schwab mutual funds into your choice of funds - the default will be your money market fund.

Other transactions, such as Contribution Rate Changes and Investment Fund Transfers, will continue until 3:00pm CST on October 26.

EnronBenefits... *keeping pace with your lifestyle.*

Rath, Mikie

From: Enron Announcements/Corp/Enron@ENRON on behalf of Corporate Benefits@ENRON
Sent: Monday, October 22, 2001 10:28 PM
To: All Enron Employees United States Group@ENRON
Subject: To: All Domestic Employees who Participate in the Enron Corp Savings Plan

October 26 is fast approaching!

Mark your calendar--
as the Enron Corp. Savings Plan moves to a new administrator!

As a Savings Plan Participant, **Friday, October 26 at 3:00pm CST** will be your last day to:

- Transfer Investment Fund Balances and make Contribution Allocation Changes
- Change your Contribution Rate for the November 15th payroll deductions
- Enroll if you were hired before October 1

TWO important reminders:

- Vanguard Lifestrategy investment options are being replaced with Fidelity Freedom funds and;
- Your funds will remain invested in the funds chosen as of 3:00pm CST until 8:00 am November 20.

At 8:00 am CST, November 20 the Savings Plan system re-opens with great new features.

Should you need assistance during the transition period, call ext. 3-7979 and press **Option 6.** This option will be **available from 8:00am CST October 29 until 5:00pm CST November 19.**

Enron Benefits... *keeping pace with your lifestyle.*

From: Enron Announcements/Corp/Enron@ENRON on behalf of Corporate Benefits@ENRON
Sent: Thursday, October 25, 2001 11:44 PM
To: All Enron Employees United States Group@ENRON
Subject: IMPORTANT-To All Domestic Employees who Participate in the Enron Corp Savings Plan

If you are a participant in the Enron Corp. Savings Plan, please read this very important message.

We understand that you are concerned about the timing of the move to a new Savings Plan administrator and the restricted access to your investment funds during the upcoming transition period scheduled to take place beginning at 3:00PM CST on October 26 and ending at 8:00AM CST on November 20.

We have been working with Hewitt and Northern Trust since July. We understand your concerns and are committed to making this transition period as short as possible without jeopardizing the reconciliation of both the Plan in total or your account in particular.

Remember that the Enron Corp. Savings Plan is an investment vehicle for your **long-term** financial goals. The Enron plan will continue to offer a variety of investment opportunities with different levels of risk.

As always, we advise you to review your overall investment strategy and carefully weigh the potential earnings of each investment choice against its risk before making investment decisions that are aligned with your long-term financial plans and your risk tolerance.

For that reason, it is critical that ALL trades among your investment funds be completed by **3:00 PM CST Friday, October 26 before the transition period begins.**

Rath, Mikie

From: Enron Announcements/Corp/Enron@ENRON on behalf of Corporate Benefits@ENRON
Sent: Friday, October 26, 2001 11:58 AM
To: All Enron Employees United States Group@ENRON
Subject: DRAFT- FINAL REMINDER- To All US Employees who Participate in the Enron Savings Plan

Final Reminder

If you are a participant in the Enron Corp. Savings Plan, all trades among your investment funds must be completed by **3:00 PM CST Friday, October 26.**

The makeup of your investment funds in the Savings Plan at 3:00 p.m., October 26, will reflect your investment decision for the duration of the transition period.

Rath, Mikie

From: Enron Announcements/Corp/Enron@ENRON on behalf of Corporate Benefits@ENRON
Sent: Wednesday, November 14, 2001 9:07 PM
To: All Enron Employees United States Group@ENRON
Subject: SAVINGS PLAN TRANSITION PERIOD ENDS For All Employees who Participate in the Enron Corp Savings Plan

The Savings Plan Transition Period Ends Early!

We have been working closely with Hewitt Associates to get you access to your Savings Plan account before November 20 and are pleased to announce that the internet site went live as of 8:00 AM yesterday morning, November 13.

Log on to benefits.enron.com and check out the new website - you will enjoy the new features.

Once again, we have appreciated your patience during the transition period.

EnronBenefits . . . *keeping pace with your lifestyle.*

EC000023719

IV. EXECUTIVE COMPENSATION "WHITE PAPERS"

ENRON EXECUTIVE COMPENSATION PROGRAM

"WHITE PAPER"
(Updated, January, 1998)

During 1986, the Compensation Committee, with the assistance of Hewitt Associates, developed the compensation philosophy, objectives, and comprehensive executive compensation program for senior Enron executives to be implemented January 1, 1987. The Compensation Committee and the full Board of Directors approved it on December 8, 1986, subject to ongoing review and change.

Compensation Philosophy and Objectives

Enron's compensation philosophy for its senior management team includes the following tenets:

- Total Compensation consists of base salary, annual bonus, long-term incentive pay, benefits, and perquisites.
- Individuals have the opportunity to earn at the 75th percentile or higher level relative to peer companies, subject to obtaining performance at the 75th percentile or higher. Higher achievement provides higher payouts, while lesser performance decreases total compensation. In order to assure that individual compensation is tied to performance, more dollars of total compensation are placed at risk, tied to Enron absolute performance, and performance relative to its peers.
- Program design promotes teamwork by tying a significant portion of compensation to subsidiary and Enron Corp. performance.

Table A outlines the compensation targets for the Enron Program that flow from this philosophy.

EC 001934688

TABLE A
Compensation Objectives

Component	Enron Target
Base Salary	50th Percentile
Target Annual Bonus for Outstanding Performance	"Gap" between Total Direct Target and Base Salary
Total Direct Compensation	Commensurate with Company Performance - Target of 75th Percentile
Long-Term Incentive Pay	Grants at 75th Percentile - Payouts Commensurate with Company Performance
Benefits	Same as All-Employee Benefits Target
Perquisites	50th Percentile

Peer Company Comparison - Performance and Compensation

Management and the Compensation Committee have determined that the companies listed in Table B best represent Enron's peers in the pipeline/diversified energy industry. Annual bonuses and long-term incentive pay, therefore, are based, in large part, on how well Enron performs relative to this group of peer companies.

TABLE B
Peer Companies for Performance Comparison

Amoco
British Gas
El Paso Energy
Coastal Corp.
Columbia Gas
Consolidated Natural Gas
Natural Gas Clearinghouse
Occidental Petroleum
Duke Energy Corp
Sonat Inc.
Williams Cos.

Ideally, these companies would be used to develop the comparable compensation information for Enron's executive group. However, four of the eleven companies do not provide compensation information to Hewitt. The remaining group of seven companies is too small for meaningful statistical comparisons. To obtain a statistically significant group of companies for compensation information, we have selected an additional eight energy companies from Hewitt Associates' comprehensive list of over 600 companies that participate in Hewitt's annual compensation surveys. The list of companies used for compensation information are listed in Table C.

TABLE C
Hewitt Data Base Energy Companies

Amoco Corp.
ARCO
BP America Inc.
Burlington Resources Inc. (Meridian Oil)
Chevron Corp.
Consolidated Natural Gas Co.
El Paso Energy
NorAm Energy Corp. (Houston Industries)
Occidental Petroleum Corp.
Duke Energy Corp.
Shell Oil Co.
Sonat Inc.
Sun Company, Inc.
USX Corp.
The Williams Cos., Inc.

Because all 15 companies vary in size and organizational structure, Hewitt uses regression analysis to make adjustments to compensation data so comparisons of salaries and organizational position/title more closely match Enron. Hewitt's statistical procedures are well tested and have been successfully used for years. However, sensitivities due to acquisitions, divestitures, and diversification by Enron and the other companies require a regular assessment of the data to assure equitable comparisons.

To determine how Enron's executives compare in total compensation to the executives of those companies listed in Table C, we look at 30 - 35 benchmark positions every other year. The total compensation items compared are the base salary, annual incentive award, long-term incentive pay, benefits and perquisites. This information is also used to set the salary ranges.

Participation

Approximately 78 Enron executives participate in the program. These 78 executives include Management Committee members, operating company presidents, corporate officers, and selected key line and staff officers in the operating companies. These 78 executives represent approximately 1% of the total Enron employee population.

Base Salary

Target for base salary is the 50th percentile of market data. The salary range midpoints are set at the 50th percentile for the executive positions. The annual merit increase budget is set to maintain Enron's market position.

Annual Incentive Plan

The primary objective of the annual incentive plan is to promote outstanding performance by Enron in absolute terms, as well as in comparison to its peer companies. The plan is funded as a percent of after-tax net income as approved by the Compensation Committee each year. Payout under the program will be made in the year following the year of performance. The payout will be based upon Enron's performance against pre-established goals, as well as subsidiary and individual performance.

Annual bonus payouts are based upon Enron's performance measured against the Operating Plan as approved by the Board of Directors. Key performance criteria such as cash flow, return on equity, debt reduction, earnings per share improvements, and other relevant factors will be considered at the option of the Compensation Committee. A Performance Review Report is presented to the Compensation Committee in January. This report summarizes management's view regarding whether and to what extent the key performance criteria were attained. The Performance Review Report also discusses any other significant, but unforeseen factors that positively or negatively affect Enron's performance. The Compensation Committee verifies Enron's actual after-tax net income, reviews management's funding level recommendation and approves the resulting award fund.

The market target is the "gap" between the base salary and the total direct target based on company performance relative to the peer group. Individual performance is measured against a set of supervisor approved individual goals and objectives established no later than the end of January of the bonus year. Also, for employees whose compensation is disclosed in the proxy statement, the Compensation Committee establishes an individual target award level, expressed as a percent of after-tax net income, at the beginning of each year. Subsidiary or operating company performance is measured against the appropriate operating company annual plan. After the Board determines the overall funding level, the Office of the Chairman determines the allocations for each operating group based on performance. Individual awards are also based on the employee's individual performance and teamwork contribution and can range from $0 to an unlimited maximum. However, for employees whose compensation is disclosed in the proxy statement, in no event will the actual payout exceed the individual target level established at the beginning of each year. Generally, the Compensation Committee will review the individual recommendations for the 78 executive compensation participants and Management Committee members. The Office of the Chairman approves the recommendations for all other participants.

Long-Term Incentives

Enron's long-term incentive program is designed to tie executive performance directly to the creation of stockholder wealth over a four year period. Accordingly, the payout is based upon how well Enron's stock price performs absolutely and how well it performs against the stock prices of its peer companies.

Each participant will be assigned a "Targeted Grant Value" coincident with selection for participation in the program and in December of each year thereafter. The "Targeted Grant Value" will be determined by the results of the Hewitt Compensation Survey.

Grants are targeted at the 75th percentile. One half of the grants are paid in non-qualified stock options to foster shareholder returns. The remaining one half is granted in the form of performance units to be paid within six weeks after the close of books for the fourth year (See Attachment I for an example). The Compensation Committee has the option to substitute any other long-term compensation vehicles that they deem appropriate (e.g., restricted stock).

The initial value of a performance unit is $1.00, but units are revalued at the end of the four year period. For example, the value of the performance units granted in 1998 is determined by calculating the total shareholder return (TSR) of Enron and of each company in the peer group through 2001 as follows:

$$\frac{\text{(Stock Price End of Period)-(Stock Price Beginning of Period)+Dividends}}{\text{Stock Price Beginning of Period}}$$

The TSR's for the peer group over the 4 year period are then ranked from highest to lowest. The performance unit revaluation is determined by reference to Table D.

TABLE D

LTIP Performance Unit Revaluation Factors

Enron's TSR Position	Revaluation Factor
1	$2.00
2	$1.50
3	$1.00
4	$0.75
5	$0.50
6	$0.25
7-12	$0.00

3

EC 001934692

Notwithstanding the above, Enron's TSR must be above the return on 90 day U.S. Treasury Bills over the same time period before any payout is made for performance units. The intent is to relate executive performance/management results directly with the creation of shareholder wealth.

If, over the four year period, Enron ranks first in total shareholder return and exceeds the 90 day Treasury Bill rate for the same period, the performance units double in value. If Enron ranks seventh or lower, the performance units are worth zero. The Compensation Committee has reserved the right to adjust payouts downward or eliminate them altogether if absolute stockholder returns are deemed to have been inadequate.

Payment for the revalued performance units are made at the close of the performance period, providing that the participant is then in the company's employment. In the event that a participant dies, retires, becomes disabled or is involuntarily terminated during the performance period, such participant's performance units shall be revalued as of the close of the quarter preceding that event, and the result shall be prorated on the basis of the completed quarters in the performance period divided by 16. The result thereof shall be paid to the participant (or his estate) as soon as practical.

If an unapproved change of control occurs, the performance period closes and full payouts are made based on Enron's TSR compared to peer companies as of the close of the quarter preceding the change of control.

In the event of a participant's termination of employment for any reason other than involuntary termination, death, retirement, or disability, the participant's performance units will be canceled.

Benefits

Executives selected to participate in the comprehensive compensation program will have the same benefit plans as other Enron employees. In addition, they may have supplemental benefits to restore lost benefits due to government imposed statutory limits and IRS regulations.

Perquisites

The program provides each executive with Enron FlexPerq Dollars equal to 3% of midpoint. These dollars can then be used to purchase business related perquisites best suited to individual needs. A list of pre-authorized perquisites is provided to executives and accounting so that duplicate payments do not occur.

Summary

The Enron Executive Compensation Program is designed to promote excellence in both team and individual performance. The program is reviewed biannually for market competitiveness. It is also reviewed periodically to determine if changes in philosophy, targets or compensation vehicles are necessary.

ATTACHMENT I

Long-Term Incentives

EXAMPLE

Grant Year	1998
Individual Salary Range Midpoint	$150,000
Targeted Grant Value	$ 75,000

PERFORMANCE UNITS

1998 Grant of 1/2 Targeted Grant Value = 37,500 Performance Units

These performance units will be revalued in 2001, based upon the TSR performance, over the 1998 - 2001 time period. If Enron ranks first, the performance units double in value to $75,000. If Enron ranks fourth, the performance units decrease in value to $28,125 (0.75 x 37,500). If Enron ranks seventh or lower, the performance units decrease to a value of zero. Enron's TSR must be greater than the return on 90 day U.S. Treasury Bills over the same four year period.

STOCK OPTIONS

1998 Grant of 1/2 Targeted Grant Value = $37,500
Value of Enron Stock Option = $9.75*

Stock Options: $\frac{\$37,500}{\$9.75/\text{Share}}$ = 3,846.20 Shares, Rounded to 3,850

* The value of an Enron stock option is based upon the value of Enron stock at the time of the grant and upon many other factors, including stock price volatility, dividend rate, option term, vesting schedule, long-term interest rates, differential income tax treatment, etc. All these factors are taken into account in establishing a value at time of grant.

In summary, in this example the Enron executive would be granted for 1998, the following:

Performance Units	37,500 To be revalued in 2001
Stock Options	3,850 Granted December 31, 1997

EC 001934694

Enron Corp. Executive Compensation Program

This comprehensive brochure provides you with information pertaining to Enron's Executive Compensation Program, with special emphasis on the Long-Term Incentive Program.

Compensation Philosophy
The central philosophy of Enron's executive compensation program is to provide executives with rewards which reflect their impact on Enron's total shareholder returns and creation of long-term shareholder value. The Program is targeted at Enron's senior management team, which is approved each year by the Compensation and Management Development Committee (the "Committee") of the Enron Board of Directors. The key tenets of the program are:

- To deliver market competitive total compensation targets as determined through comprehensive market studies.
- To deliver a significant portion of total compensation in a combination of short-term and long-term incentives so that executives have the opportunity to earn at the 75th percentile of the external marketplace or higher, subject to the achievement of company financial and non-financial goals and individual performance objectives.
- To tie executive compensation to the creation of shareholder value.
- To promote teamwork and support Enron's desire for a transferable workforce.

The following represent the key components of Enron's Executive Compensation Program:

Base Salary
Base salaries are targeted at the 50th percentile of the external marketplace. An annual salary increase budget is set to maintain Enron's market position. Base pay is reviewed and adjusted on February 1 of each year, if appropriate.

Annual Incentives
The primary objectives of Enron's annual incentive plan are to provide cash awards aligned with Enron's achievement of pre-established financial and non-financial operating goals which are critical to Enron's short-term and long-term success and to reward individual contribution to that success. Subject to approval by the Committee, annual incentives are funded as a percentage of actual after-tax net income.

Competitive annual incentive targets are established by the Committee each year based on an assessment of external trends and market data. Cash awards are determined each January based on company and business unit performance as determined by the Committee. Individual performance, as determined through the year end Performance Review Committee ("PRC") process, has significant influence on actual incentive awards paid.

Long-Term Incentives

Overview
The Long-Term Incentive Program (the "LTIP") was designed to link executive pay to the creation of long-term shareholder value. The LTIP provides for awards of Enron non-qualified stock options and restricted

stock. Option grants provide for time-based vesting; restricted stock grants are made with a future vesting date which may be accelerated based on Enron's performance relative to the S&P 500.

The Committee has the option to add or substitute any other long-term compensation vehicle that they deem appropriate.

Eligibility

Participation in the LTIP is available to employees in the vice president job group and above. Eligibility is limited to top performers who are key to Enron's success.

Competitive long-term incentive target values are established by the Committee each year based on an assessment of external trends and market data. Actual grants are determined each January based on the year end PRC assessments and are subject to approval by the Enron Corp. Office of the Chairman. Award agreements which provide the terms and provisions of the awards are typically presented to each recipient during the first quarter of the year.

For Section 16(b) officers, grants require Compensation and Management Development Committee approval.

Stock Options

One-half of the value of the LTIP award will be delivered in non-qualified stock options. A stock option provides the option holder with an opportunity to purchase stock at a fixed price over a specified period of time. Generally, LTIP awards will consist of 5-year term options. The option term and vesting schedule is reviewed each year and is subject to change. The following table depicts the vesting schedule applicable to awards made in January, 2001:

Grant/Vest Dates	Vesting
1/23/01(Date Granted)	15%
7/31/01	15%
1/31/02	15%
7/31/02	15%
1/31/03	15%
7/31/03	15%
1/31/04	10%

The grant price will be the closing price of Enron Corp. common stock as reported in the New York Stock Exchange (NYSE) Composite Transactions section of the Wall Street Journal as applicable for the actual grant date.

The number of options to be awarded will be determined based on the approved Black-Scholes value as determined by the Committee. The Black-Scholes value of an Enron stock option is based upon the value of Enron stock at the time of the grant and other factors, including, but not limited to, stock price volatility, dividend rate, option term, vesting schedule and long-term interest rates. Enron engages a third party compensation consultant to derive its Black-Scholes values.

Restricted Stock

The other half of the LTIP award will generally be delivered in restricted stock. The stock will vest four (4) years following the grant date. However, vesting can accelerate based upon Enron's annual cumulative shareholder return relative to the S&P 500. The following table illustrates possible vesting scenarios:

Enron's Cumulative Shareholder Return Relative to the S&P 500	**Cumulative % Restricted Stock to Vest by Year After Grant**			
	Year 1	**Year 2**	**Year 3**	**Year 4**
<50th Percentile	0%	0%	0%	100%
50-69th Percentile	25%	50%	75%	100%
70-79th Percentile	33%	67%	100%	
80-89th Percentile	50%	100%		
90-99th Percentile	100%			

Example:
Year 1 – Enron ranks 75th Percentile, shares vest 33%
Year 2 – Enron ranks in 40th Percentile, shares vest 33% on a cumulative basis
Year 3 – Enron ranks in 65th Percentile, shares vest 75% on a cumulative basis
Year 4 – Enron ranks in 80th Percentile, shares vest 100% on a cumulative basis

	1993	1994	1995	1996	1997	1998	1999	2000
ENE	27.39%	7.81%	27.67%	15.38%	-1.51%	39.61%	57.28%	88.45%
S&P 500	14.57%	0.43%	32.35%	20.13%	28.75%	7.13%	20.92%	-9.03%
ENE Position in S&P 500	114	161	283	271	417	109	76	33
Percentile	70-79TH	50-69TH	<50th	<50th	<50th	70-79TH	80-89th	90-99th

LTIP Termination Provisions

Generally, if your employment with Enron is terminated, you will have the earlier of the expiration date or the dates referenced below (from date of termination) to exercise your stock options. The following diagram summarizes the termination provisions.

Reason	***Restricted Shares***	***Stock Options***
Retirement, Death, Disability	Unearned Shares Supervest	3 Years; unvested options supervest
Voluntary Termination	Unearned Shares are Forfeited	3 months (1991Stock Plan) 1 month (1994 Stock Plan) Unvested Options Cancel
Involuntary Termination	Unearned Shares Supervest	3 Years; unvested options cancel

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Executive Deferral Plans
LTIP participants are eligible to defer all or a portion of salary, bonus and long-term compensation into Company-sponsored deferral plans. These plans provide executives with an opportunity to delay payment of federal and state income taxes, and earn tax-deferred returns on deferrals, while actively employed. Full details of these plans are provided to eligible executives during the fourth quarter for elections effective the following tax year.

Benefits
Executives selected to participate in the LTIP will typically have the same benefit plans as other Enron employees.

Summary
The Enron Corp. Executive Compensation Program is designed to promote excellence in both team and individual performance and to attract and retain key talent. The program is reviewed annually for market competitiveness. It is also reviewed periodically to determine if changes in philosophy, targets or compensation vehicles are necessary to help attract, motivate and retain executive talent.

Note: All benefits earned and payable under the plans and/or programs outlined in this brochure shall be governed by the terms and provisions of the plans, governing documents and any amendments thereto. All calculations contained herein are made in accordance with provisions of the appropriate plans. In the event of error, the terms and provisions of the plans shall govern. Subject to the provisions thereof, the Company reserves the right to amend, alter, and terminate any plans and/or programs at any time.

V. MATERIALS PROVIDED TO ENRON BY OUTSIDE CONSULTANTS REGARDING EXECUTIVE COMPENSATION

Charles E. Essick
Principal

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Towers Perrin

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December 3, 2001

Dr. Charles A. LeMaistre
Chairman, Enron Compensation Committee
Enron Corp.
7 Bristol Green
San Antonio, TX 78209

Dear Dr. LeMaistre:

As requested by Enron's Compensation Committee, Tower Perrin has prepared this letter providing our opinion regarding the competitiveness of the executive compensation programs at Enron Corp. Our comments about pay competitiveness relates to organizations that are going concerns, without any adjustments for a company's financial condition. The remainder of this letter provides a discussion of Enron's pay philosophy, the methodology used to assess pay competitiveness, and the competitiveness of specific executive compensation programs.

Pay Philosophy

Enron's executive pay philosophy has been to target approximately the market median (50^{th} percentile) for base salaries, the 75^{th} percentile for total cash (i.e., base plus bonus), and the 75^{th} percentile for long-term incentives. However, actual bonus payments and long-term incentive awards are to vary based on performance.

Market Pay Assessment Methodology

Enron has for years collected marketplace compensation data for as many of its jobs as possible. Towers Perrin's involvement in this process has varied over time, ranging from actually developing market compensation rates for hundreds of jobs to opining on the overall methodology used by Enron's executive compensation staff. Towers Perrin has also reviewed the individual market pay rate and recommendations developed by Enron Executive Compensation staff for the Management Committee. However, the Compensation Committee has consistently relied on Towers Perrin for market pay data for the CEO and at least two other senior officer positions each year.

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In Towers Perrin's experience, the appropriate market data to be used depends on the size of the company (most often measured by revenues, as shown in most reputable executive pay surveys) and industry affiliation (for certain commercial jobs). In our opinion, the data sources relied upon by Enron for developing executive and commercial market compensation rates are widely accepted and utilized surveys, such as those produced by Towers Perrin, Hewitt, and McLagan Partners.

As alluded to above, company size, as measured by revenues, is an important factor in determining market pay competitiveness. Traditionally, Enron, like most of its energy industry competitors, considered the Company's full revenues in assessing its size for market pay determination purposes. However, with increased trading volumes and volatility, the Company's 2001 actual and 2002 expected revenues escalated dramatically. For example, 2000 actual revenues were about $100 billion and 2001 expected revenues (until the turmoil experienced in the last quarter) were estimated at about $200 million. Because these revenue growth rates were so unpresidented and because the Company's size had not increased as dramatically using other measures (such as assets, employees), the Compensation Committee agreed to moderate the revenue growth impact on compensation decision-making for 2000 and 2001. For 2000, budgeted revenues of $56 billion (versus actual revenues of about $100 billion) were used to determine company size. For 2001, the recommended methodology was to use revenues equal to the revenues of companies with market capitalization equal to roughly 50% to 200% of Enron's market cap for a trailing 6 month period. This methodology produced net adjusted revenue of $45 billion for Enron to use as of August of this year.

Please note that most of Enron's energy industry peer companies still use total gross revenues to determine their size for executive pay purposes. Consequently, the methodology used by Enron in 2000 and 2001 was conservative.

Competitiveness of Enron Pay Programs

While Towers Perrin and Enron's executive compensation staff have worked together in assessing the competitiveness of executive pay at Enron over time, a comprehensive analysis examining the relationship between pay and performance was conducted in April 2001. This "stress test" analysis (which was requested by the Compensation Committee) included:

- Interviews with senior management and members of the Board on the perceived effectiveness of Enron's executive pay programs;

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- A competitive compensation analysis for 60 key executive positions;
- A review of the in-the-money value of equity-based pay;
- An analysis of expected total direct pay at various share prices; and
- An assessment of potential stock overhang under various projected share price levels.

As part of this analysis, Enron's performance was compared to selected investment banking and energy industry peer companies for 1998 to 2000. A copy of this analysis is shown in Attachment A. As shown, Enron's performance on ROE and TSR was typically above the median and was often around the 75th percentile compared to its energy industry peers. On a market cap basis, Enron was larger than all of the energy and investment banking companies analyzed, except Morgan Stanley Dean Witter.

The competitive pay assessment showed that Enron's base salaries were 91% of the market median (using the $56 billion sales figure regression analysis previously sited) and that total pay levels for 2000 (including base, bonus, and the expected value of long-term incentives) was 113% of 75th percentile. Towers Perrin believes an organization's pay levels are competitive if they fall within 90% to 110% of a market reference point. Therefore, we concluded that Enron's total direct pay levels for the executives in the study were slightly above the 75th percentile, based on the Compensation Committee's judgement regarding company performance.

Annual Incentive Pay Structure

Until the year 2000, Enron funded bonus pools for each business unit and corporate staff based on market levels of incentive funding by business line (e.g., trading versus asset business). In 2000, senior management expressed concern that this bonus funding structure discouraged key commercial employees from leaving profitable units to take critical positions in less profitable units (since funding was based on a percentage of net income for each unit).

To address this concern, Towers Perrin recommended (and the Compensation Committee adopted) a new bonus funding scheme under which bonuses throughout the Company would be funded at the equivalent of 16% of corporate earnings before interest and taxes (EBIT). (This recommendation was revised at management's request to be expressed as about 24.5% of recurring net income so that taxes and interest expenses would impact the calculation, assuming a 35% tax rate). Individual employee bonus allocations from the pool were then to be made using discretion, but considering the value of the individual's position using market data and individual performance.

In Towers Perrin's experience, this annual incentive plan design is consistent with market 75th percentile practices for energy trading and marketing entities.

Long-Term Incentive Plan Design

Enron's long-term incentive plan consists of two parts: stock options and performance accelerated restricted stock (TARSAP). Under this program, 50% of the expected value of long-term incentives is delivered using each vehicle.

Enron is consistent with market practice in using stock options. According to Towers Perrin's 2001 Long-Term Incentive Plan Survey, 89% of companies use stock options.

The Company's use of restricted stock is somewhat less common. Towers Perrin's survey data show that 20% of companies use restricted stock. Prior to 1999, the Company used a combination of stock options and a long-term performance plan. However, the Company began experiencing retention problems in 1998/99 that led to the need to provide retention incentives. The restricted stock element of this program was intended to meet this objective. However, Enron's restricted stock plan provides for awards to cliff vest 4 years after the date of grant, with vesting to be accelerated if certain performance levels are achieved relative to the S&P 500 index. This plan feature increases the performance sensitivity of the restricted stock element of the plan while at the same time aiding in employee retention.

Other Pay Actions

This fall, Enron experienced a sudden and unexpected decline in its share price and investor confidence. Because the Company has relied significantly on stock-based pay and cash incentive pay to attract and retain employees, this turn of fortunes resulted in significant concerns about how to hold the Company together during this time of turbulence.

Enron then entered into a merger agreement with Dynegy. Because compensation issues during an expected merger are unique, Towers Perrin prepared the November 14, 2001 letter (Attachment B) to help guide Enron's Compensation Committee in its decision-making. This letter recommended that the Committee

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provide fully competitive 2001 bonuses for key commercial employees (based on their performance and market values), since their talent is significantly in demand in the market and since Enron's ultimate value to shareholders would depend on keeping key talent in this area. Based on these facts and market pressures, the Compensation Committee established a 2001 annual bonus pool of $50 million to be paid to up to 100 key commercial employees in Enron Americas. This funding equals about 2.5% of Enron Americas' (its most important commercial unit) ~~EBIT, which is~~ dramatically less than market median funding of 15% of EBIT for energy trading units.

Following Dynegy's withdrawal from the merger agreement, Enron then faced the issue of retention of critical non-commercial staff. Enron's Compensation Committee chose to establish a 2001 bonus pool for this group of about $54 million. This plan excluded any payments to 16(b) officers and contains a requirement that any recipient who voluntarily terminates employment prior to 90 days after receipt of payment must pay back 125% of the award.

This bonus plan was approved for 528 individuals (out of an employee population of 20,000) who are considered critical to the Company's ability to function. In essence, the plan pays awards equal to about 90% of prior year bonuses (on average) in order to retain key staff not covered by the Enron Americas plan cited above. As shown in Attachment B, 45% of surveyed companies report using stay bonuses. The Enron bonus payments to these critical employees were structured to be a form of stay bonus, since the payouts contain a claw-back feature and a premium repayment to the Company of 25% in the event of voluntary termination.

★ ★ ★ ★ ★

I hope this letter meets Enron's needs. Please call me with any questions.

Sincerely,

Charles Essick

CEE:mhm

cc: Ms. Mary Joyce
Mr. John Duncan

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Attachment A

Table I

Enron Corp.
Financial Analysis
Selected Financial Measures for Enron and Selected Peer Companies

Company	Calender Year End 2000 Market Capitalization ($Millions)	Total Shareholder Return (as of the end of 2000) 1-Year (%)	3-Year (%)	5-Year (%)	Return on Equity 2000 (%)	1999 (%)	1998 (%)	Current PE Ratio* (Ratio)	Share Price Used to Calculate PE Ratio	Earnings Per Share
Investment Banking Peers										
MORGAN STANLEY DEAN WITTER	$87,751	12%	40%	47%	29%	29%	25%	13	$57.40	$4.42
MERRILL LYNCH & CO	$55,024	65%	25%	42%	21%	21%	13%	15	$60.55	$4.04
GOLDMAN SACHS GROUP INC	$51,702	14%	N/A	N/A	19%	27%	38%	16	$91.78	$5.74
LEHMAN BROTHERS HOLDINGS INC	$15,966	60%	39%	46%	24%	19%	14%	11	$66.23	$6.02
BEAR STEARNS COMPANIES INC	$5,624	20%	7%	27%	15%	15%	18%	11	$48.49	$4.41
25th Percentile:	$15,966	14%	20%	38%	19%	19%	14%	11	$57.40	$4.41
Median:	$51,702	20%	32%	44%	21%	21%	18%	13	$60.55	$4.42
75th Percentile:	$55,024	60%	39%	46%	24%	27%	25%	15	$66.23	$5.74
Energy Industry Peers										
DUKE ENERGY CORP	$31,457	76%	20%	17%	17%	9%	16%	18	$42.51	$2.36
DYNEGY INC	$17,473	220%	65%	55%	13%	12%	10%	36	$53.16	$1.48
EL PASO CORP	$16,736	88%	32%	41%	16%	-8%	11%	28	$67.77	$2.42
RELIANT ENERGY INC	$12,762	99%	24%	19%	14%	31%	-3%	31	$47.00	$1.52
UTILICORP UNITED INC	$2,890	69%	12%	16%	11%	11%	9%	16	$33.89	$2.26
25th Percentile:	$12,762	76%	20%	17%	13%	9%	9%	18	$42.51	$1.62
Median:	$16,736	88%	24%	19%	14%	11%	10%	28	$47.00	$2.26
75th Percentile:	$17,473	99%	32%	41%	16%	12%	11%	31	$53.16	$2.36
ENRON CORP **	$65,344	88%	62%	36%	12%	12%	11%	53	$59.44	$1.12

* P/E ratio taken from April 17, 2001 Wall Street Journal and is calculated by dividing the closing market price by the Company's diluted per-share earnings, as available, for the most recent four quarters. Charges and other adjustments usually are excluded when they qualify as extraordinary items under generally accepted accounting rules.

** Data presented for Enron developed by Enron staff.

Source: Standard & Poor's Compustat Database

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EC2 000028646

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Attachment B

November 14, 2001

Dr. Charles A. LeMaistre
Chairman, Enron Compensation Committee
Enron Corp.
7 Bristol Green
San Antonio, TX 78209

Dear Dr. LeMaistre:

As requested by Enron, Towers Perrin has prepared this letter addressing potential strategies Enron may want to consider in dealing with 2001 bonus allocations and possible ways to retain key employees during the period before the merger with Dynegy is completed. We have also outlined our understanding of how Enron's Compensation Committee is impacted by the announced merger.

Special Merger-Related Decision-Making Considerations

Before discussing specific compensation strategies, we want to remind the Compensation Committee about the extra importance of its decisions in light of the Company's "in-play" status and other pending litigation. We believe it is critical that the Compensation Committee understand how the announced merger needs to impact is decision-making. This input reflects our extensive experience as compensation consultants and advisors to Enron and its board, but should not be taken as legal advice. **TOWERS PERRIN DOES NOT ENGAGE IN THE PRACTICE OF LAW, SO THE COMPANY SHOULD SEEK LEGAL COUNSEL'S OPINION ON THESE ISSUES.**

Also note that lawyers and courts do not always interpret these matters in exactly the same way. What we're outlining here reflects what we have seen as mainstream interpretations of law firms with which we deal.

Under most circumstances, Compensation Committee actions are governed by the Business Judgment Rule. Under this rule, Compensation Committee (and full Board) decisions are not to be second-guessed if good processes have been used in making decisions, even if the impact of the decisions turn out to be unfavorable. A helpful

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condition for demonstrating sound business judgment is the use of reputable professional experts (such as compensation consultants in the case of making compensation decisions).

However, once a company is "in play" a higher standard of decision-making may apply. Many legal experts believe the burden of proof that the decisions taken by a Board of Directors are reasonable shifts to a higher standard. This standard, in essence, is that decisions made must be directly in the shareholders' interest. Consequently, actions taken by a Compensation Committee during this period are scrutinized much more closely and documentation of the reasons for decisions taken is critical. At such a time, company should not be making significant increases in pay or other program changes unless it can substantiate a compelling business rationale for doing so. Otherwise, charges of Corporate Waste or other breach of fiduciary duty could be levied.

Enron Compensation Issues

Enron faces a variety of critical compensation issues in light of the announced merger with Dynegy. In our opinion, it is critical that these decisions be made recognizing the following facts:

- Enron's financial performance for the year (as measured by recurring net income) is likely to be good. However, its stock price has dropped dramatically.

- Enron's greatest value is in its core trading, other commercial and pipeline businesses. With respect to the trading and other commercial businesses, the value imbedded in the business resides largely in the intellectual capital of the employees. Therefore, it is critical that key people associated with these businesses be retained in order for the Company pre- and post-merger to have value to shareholders. This is particularly true of key commercial people who, in our opinion, can find other job opportunities with equivalent pay opportunities instantly.

To deal with these concerns, Towers Perrin has developed some suggested parameters for Enron to consider in making 2001 compensation decisions. We will address possible 2002 compensation structure issues at a later date.

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Suggested 2001 Compensation Decision Parameters

Given the announced merger, Enron's financial performance, Enron's stock price performance, and the fact that Enron's commercial talent has highly portable skills, Towers Perrin suggests that Enron make its 2001 compensation decisions within the following parameters:

- *Equity Compensation* – In most companies, immediate vesting of equity compensation takes place upon a change-in-control. In Enron's case, the equity plans only accelerate vesting in the event of a hostile takeover. (It is our understanding that the Dynegy merger does not represent a hostile takeover.)

  This lack of vesting complicates matters for Dynegy following the merger. Specifically, Dynegy's stock overhang (i.e., the percentage of shares reserved for stock-based pay) is about 10% while Enron's overhang is about 15%. With no acceleration of vesting (which is typically coupled with a requirement that options be exercised or cancelled within 3 months of the change-in-control), Dynegy will inherit Enron's overhang. What is more, this overhang may exist for years since Enron's stock options are deeply underwater. (However, this overhang problem may decline if there are significant employee terminations.)

  In addition, since most companies accelerate vesting of equity incentives in the event of a change-in-control, there is little precedence for making any new equity grants to the acquired company's employees once a merger is announced.

  Given these issues, Towers Perrin recommends that Enron generally not make additional equity grants to its employees. The one exception to this rule is in the case of employees who have equity award guarantees within their employment agreements. In this case, Enron may want to buy-out the equity award portion of the contract with deferred cash payouts over the next year. However, unless contract employees agree to a buyout, we believe Enron must honor its contracts.

- *2001 Annual Incentives* – Enron's annual incentive plan is funded with up to 24.5% of recurring after-tax net income. This funding level was established based on market 75th percentile norms of 16% of EBIT for energy trading and marketing organizations, converted to a percentage of after-tax net income using an assumed tax rate of 35%. Enron then allocates bonuses to individuals based on targeting market 75th percentile bonus awards for comparable positions, adjusted

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for performance.

Towers Perrin understands that Enron expects to have a 2001 bonus pool of about $280 million for 2001 performance. (Note: We believe this figure is based on recurring net income levels and does not reflect restatements of earnings or write-downs. The Committee clearly should consider the impact of these one-time events on the size of the bonus pool.) While we understand that the merger agreement with Dynegy allows Enron's Compensation Committee ~~to make~~ 2001 bonus (and other pay) decisions, we recommend that the following parameters be considered in the bonus allocation process:

— The CEO and other key corporate officers named in the proxy and/or directly involved in the ongoing SEC investigation should receive no bonus for the year. This recommendation is based on the dramatic decline in Enron's share price and the fact that questions exist regarding the actions (or inactions) of these officers that led to the market decline.

— Key commercial (e.g., trading) and pipeline employees who have contributed to Enron's profitability and who are key to its ongoing success should be receiving bonuses fully commensurate with their market value and performance.

— Certain officers (including those who may have recently become proxy-named executives) who have been, and continue to be, critical to the past and future success of the core pipeline and commercial business should receive bonuses based on their market value and performance, but adjusted in the case of newly-named proxy officers to reflect the time spent in commercial roles.

— Other key staff support people (e.g., IT, Accounting, Risk Control) who played a critical role in Enron's 2001 success and who are critical to maintaining the current systems required to run the company should receive competitive bonuses, adjusted to reflect their performance.

In considering the timing of bonus payouts, Enron should note that most companies pay the full bonus with no mandatory deferrals based upon audited financial results (e.g., late February or early March of the year following the performance period). The one notable exception to this practice exists within energy trading and marketing units. Approximately 60% of the major energy trading and marketing groups defer a

Towers Perrin

portion of trader/originator bonuses in excess of some threshold amount over a 2-year period. A conservative model for this deferral would be to defer 50% of any bonus over $1 million over two years, with one-half of this amount payable one year after the initial payout and the remainder payable two years after the initial payout. This deferral feature is intended to help retain key trading talent. We recommend that Enron consider deferring a portion of its 2001 commercial employee bonuses for at least a one to two year period to aid in retaining key talent, which should aid in employee retention. However, we recognize that the Company will need to handle this issue with great care, since it has not deferred these bonus payouts in the past and since its best commercial employees have tremendous market opportunities.

Finally, to help Enron in making bonus allocations to key commercial talent, please note that while the data contained in Towers Perrin's 2001 Energy Trading and Marketing Survey provides a good starting point for determining competitive bonus levels, market practice varies widely based on performance. Specifically, the survey shows statistics based on the average pay rates reported by a company for all employees in a given position. Therefore, intra-company pay differences among employees in a given job are not shown.

While Towers Perrin has not conducted a formal survey of individual incumbent pay levels among energy trading and marketing units, we know from our consulting experience that many individuals who are not corporate officers received annual bonuses in excess of $1 million in 2001 for 2000 performance. We also were told by one company that they paid a bonus of about $10 million to their leading trader, and that a small number of traders received bonuses of $5 million to $9 million. We are not providing this information to recommend any specific pay actions for Enron, but to simply give you the information you need to compete in today's commercial market.

Other Retention Issues

Given that most of Enron's businesses are based largely on the intellectual capital of its people, retention of key talent is critical in order to ensure that shareholder value is maximized in the merged entity. Since the merger will impact both Enron and Dynegy employees (and since Dynegy has infused significant capital into Enron), we believe that any significant retention strategies should be discussed jointly between Enron and Dynegy.

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Nevertheless, Towers Perrin believes Enron faces some immediate and significant retention issues as a result of having no current positive spread in its stock options, the fact that many of its best employees are questioning whether they will be paid for their contributions in 2001 or 2002, and the Company's history of relying heavily on stock-based pay. We believe Enron and Dynegy need to move quickly to address the retention of key employees that will be needed during the merger transition period and beyond.

The traditional tools used to retain employees are restricted stock grants, contracts and/or change-in-control agreements, and stay bonuses. Enron has already used restricted stock to provide 50% of the expected value of long-term incentives in recent years. However, while this stock has some retention value, this value has been vastly diminished as a result of Enron's stock price decline. Enron also has hundreds of employment agreements that provide severance pay and contain non-compete clauses, which should help with retention, as well.

However, we believe these devices alone will not likely hold all of the employees Enron needs to continue operating and to provide value to shareholders in the newly merged company. To effectively retain key employees, we believe Enron and Dynegy need to work together quickly to:

- Identify critical functions and people that need to be retained until the merger is closed and after closing;
- Determine (based on current pay and market opportunities) the magnitude of the handcuffs required to lock in key staff, considering the value of existing employment contracts and unvested restricted stock; and
- Consider establishing a stay bonus plan for critical employees who do not have sufficient retention hooks through existing devices.

In evaluating the need for a stay bonus plan, Enron should note that the <u>2nd Annual Retention Bonus Survey</u> conducted by WorldatWork showed that 45% of 550 companies adopted retention bonus programs in the last year and that eligibility was extended to key employees in technical, professional, and management positions. While the data from this survey show a wide range of practices in terms of the size of awards, Towers Perrin believes that awards would need to be in the following ranges

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to have meaning to Enron employees (given historical pay practices and market conditions).

Employee Group/Level	Potential Stay Bonus as % of Base Pay
Executives/Key Commercial	100% to 200%
Key Technical	50% to 100%
Key Staff Support	20% to 40%

These payout ranges assume the retention period is one year, so the numbers would need to be reduced for a shorter retention period on a pro-rata basis. Also, the value of any employment contracts should be netted out against the value of stay bonuses. Finally, Towers Perrin believes that a properly designed 2002 annual bonus program may mitigate the need for stay bonuses to some degree. We plan to work with Enron on this issue in the coming weeks.

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Dr. LeMaistre, I hope this letter is helpful. However, Towers Perrin re-emphasizes the need to coordinate retention pay issues with Dynegy's Top Management and Board. In the overall scheme of the merger, Dynegy's plans for the core business of Enron will have a major impact on the number of key employees they will want to retain. Please call me with any questions.

Sincerely,

CEE:mhm

cc: Mary K. Joyce – Enron
John Ellerman – Towers Perrin/Dallas
Paula Todd – Towers Perrin/Stamford

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Dick Foster -

Confidential

ENRON CORP.

Mary

EXECUTIVE COMPENSATION STRESS TEST FINDINGS

D-141

Revised Draft Report #2

~~John Duncan~~ Norm Blake

1. Very comprehensive & reassuring. Conclusions - don't overreact - Concur w/. Understand Exhibit 17. options scale.

April 20, 2001

2. Function of mkt multi
3. Justified to have off cycle grants
4. R/S is good.
5. ~~Anter~~ year grants.

EC 002634703

Towers Perrin

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Attachment 5

Table of Contents

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EC 002634704

Overview

- As a result of recent volatility in U.S. equity markets and in Enron's stock price, the Compensation Committee of the Board asked Towers Perrin and Enron's Executive Compensation Group to assess the impact of this volatility on Enron's ability to attract and retain key talent within a pay-for-performance philosophy.

- To this end, Towers Perrin and Enron's Executive Compensation Group have prepared this report providing an analysis of the impact of higher and lower Enron stock prices on executive pay.

- The remainder of this report provides the following information:

  — Summary of interview findings;

  — Competitive compensation analysis;

  — Review of in-the-money value of Enron long-term incentives at various share prices;

  — An analysis of expected total direct compensation levels at various share prices; and

  — An assessment of potential stock "overhang" for Enron assuming current levels of expected long-term incentive value are provided, but under various share price scenarios.

- In addition, Towers Perrin has provided a number of case studies showing how other companies have dealt with a declining stock price in terms of long-term incentive management.

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I. Interview Findings

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Interview Findings

- Towers Perrin conducted interviews with the following executives and Board members to determine the issues to be covered by this study and to determine the major business issues that may impact Enron's total executive pay program:

Executives	**Board Members**
— Ken Lay	— John Duncan
— Jeff Skilling	— Dr. Charles LeMaistre
— Andy Fastow	

After Jeff - call + work w/ other members before 5/1/01 meeting.

- The key interview findings are as follows:
  - —While there are a number of factors that could negatively affect Enron's earnings (e.g., India, California), there is generally a sense of optimism about the Company's earnings growth potential.
  - —The major concern raised is not how Enron will perform; rather, it is the multiple of earnings Wall Street will apply to the market in general and to Enron in particular.
  - —Thus, the key risk to Enron's stock-based pay program producing value for participants is a potential decline in market multiples to more traditional levels. This could result in the paradox of the Company's financial performance being strong, while realized executive compensation declines.

"Too much paid for value delivered" comment + cultural residue from "old" Plans. EI, EES, ECI . . .

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EC 002634707

Interview Findings (continued)

— Further, since Enron's stock trades at a premium multiple compared to most of its industry peers (e.g., Reliant, Dynegy, El Paso), Enron may experience greater pressure on its stock price than its competitors. This, in turn, could lead key talent to leave the Company and join a competitor that is perceived to have more upside potential. (Note: The financial analyses shown for Enron and selected energy and investment banking peer companies demonstrates that Enron's P/E multiple is extremely high.)

Table I

Enron Corp.
Financial Analysis
Selected Financial Measures for Enron and Selected Peer Companies

Company	Calendar Year End 2000 Market Capitalization ($Millions)	Total Shareholder Return (as of the end of 2000) 1-Year (%)	3-Year (%)	5-Year (%)	Return on Equity 2000 (%)	1999 (%)	1998 (%)	Current PE Ratio* (Ratio)	Share Price Used to Calculate PE Ratio	Earnings Per Share
Investment Banking Peers										
MORGAN STANLEY DEAN WITTER	$87,751	12%	40%	47%	29%	29%	25%	13	$57.40	$4.42
MERRILL LYNCH & CO	$55,024	65%	25%	42%	21%	21%	13%	15	$60.55	$4.04
GOLDMAN SACHS GROUP INC	$51,702	14%	N/A	N/A	19%	27%	38%	16	$91.78	$5.74
LEHMAN BROTHERS HOLDINGS INC	$15,986	60%	39%	46%	24%	19%	14%	11	$66.23	$6.02
BEAR STEARNS COMPANIES INC	$5,524	20%	7%	27%	15%	15%	18%	11	$48.49	$4.41
25th Percentile:	**$15,986**	**14%**	**20%**	**38%**	**19%**	**19%**	**14%**	**11**	**$57.40**	**$4.41**
Median:	**$51,702**	**20%**	**32%**	**44%**	**21%**	**21%**	**18%**	**13**	**$60.55**	**$4.42**
75th Percentile:	**$55,024**	**60%**	**39%**	**46%**	**24%**	**27%**	**25%**	**15**	**$66.23**	**$5.74**
Energy Industry Peers										
DUKE ENERGY CORP	$31,457	76%	20%	17%	17%	9%	15%	18	$42.51	$2.36
DYNEGY INC	$17,473	220%	65%	55%	13%	12%	10%	36	$53.15	$1.48
EL PASO CORP	$16,736	88%	32%	41%	16%	-8%	11%	28	$67.77	$2.42
RELIANT ENERGY INC	$12,762	99%	24%	19%	14%	31%	-3%	31	$47.00	$1.52
UTILICORP UNITED INC	$2,890	69%	12%	16%	11%	11%	9%	15	$33.89	$2.26
25th Percentile:	**$12,762**	**76%**	**20%**	**17%**	**13%**	**9%**	**9%**	**18**	**$42.51**	**$1.52**
Median:	**$16,736**	**88%**	**24%**	**19%**	**14%**	**11%**	**10%**	**28**	**$47.00**	**$2.26**
75th Percentile:	**$17,473**	**99%**	**32%**	**41%**	**16%**	**12%**	**11%**	**31**	**$53.15**	**$2.36**
ENRON CORP **	**$65,344**	**88%**	**62%**	**36%**	**12%**	**12%**	**11%**	**53**	**$59.44**	**$1.12**

Diluted EPS before extraordinary items

* P/E ratio taken from April 17, 2001 Wall Street Journal and is calculated by dividing the closing market price by the Company's diluted per-share earnings, as available, for the most recent four quarters. Charges and other adjustments usually are excluded when they qualify as extraordinary items under generally accepted accounting rules.

** Data presented for Enron developed by Enron staff.

Source: Standard & Poor's Compustat Database

Set Income Growth 1, 3 & 5 yr geometric mean rolling average

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EC 002634709

Lots of confidence in the marketplace in Enron

C135

Enron's ability to respond quickly

Frank's comment

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II. Competitive Compensation Analysis

EC 002634710

Competitive Compensation Analysis

- Enron's Executive Compensation Group, with oversight and input provided by Towers Perrin, developed market base salary, total cash (i.e., base plus bonus), long-term incentive, and total direct compensation (i.e., the sum of base, bonus, and long-term incentives) rates for Policy Committee members, Executive Committee members, as well as other key contributors within Enron (which consistent about 60 key executive positions).

- These data are the same as those presented to the Compensation Committee in late 2000/ early 2001 and reflect the following methodology:

  — For corporate positions, data are for general industry companies with revenues of about $56 billion (regressed);

  — For business unit positions the data reflect a blend of general industry data for comparably sized businesses (as measured by revenues) and investment banking, high-tech, or other industry specific data relevant to the unit, as available.

- The long-term incentive levels shown reflect the Black-Scholes value of stock option and restricted stock awards made in 2001 to Enron employees, but are 2000 annualized long-term incentive awards in the market data.

- Also, the market data provided are consistent with Enron's compensation philosophy of targeting the 50th percentile for base salaries and the 75th percentile for total cash, long-term incentives, and total direct pay.

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Mkt Cap
Earnings
π margin
Revenue | π

Plan Rev
79 B
1.5 π
1.8% margin

Recommend market cap for use in job market match.

EC 002634711

Competitive Compensation Analysis (continued)

- The following exhibits summarize the findings:

Exhibit	Pay Element	Findings
Exhibit 1	Base Salaries	Enron is 91% of market median
Exhibit 2	Total Cash	Enron is 140% of market 75th percentile*
Exhibit 3	Long-Term Incentives	Enron is 97% of market 75th percentile*
Exhibit 4	Total Direct Pay	Enron is 113% of market 75th percentile*

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EC 002634712

*Excludes 9 stellar performers from the overall average, since these incumbents received extraordinary incentive awards for 2000 performance. Based on weighted average.

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III. In-The-Money Value of Enron Long-Term Incentives

EC 002634713

Value of All Enron Long-Term Incentives

- One of the key issues facing Enron is the extent to which the Company's current long-term incentive plan can help retain key executives if the Company experiences downward pressure on its stock price.
- To assess this issue, the following exhibits show the value of in-the-money stock options and unvested restricted stock for key executives at various share prices:

Exhibit	Share Price Scenario	Value in Millions	
		Total Unvested Value	Total Value
Exhibit 5	$40 stock price	$87	$263
Exhibit 6	$60 stock price	$226	$630
Exhibit 7	$80 stock price	$446	$1,126
Exhibit 8	$100 stock price	$758	$1,746
Exhibit 9	$120 stock price	$1,073	$2,358

10 to 1 multiple w/3x's stk price

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EC 002634714

IV. Analysis of Potential Realized Total Direct Compensation Levels at Various Share Prices

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EC 002634715

Total Direct Compensation Sensitivity Analysis

- For compensation planning and design purposes, Enron (like the vast majority of companies in the market) uses the Black-Scholes model to value stock options.

- While Towers Perrin recommends that Enron continue using this methodology, we also believe that it is useful for this stress testing exercise to look at the potential value of Enron's compensation package assuming various earnings and share price levels in terms of potential realized compensation.

- The following exhibits show the potential realized compensation for key Enron executives under various stock price and corporate net income scenarios. Please note these figures include current base salary, 2000 earned bonus (adjusted linearly to reflect the assumed changes in corporate net income shown below), and the actual in-the-money future value of stock options and restricted stock at the share price assumptions shown:

Exhibit	Assumptions		Total Estimated Realized TDC Value (in millions)
	Share Price	Net Income as % of 2000 Net Income	
Exhibit 10	$40	80%	$346
Exhibit 11	$60	90%	$721
Exhibit 12	$80	100%	$1,225
Exhibit 13	$100	115%	$1,856
Exhibit 14	$120	125%	$2,486

5 to 1 ratio rather than 10 to 1

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V. Assessment of Stock Overhang Sensitivity to Share Price

EC 002634717

Stock Overhang Analysis

- One of the critical statistics tracked by institutional shareholders and shareholder services groups is stock overhang.

- Stock overhang is simply the percentage of common shares outstanding available for employee stock compensation awards or currently held by employees as stock compensation awards.

- As a point of reference, the median share overhang for Fortune 200 companies is 13.9%, according to the 1999 Equity Stake Report prepared by Pearl Meyer & Partners.

- Exhibit 15 provides a summary of projected April 1, 2002 stock overhang levels for Enron at various share price assumptions.

- The analyses in this exhibit are also based on the assumption that Enron's long-term incentives for the next year deliver the same Black-Scholes value as its 2001 grants.

- As shown, the projected overhang levels after one year vary from 15% (assuming a $40 share price) to 8.6% (assuming a $120 share price).

- This results from two primary facts:

  — A company must issue more shares of stock options or restricted stock at lower share prices to achieve a comparable level of Black-Scholes long-term incentive value; and

  — Fewer options are exercised by employees at lower share prices than at higher prices.

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EC 002634718

Stock Overhang Analysis (continued)

- In Towers Perrin's opinion, this stock overhang issue is critical to how Enron might deal with a lower share price in its executive compensation planning, since a high level of overhang can adversely impact the Company's range of alternatives to address executive pay competitiveness.

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EC 002634719

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VI. Case Studies

Case Studies

- This section provides a brief description of how major companies have addressed sustained stock price declines in their executive compensation plan administration.
- Exhibit 16 summarizes recent actions taken by the following companies:*

  — Dell

  — Lucent Technologies

  — Microsoft

  — Sprint

  — Cisco Systems

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EC 002634721

* Please note that these findings were developed from published materials and executive interviews within these companies.

Case Studies (continued)

- As shown in Exhibit 16, the most common approach taken by these companies has been to simply issue additional stock options to employees (at new, lower share prices). In addition, some of these companies have increased the frequency of long-term incentive awards.

- Finally, Towers Perrin has prepared Exhibit 17 showing alternative approaches taken by general industry companies to address the issue of underwater stock options.

- In reviewing these alternatives, please note that the alternative that is most acceptable to shareholders for 16(b) officers is alternative #1. However, alternatives #4 and #5 are increasingly being used for non-16 (b) officers among companies that have had a downward trend in their stock price for an extended period (typically 18 months or more), companies in the high-tech industry, and companies whose stock overhang is very high.

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EC 002634722

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VII. Conclusions

EC 002634723

Conclusions

- Based on our assessment of Enron's executive compensation program, Towers Perrin concludes that the basic structure of the program is consistent with the Company's stated pay philosophy and that the program is appropriately tied to performance.

- In addition, we conclude that the basic structure of the program should allow Enron to retain most key employees even during a period of lower share prices (as long as the share price rebounds within a period of 18 months or so) for the following reasons:

  — Enron (unlike Duke, Dynegy, El Paso, and most other companies) delivers a significant portion of its long-term incentive value in the form of restricted stock. (Most of Enron's direct industry competitors depend primarily on stock options and, to some extent, long-term bonus plans). Since restricted stock has value at any share price, this element of pay provides some value to participants even during a period of weaker share price.

  get BNs spent or project NI this year

  23.1 for 2000 11.2 for 2000

  — Enron's annual incentive plan allows for bonuses to be funded at a level of about 15% of EBIT, which is equivalent to a funding pool of approximately 23% to 27% of after-tax net income. Also, this funding begins at the first dollar of profit. This bonus pool funding mechanism gives the Company the flexibility to allocate bonus dollars to key contributors in a given year, even if results are depressed. Similarly, the Compensation Committee can reduce the size of the pool based on corporate performance on a variety of measures, which ensures pay-for-performance is maintained.

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EC 002634724

Conclusions (continued)

- Nevertheless, it is likely that Enron will need to provide some short-term relief to certain key employees if the Company's stock price stays in the $55 to $65 range. For example, the Company may need to make out-of-cycle option awards to employees who are relatively new and who have little in the way of past in-the-money stock option and restricted stock awards outstanding.

- The Company could also consider taking normal annual option and restricted stock grants, dividing the grants by 4, and making awards quarterly to dollar price average future grant prices.

- However, Towers Perrin suggests that Enron not make any broad-based, programmatic changes to its executive pay programs at this point. The decline in the Company's share price is relatively recent and follows a period of significant increase in stock price. Pay-for-performance systems work when pay (including options gains) rise and fall according to the gains realized by shareholders.

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EC 002634725

Executive Pay Elements

Base Compensation **Exhibit 1**

Name	Job Group	Title	2001 Base Salary	Base Salary @ 50th %ile*	Variance %
Lay, Ken	OOC	CHAIRMAN & CEO**	975,000	839,000	116%
Skilling, Jeff	OOC	CHIEF EXEC OFFICER**	1,300,000	1,417,000	92%
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	500,000	402,000	124%
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	400,000	494,000	81%
Delainey, David W	Policy Committee	CHAIRMAN & CEO	350,000	488,800	72%
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	470,000	527,600	89%
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	400,000	347,200	115%
Frevert, Mark A	Policy Committee	CHMN & CEO	520,000	662,000	79%
Hannon, Kevin P.	Policy Committee	PRES & COO	400,000	546,000	73%
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	520,000	523,800	99%
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	400,000	487,000	82%
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	420,000	622,400	67%
Sherriff, John R	Policy Committee	PRESIDENT & CEO	400,000	415,000	96%
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	400,000	507,000	79%
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	325,000	245,200	133%
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	249,000	96%
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	265,000	409,400	65%
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	325,000	187,800	173%
Cox, David	Exec. Committee	MD ORIGINATION	300,000	258,100	116%
Dietrich, Janet***	Exec. Committee	PRESIDENT	225,000	442,300	51%
Glisan Jr, Ben F	Exec. Committee	MD, FINANCE & TREASURER	300,000	223,950	134%
Hayslett, Roderick J.	Exec. Committee	MANAGING DIRECTOR ETS FINANCE & ACCTG	250,000	257,400	97%
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	216,765	522,200	42%
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	300,000	264,300	114%
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	300,000	488,800	61%
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	265,000	395,500	67%
McCarty, Danny J.	Exec. Committee	MANAGING DIRECTOR	300,000	185,200	162%
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	350,000	573,000	61%
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	390,938	375,500	104%
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	350,000	573,000	61%
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	350,000	331,800	105%
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	240,000	186,500	129%
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	315,000	400,100	79%
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	250,000	161,200	155%
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	300,000	409,400	73%
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	265,000	311,300	85%
Allen, Phillip K	MD	MNG DIR TRADING	200,000	148,200	135%
Belden, Timothy N	MD	MNG DIR TRADING	219,962	181,600	121%
Butts, Robert H	MD	MNG DIR & CONTROLLER	250,000	297,000	84%
Carter, Rebecca C.	MD	MNG DIR CORPORATE SECRETARY	252,000	250,800	100%
Colwell, Wesley	MD	MNG DIR ACCTG	275,004	298,600	92%

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EC 002634726

Executive Pay Elements   Base Compensation   Exhibit 1

Name	Job Group	Title	2001 Base Salary	Base Salary @ 50th %ile*	Variance %
Haedicke, Mark E	MD	MNG DIR LEGAL	350,004	289,200	121%
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	250,000	304,300	82%
Hickerson, Gary J	MD	MNG DIR TRADING	200,000	131,900	152%
Kopper, Michael J	MD	MNG DIR FIN	275,000	328,500	84%
Meyer, Rockford G	MD	PRESIDENT CITRUS	260,000	284,900	91%
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	240,000	227,900	105%
Arnold, John D	VP	VP TRADING	160,000	148,200	108%
Bradley, Michael W	VP	VP EQUITY TRADING	175,000	147,600	119%
Gorte, David	VP	VP UNDERWRITING	200,000	152,800	131%
Jones, Robert W	VP	VP HR	190,000	238,300	80%
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	234,563	209,000	112%
Lynch, Drew C	VP	VP HR	230,400	238,300	97%
Mintz, Jordon	VP	VP & GEN CNSL	200,000	235,900	85%
Oxley, David	VP	VP HR	204,000	282,700	72%
Palmer, Mark A.	VP	VP COMMUNICATIONS	206,000	272,000	76%
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	210,000	189,300	111%
Presto, Kevin M	VP	VP TRADING	185,004	147,500	125%
Schuler, W Lance	VP	VP & ASST GEN CNSL	175,000	n/a	n/a
Shively, Hunter	VP	VP TRADING	170,000	141,700	120%
Swerzbin, Michael J	VP	VP TRADING	120,000	147,500	81%
Taylor, Mark E	VP	VP & GEN CNSL	175,000	n/a	n/a
Weighted Variance Excluding Key Commercial (Shaded)					91%

* Market data has been trended to 7/1/2001

** Base and LTI grant value reflect new roles as Chairman of the Board and CEO, respectively.

*** TDC reflects new role; additional grants pending

Indicates key commercial employees in 2000. Bonus and long-term grants reflect significant revenue generation in 2000.

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EC 002634727

Executive Pay Elements

Total Cash Compensation
(Base + Bonus)

Exhibit 2

Name	Job Group	Title	2001 Total Cash	Total Cash @ 75th %ile	Variance %
Lay, Ken	OOC	CHAIRMAN & CEO**	7,975,000	4,225,000	189%
Skilling, Jeff	OOC	CHIEF EXEC OFFICER**	6,900,000	3,422,000	202%
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	1,700,000	892,000	191%
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	1,400,000	1,152,000	122%
Delainey, David W	Policy Committee	CHAIRMAN & CEO	3,350,000	1,750,000	191%
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	1,270,000	1,245,000	102%
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	1,700,000	1,622,000	105%
Frevert, Mark A	Policy Committee	CHMN & CEO	2,520,000	2,423,000	104%
Hannon, Kevin P.	Policy Committee	PRES & COO	1,900,000	1,324,000	144%
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	1,720,000	1,161,000	148%
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	1,400,000	1,194,000	117%
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	2,170,000	1,513,000	143%
Sherriff, John R	Policy Committee	PRESIDENT & CEO	1,900,000	1,396,400	136%
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	3,400,000	1,859,000	183%
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	1,325,000	846,000	157%
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	840,000	507,000	166%
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	865,000	1,025,000	84%
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	1,225,000	1,960,500	62%
Cox, David	Exec. Committee	MD ORIGINATION	1,100,000	562,000	196%
Dietrich, Janet***	Exec. Committee	PRESIDENT	525,000	1,019,000	52%
Glisan Jr, Ben F	Exec. Committee	MD, FINANCE & TREASURER	900,000	433,425	208%
Hayslett, Roderick J.	Exec. Committee	MANAGING DIRECTOR ETS FINANCE & ACCTG	650,000	523,000	124%
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	1,296,300	1,383,000	94%
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	1,000,000	504,000	198%
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	3,300,000	1,750,000	189%
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	965,000	843,000	114%
McCarty, Danny J.	Exec. Committee	MANAGING DIRECTOR	675,000	324,000	208%
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	1,450,000	1,298,000	112%
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	990,938	766,000	129%
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	1,450,000	1,298,000	112%
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	950,000	728,000	130%
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	940,000	301,000	312%
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	1,065,000	956,000	111%
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	750,000	420,400	178%
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	2,300,000	1,025,000	224%
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	965,000	634,000	152%
Allen, Phillip K	MD	MNG DIR TRADING	3,700,000	322,300	1148%
Belden, Timothy N	MD	MNG DIR TRADING	2,969,962	518,300	573%
Butts, Robert H	MD	MNG DIR & CONTROLLER	625,000	633,000	99%
Carter, Rebecca C.	MD	MNG DIR CORPORATE SECRETARY	552,000	501,800	110%
Colwell, Wesley	MD	MNG DIR ACCTG	875,004	577,900	151%

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EC 002634728

Executive Pay Elements

Total Cash Compensation (Base + Bonus)

Exhibit 2

Name	Job Group	Title	2001 Total Cash	Total Cash @ 75th %ile*	Variance %
Haedicke, Mark E	MD	MNG DIR LEGAL	750,004	637,400	118%
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	650,000	625,800	104%
Hickerson, Gary J	MD	MNG DIR TRADING	1,200,000	704,100	170%
Kopper, Michael J	MD	MNG DIR FIN	1,075,000	692,900	155%
Meyer, Rockford G	MD	PRESIDENT CITRUS	560,000	564,800	99%
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	640,000	475,100	135%
Arnold, John D	VP	VP TRADING	810,000	322,300	251%
Bradley, Michael W	VP	VP EQUITY TRADING	1,425,000	777,700	183%
Gorte, David	VP	VP UNDERWRITING	450,000	322,400	140%
Jones, Robert W	VP	VP HR	490,000	434,200	113%
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	534,563	375,000	143%
Lynch, Drew C	VP	VP HR	530,400	434,200	122%
Mintz, Jordon	VP	VP & GEN CNSL	500,000	482,400	104%
Oxley, David	VP	VP HR	604,000	545,300	111%
Palmer, Mark A.	VP	VP COMMUNICATIONS	606,000	561,400	108%
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	460,000	364,100	126%
Presto, Kevin M	VP	VP TRADING	685,004	406,500	169%
Schuler, W Lance	VP	VP & ASST GEN CNSL	375,000	365,900	102%
Shively, Hunter	VP	VP TRADING	1,420,000	276,600	513%
Swerzbin, Michael J	VP	VP TRADING	2,120,000	406,500	522%
Taylor, Mark E	VP	VP & GEN CNSL	350,000	365,900	96%
Weighted Variance Excluding Key Commercial (Shaded)					140%

* Market data has been trended to 7/1/2001

** Base and LTI grant value reflect new roles as Chairman of the Board and CEO, respectively.

*** TDC reflects new role; additional grants pending

(Shaded) Indicates key commercial employees in 2000. Bonus and long-term grants reflect significant revenue generation in 2000.

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EC 002634729

Executive Pay Elements

Long-Term Incentives **Exhibit 3**

Name	Job Group	Title	2001 LTI Award Value	LTI @ 75th %ile	Variance %
Lay, Ken	OOC	CHAIRMAN & CEO**	16,000,000	14,612,000	109%
Skilling, Jeff	OOC	CHIEF EXEC OFFICER**	19,000,000	21,532,000	88%
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	900,000	1,413,100	64%
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	1,750,000	1,981,000	88%
Delainey, David W	Policy Committee	CHAIRMAN & CEO	4,500,000	4,937,400	91%
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	1,750,000	2,412,200	73%
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	4,000,000	1,449,800	276%
Frevert, Mark A	Policy Committee	CHMN & CEO	4,200,000	5,285,000	79%
Hannon, Kevin P.	Policy Committee	PRES & COO	3,650,000	3,160,500	115%
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	2,000,000	2,070,600	97%
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	1,750,000	1,819,000	96%
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	3,800,000	3,731,500	102%
Sherriff, John R	Policy Committee	PRESIDENT & CEO	3,250,000	4,726,200	69%
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	5,835,000	4,975,400	117%
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	1,000,000	760,100	132%
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	700,000	817,800	86%
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	750,000	1,479,400	51%
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	1,000,000	861,450	116%
Cox, David	Exec. Committee	MD ORIGINATION	2,266,000	2,453,000	92%
Dietrich, Janet***	Exec. Committee	PRESIDENT	500,000	1,650,000	30%
Glisan Jr, Ben F	Exec. Committee	MD, FINANCE & TREASURER	2,600,000	555,375	468%
Hayslett, Roderick J.	Exec. Committee	MANAGING DIRECTOR ETS FINANCE & ACCTG	625,000	1,161,800	54%
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	1,900,000	2,929,500	65%
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	800,000	562,600	142%
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	4,250,000	4,937,000	86%
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	800,000	1,534,800	52%
McCarty, Danny J.	Exec. Committee	MANAGING DIRECTOR	1,500,000	169,200	887%
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	2,600,000	2,349,000	111%
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	1,013,000	1,013,000	100%
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	2,600,000	2,349,000	111%
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	800,000	833,600	96%
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	800,000	264,200	303%
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	1,200,000	1,320,500	91%
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	650,000	169,300	384%
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	2,000,000	1,479,400	135%
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	800,000	1,437,900	56%
Allen, Phillip K	MD	MNG DIR TRADING	3,500,000	139,500	2509%
Belden, Timothy N	MD	MNG DIR TRADING	2,750,000	244,200	1126%
Butts, Robert H	MD	MNG DIR & CONTROLLER	500,000	638,000	78%
Carter, Rebecca C.	MD	MNG DIR CORPORATE SECRETARY	450,000	488,400	92%
Colwell, Wesley	MD	MNG DIR ACCTG	600,000	740,500	81%

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Executive Pay Elements

Long-Term Incentives **Exhibit 3**

Name	Job Group	Title	2001 LTI Award Value	LTI @ 75th %ile	Variance %
Haedicke, Mark E	MD	MNG DIR LEGAL	750,000	724,600	104%
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	600,000	756,300	79%
Hickerson, Gary J	MD	MNG DIR TRADING	1,000,000	187,900	532%
Kopper, Michael J	MD	MNG DIR FIN	1,150,000	863,700	133%
Meyer, Rockford G	MD	PRESIDENT CITRUS	250,000	646,000	39%
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	625,000	422,900	148%
Arnold, John D	VP	VP TRADING	850,000	139,500	609%
Bradley, Michael W	VP	VP EQUITY TRADING	1,250,000	185,200	675%
Gorte, David	VP	VP UNDERWRITING	250,000	93,200	268%
Jones, Robert W	VP	VP HR	375,000	455,100	82%
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	400,000	531,000	75%
Lynch, Drew C	VP	VP HR	300,000	455,100	66%
Mintz, Jordon	VP	VP & GEN CNSL	375,000	519,500	72%
Oxley, David	VP	VP HR	400,000	643,900	62%
Palmer, Mark A.	VP	VP COMMUNICATIONS	375,000	574,200	65%
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	250,000	359,400	70%
Presto, Kevin M	VP	VP TRADING	500,000	139,600	358%
Schuler, W Lance	VP	VP & ASST GEN CNSL	375,000	225,100	167%
Shively, Hunter	VP	VP TRADING	1,250,000	119,300	1048%
Swerzbin, Michael J	VP	VP TRADING	2,000,000	139,600	1433%
Taylor, Mark E	VP	VP & GEN CNSL	300,000	225,100	133%
Weighted Variance Excluding Key Commercial (Shaded)					97%

* Market data has been trended to 7/1/2001

** Base and LTI grant value reflect new roles as Chairman of the Board and CEO, respectively.

*** TDC reflects new role; additional grants pending

Indicates key commercial employees in 2000. Bonus and long-term grants reflect significant revenue generation in 2000.

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Executive Pay Elements

Total Compensation
(Cash + Equity)

Exhibit 4

Name	Job Group	Title	2001 Total Direct Comp (TDC)	Total Compensation @ 75th %ile	Variance %
Lay, Ken	OOC	CHAIRMAN & CEO**	23,975,000	18,837,000	127%
Skilling, Jeff	OOC	CHIEF EXEC OFFICER**	25,900,000	24,954,000	104%
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	3,400,000	2,304,900	148%
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	3,150,000	3,133,000	101%
Delainey, David W	Policy Committee	CHAIRMAN & CEO	7,850,000	6,687,200	117%
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	3,020,000	3,657,100	83%
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	5,700,000	3,071,500	186%
Frevert, Mark A	Policy Committee	CHMN & CEO	6,720,000	7,707,000	87%
Hannon, Kevin P.	Policy Committee	PRES & COO	5,550,000	4,484,300	124%
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	3,720,000	3,231,300	115%
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	3,150,000	3,013,000	105%
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	5,970,000	5,244,700	114%
Sherriff, John R	Policy Committee	PRESIDENT & CEO	5,150,000	6,122,600	84%
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	9,235,000	6,835,000	135%
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	2,325,000	1,598,200	145%
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	1,540,000	972,800	158%
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	1,615,000	2,504,600	64%
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	2,225,000	2,822,175	79%
Cox, David	Exec. Committee	MD ORIGINATION	3,366,000	2,953,000	114%
Dietrich, Janet***	Exec. Committee	PRESIDENT	1,025,000	2,669,000	38%
Glisan Jr, Ben F	Exec. Committee	MD, FINANCE & TREASURER	3,500,000	994,275	352%
Hayslett, Roderick J.	Exec. Committee	MANAGING DIRECTOR ETS FINANCE & ACCTG	1,275,000	1,086,400	117%
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	3,196,300	4,225,900	76%
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	1,800,000	1,066,100	169%
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	7,550,000	6,687,000	113%
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	1,765,000	2,101,900	84%
McCarty, Danny J.	Exec. Committee	MANAGING DIRECTOR	2,175,000	523,900	415%
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	4,050,000	3,647,000	111%
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	2,003,938	1,778,900	113%
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	4,050,000	3,647,000	111%
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	1,750,000	1,561,500	112%
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	1,740,000	565,000	308%
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	2,265,000	2,276,000	100%
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	1,400,000	589,700	237%
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	4,300,000	2,504,600	172%
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	1,765,000	1,394,200	127%
Allen, Phillip K	MD	MNG DIR TRADING	7,200,000	461,800	1559%
Belden, Timothy N	MD	MNG DIR TRADING	5,719,962	762,500	750%
Butts, Robert H	MD	MNG DIR & CONTROLLER	1,125,000	1,271,000	89%
Carter, Rebecca C.	MD	MNG DIR CORPORATE SECRETARY	1,002,000	990,200	101%
Colwell, Wesley	MD	MNG DIR ACCTG	1,475,004	1,325,700	111%

Executive Pay Elements

Total Compensation
(Cash + Equity)

Exhibit 4

Name	Job Group	Title	2001 Total Direct Comp (TDC)	Total Compensation @ 75th %ile*	Variance %
Haedicke, Mark E	MD	MNG DIR LEGAL	1,500,004	1,361,900	110%
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	1,250,000	1,382,100	90%
Hickerson, Gary J	MD	MNG DIR TRADING	2,200,000	892,100	247%
Kopper, Michael J	MD	MNG DIR FIN	2,225,000	1,556,600	143%
Meyer, Rockford G	MD	PRESIDENT CITRUS	810,000	1,210,900	67%
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	1,265,000	898,100	141%
Arnold, John D	VP	VP TRADING	1,660,000	461,800	359%
Bradley, Michael W	VP	VP EQUITY TRADING	2,675,000	962,900	278%
Gorte, David	VP	VP UNDERWRITING	700,000	415,600	168%
Jones, Robert W	VP	VP HR	865,000	889,200	97%
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	934,563	907,000	103%
Lynch, Drew C	VP	VP HR	830,400	889,200	93%
Mintz, Jordon	VP	VP & GEN CNSL	875,000	1,001,900	87%
Oxley, David	VP	VP HR	1,004,000	1,189,200	84%
Palmer, Mark A.	VP	VP COMMUNICATIONS	981,000	1,135,600	86%
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	710,000	723,500	98%
Presto, Kevin M	VP	VP TRADING	1,185,004	546,000	217%
Schuler, W Lance	VP	VP & ASST GEN CNSL	750,000	590,900	127%
Shively, Hunter	VP	VP TRADING	2,670,000	395,900	674%
Swerzbin, Michael J	VP	VP TRADING	4,120,000	546,000	755%
Taylor, Mark E	VP	VP & GEN CNSL	650,000	590,900	110%
Weighted Variance Excluding Key Commercial (Shaded)					113%

* Market data has been trended to 7/1/2001

** Base and LTI grant value reflect new roles as Chairman of the Board and CEO, respectively.

*** TDC reflects new role; additional grants pending

Indicates key commercial employees in 2000. Bonus and long-term grants reflect significant revenue generation in 2000.

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LTI Current Value Analysis

Exhibit 5

Value of In-The-Money Stock Options and Restricted Stock

(At $40.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	75,620,518	4,155,549	6,077,960	85,854,027
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	4,928,555	2,039,888	5,887,080	12,855,523
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	0	3,110,139	239,840	3,349,979
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	439,097	481,877	1,306,680	2,227,654
Delainey, David W	Policy Committee	CHAIRMAN & CEO	0	788,650	996,720	1,785,370
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	35,890,091	1,498,498	746,680	38,135,270
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	2,005,048	1,524,579	1,065,800	4,595,427
Frevert, Mark A	Policy Committee	CHMN & CEO	8,148,736	3,751,596	293,120	12,193,452
Hannon, Kevin P.	Policy Committee	PRES & COO	5,565,499	2,903,500	506,280	8,975,279
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	2,880,842	1,322,886	813,320	5,017,048
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	2,393,108	463,273	583,120	3,439,501
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	7,491,995	0	0	7,491,995
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	6,583,436	3,751,596	466,280	10,801,312
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	0	1,158,278	1,983,280	3,141,558
Sherriff, John R	Policy Committee	PRESIDENT & CEO	1,117,233	662,928	1,189,040	2,969,202
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	628,964	424,185	740,080	1,793,228
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	443,723	320,541	186,520	950,784
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	552,835	288,346	298,560	1,139,741
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	90,234	81,781	399,680	571,695
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	0	297,387	146,560	443,947
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	0	983,192	266,480	1,249,672
Cline, Wade	Exec. Committee	MNG DIR	1,508,471	0	289,440	1,797,911
Cox, David	Exec. Committee	MNG DIR ORIGINATION	44,430	66,595	463,840	574,865
Dietrich, Janet	Exec. Committee	PRESIDENT	673,427	358,041	133,240	1,164,708
Glisan Jr, Ben F	Exec. Committee	MNG DIR, FINANCE & TREASURER	0	149,482	988,760	1,138,242
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	694,321	83,041	213,320	990,681
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	137,546	264,613	418,880	821,039
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	609,901	241,061	943,880	1,794,842
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	287,220	232,808	306,640	826,668
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	0	1,047,615	799,360	1,846,975
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	27,252	0	213,160	240,412
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	2,256,347	673,851	394,640	3,324,838
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	440,929	529,722	1,087,400	2,058,052
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	303,088	303,088	334,480	940,656
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	419,464	552,876	687,760	1,660,100
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	0	14,426	213,160	227,586
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	0	231,301	213,160	444,461
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	87,472	108,221	360,680	556,373
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	543,012	436,980	469,200	1,449,192

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LTI Current Value Analysis

Value of In-The-Money Stock Options and Restricted Stock

Exhibit 5

(At $40.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	0	241,061	330,600	571,661
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	3,094,634	396,516	532,920	4,024,070
Sherrick, Jeffrey B	Exec. Committee	CEO	30,689	552,176	500,400	1,083,265
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	130,687	0	370,280	500,967
Allen, Phillip K	MD	MNG DIR TRADING	0	242,849	1,169,360	1,412,209
Belden, Timothy N	MD	MNG DIR TRADING	88,827	133,206	1,127,400	1,349,433
Butts, Robert H	MD	MNG DIR & CONTROLLER	386,410	145,285	215,040	746,735
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	375,068	113,654	178,360	667,082
Colwell, Wesley	MD	MNG DIR ACCTG	17,309	17,307	159,880	194,496
Elliott, Steven	MD	MNG DIR TRADING	68,062	852,513	1,542,880	2,463,455
Fallon, James	MD	MNG DIR TRADING	0	496,703	1,485,280	1,981,983
Haedicke, Mark E	MD	MNG DIR LEGAL	778,339	578,339	199,840	1,556,518
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	3,742,136	155,163	241,680	4,138,980
Hickerson, Gary J	MD	MNG DIR TRADING	71,780	116,159	463,840	651,779
Kopper, Michael J	MD	MNG DIR FIN	1,340,961	433,505	543,240	2,317,706
Meyer, Rockford G	MD	PRESIDENT CITRUS	78,000	133,373	125,080	336,453
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	176,576	49,315	166,560	392,451
Arnold, John D	VP	VP TRADING	332,504	396,214	463,280	1,191,998
Bradley, Michael W	VP	VP EQUITY TRADING	4,328	8,656	333,080	346,064
Gorte, David	VP	VP UNDERWRITING	0	3,749	119,920	123,669
Jones, Robert W	VP	VP HR	325,183	37,557	99,920	462,661
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	0	41,032	130,000	171,032
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	466,175	78,126	277,320	821,621
Mintz, Jordon	VP	VP & GEN CNSL	26,651	271,261	218,320	516,233
Oxley, David	VP	VP HR	109,798	59,179	225,000	393,976
Palmer, Mark A.	VP	VP COMMUNICATIONS	338,706	33,127	120,320	492,154
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	125,308	0	103,720	229,028
Presto, Kevin M	VP	VP TRADING	0	99,129	133,240	232,369
Schuler, W Lance	VP	VP & ASST GEN CNSL	177,169	78,312	99,920	355,401
Shively, Hunter	VP	VP TRADING	0	33,306	431,800	465,106
Sturm, Fletcher	VP	VP TRADING	0	0	266,480	266,480
Swerzbin, Michael J	VP	VP TRADING	176,506	66,612	730,280	973,398
Taylor, Mark E	VP	VP & GEN CNSL	302,321	66,781	79,960	449,062
Total			175,576,921	41,232,559	45,909,280	262,718,760

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LTI Current Value Analysis

Exhibit 6

Value of In-The-Money Stock Options and Restricted Stock

(At $60.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	176,994,826	25,624,550	9,116,940	211,736,316
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	13,857,157	16,399,572	8,830,620	39,087,349
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	0	8,825,847	359,760	9,185,607
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	1,348,461	1,702,125	1,960,020	5,010,606
Delainey, David W	Policy Committee	CHAIRMAN & CEO	117	1,880,474	1,495,080	3,375,671
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	65,360,659	3,731,547	1,120,020	70,212,226
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	5,311,935	4,699,420	1,598,700	11,610,055
Frevert, Mark A	Policy Committee	CHMN & CEO	21,454,668	11,670,521	439,680	33,564,869
Hannon, Kevin P.	Policy Committee	PRES & COO	15,718,707	10,952,379	759,420	27,430,506
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	7,181,323	3,496,459	1,219,980	11,897,762
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	5,263,112	1,276,811	874,680	7,414,603
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	18,948,355	0	0	18,948,355
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	16,304,662	10,694,536	699,420	27,698,617
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	40,505	3,993,001	2,974,920	7,008,426
Sherriff, John R	Policy Committee	PRESIDENT & CEO	2,968,264	2,223,643	1,783,560	6,975,466
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	1,483,433	1,112,725	1,110,120	3,706,278
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	928,654	694,874	279,780	1,903,308
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	1,307,388	668,535	447,840	2,423,764
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	245,205	310,748	599,520	1,155,473
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	34,731	828,945	219,840	1,083,516
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	162,666	2,966,445	399,720	3,528,832
Cline, Wade	Exec. Committee	MNG DIR	3,062,732	86,657	434,160	3,583,548
Cox, David	Exec. Committee	MNG DIR ORIGINATION	183,326	292,055	695,760	1,171,141
Dietrich, Janet	Exec. Committee	PRESIDENT	1,680,543	1,385,952	199,860	3,266,355
Glisan Jr, Ben F	Exec. Committee	MNG DIR, FINANCE & TREASURER	72,239	501,796	1,483,140	2,057,174
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	1,562,554	246,390	319,980	2,128,924
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	532,935	707,420	628,320	1,868,674
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	1,358,633	647,904	1,415,820	3,422,357
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	1,257,215	892,134	459,960	2,609,309
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	184,739	2,252,209	1,199,040	3,635,987
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	101,886	46,269	319,740	467,895
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	5,340,415	2,261,955	591,960	8,194,331
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	1,237,090	1,859,375	1,631,100	4,727,565
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	1,184,854	1,156,889	501,720	2,843,463
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	996,923	1,506,224	1,031,640	3,534,787
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	0	270,886	319,740	590,626
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	0	491,490	319,740	811,230
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	400,529	648,476	541,020	1,590,025
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	1,225,370	1,065,054	703,800	2,994,225

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LTI Current Value Analysis

Exhibit 6

Value of In-The-Money Stock Options and Restricted Stock

(At $60.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	0	613,290	495,900	1,109,190
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	6,078,500	878,738	799,380	7,756,618
Sherrick, Jeffrey B	Exec. Committee	CEO	562,246	1,835,486	750,600	3,148,331
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	312,961	823,730	555,420	1,692,110
Allen, Phillip K	MD	MNG DIR TRADING	0	609,082	1,754,040	2,363,122
Belden, Timothy N	MD	MNG DIR TRADING	326,038	474,453	1,691,100	2,491,591
Butts, Robert H	MD	MNG DIR & CONTROLLER	1,145,644	396,394	322,560	1,864,598
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	869,879	304,981	267,540	1,442,400
Colwell, Wesley	MD	MNG DIR ACCTG	374,469	353,954	239,820	968,243
Elliott, Steven	MD	MNG DIR TRADING	692,121	10,855,221	2,314,320	13,861,661
Fallon, James	MD	MNG DIR TRADING	59	1,916,811	2,227,920	4,144,790
Haedicke, Mark E	MD	MNG DIR LEGAL	1,550,844	1,150,835	299,760	3,001,438
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	7,267,432	428,095	362,520	8,058,047
Hickerson, Gary J	MD	MNG DIR TRADING	210,146	399,002	695,760	1,304,908
Kopper, Michael J	MD	MNG DIR FIN	2,819,965	1,055,944	814,860	4,690,768
Meyer, Rockford G	MD	PRESIDENT CITRUS	186,971	339,459	187,620	714,050
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	391,817	141,387	249,840	783,044
Arnold, John D	VP	VP TRADING	972,730	1,269,716	694,920	2,937,365
Bradley, Michael W	VP	VP EQUITY TRADING	14,328	121,082	499,620	635,030
Gorte, David	VP	VP UNDERWRITING	13,100	296,482	179,880	489,462
Jones, Robert W	VP	VP HR	680,163	105,528	149,880	935,571
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	23,202	122,265	195,000	340,467
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	1,099,266	280,972	415,980	1,796,218
Mintz, Jordon	VP	VP & GEN CNSL	112,333	602,054	327,480	1,041,868
Oxley, David	VP	VP HR	367,456	285,908	337,500	990,864
Palmer, Mark A.	VP	VP COMMUNICATIONS	801,397	125,894	180,480	1,107,771
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	266,256	14,544	155,580	436,380
Presto, Kevin M	VP	VP TRADING	28,971	219,776	199,860	448,607
Schuler, W Lance	VP	VP & ASST GEN CNSL	417,237	204,856	149,880	771,974
Shively, Hunter	VP	VP TRADING	23,202	134,579	647,700	805,481
Sturm, Fletcher	VP	VP TRADING	23,202	23,193	399,720	446,115
Swerzbin, Michael J	VP	VP TRADING	412,983	222,880	1,095,420	1,731,283
Taylor, Mark E	VP	VP & GEN CNSL	750,429	187,085	119,940	1,057,454
Total			404,092,156	156,865,961	68,863,920	629,822,037

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LTI Current Value Analysis

Value of In-The-Money Stock Options and Restricted Stock

Exhibit 7

(At $80.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	281,439,715	51,366,286	12,155,920	344,961,921
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	27,873,374	37,805,679	11,774,160	77,453,213
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	14,952	14,806,917	479,680	15,301,549
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	2,441,154	3,391,854	2,613,360	8,446,368
Delainey, David W	Policy Committee	CHAIRMAN & CEO	1,380,191	7,762,384	1,993,440	11,136,015
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	95,169,253	6,434,075	1,493,360	103,096,688
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	9,365,155	8,712,940	2,131,600	20,209,695
Frevert, Mark A	Policy Committee	CHMN & CEO	39,149,301	27,226,001	586,240	66,961,542
Hannon, Kevin P.	Policy Committee	PRES & COO	27,880,205	24,292,150	1,012,560	53,184,914
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	11,889,460	6,227,939	1,626,640	19,744,039
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	8,323,006	2,411,700	1,166,240	11,900,945
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	30,404,943	210	0	30,405,153
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	37,663,109	26,554,127	932,560	65,149,796
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	1,799,717	11,644,322	3,966,560	17,410,599
Sherriff, John R	Policy Committee	PRESIDENT & CEO	7,590,528	8,545,220	2,378,080	18,513,828
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	2,592,875	2,131,345	1,480,160	6,204,380
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	1,544,486	1,526,753	373,040	3,444,279
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	2,285,380	1,276,524	597,120	4,159,024
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	524,119	848,845	799,360	2,172,324
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	197,949	2,792,492	293,120	3,283,561
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	435,415	5,328,885	532,960	6,297,261
Cline, Wade	Exec. Committee	MNG DIR	4,927,569	540,225	578,880	6,046,674
Cox, David	Exec. Committee	MNG DIR ORIGINATION	630,467	1,767,595	927,680	3,325,742
Dietrich, Janet	Exec. Committee	PRESIDENT	2,894,856	2,658,610	266,480	5,819,946
Glisan Jr, Ben F	Exec. Committee	MNG DIR, FINANCE & TREASURER	435,164	1,340,143	1,977,520	3,752,827
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	2,600,242	626,143	426,640	3,653,025
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	1,228,054	1,338,269	837,760	3,404,083
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	2,416,586	1,506,694	1,887,760	5,811,041
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	2,430,652	1,812,400	613,280	4,856,332
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	2,163,477	7,437,579	1,598,720	11,199,776
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	687,922	404,399	426,320	1,518,640
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	8,484,515	3,910,075	789,280	13,183,871
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	2,262,842	6,153,557	2,174,800	10,591,200
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	2,653,602	2,134,634	668,960	5,457,197
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	3,070,117	6,589,363	1,375,520	11,035,000
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	61,199	696,967	426,320	1,184,486
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	92,366	1,063,540	426,320	1,582,226
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	845,869	1,523,650	721,360	3,090,879
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	2,176,938	2,011,178	938,400	5,126,516

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LTI Current Value Analysis

Value of In-The-Money Stock Options and Restricted Stock

Exhibit 7

(At $80.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	8,053	1,190,507	661,200	1,859,760
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	9,492,423	1,941,278	1,065,840	12,499,540
Sherrick, Jeffrey B	Exec. Committee	CEO	1,220,466	3,261,686	1,000,800	5,482,951
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	746,987	5,758,246	740,560	7,245,792
Allen, Phillip K	MD	MNG DIR TRADING	56,357	1,403,112	2,338,720	3,798,189
Belden, Timothy N	MD	MNG DIR TRADING	707,317	1,437,632	2,254,800	4,399,749
Butts, Robert H	MD	MNG DIR & CONTROLLER	2,181,086	852,491	430,080	3,463,657
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	1,491,567	656,986	356,720	2,505,273
Colwell, Wesley	MD	MNG DIR ACCTG	934,337	845,121	319,760	2,099,217
Elliott, Steven	MD	MNG DIR TRADING	1,316,381	20,858,301	3,085,760	25,260,441
Fallon, James	MD	MNG DIR TRADING	32,521	3,519,771	2,970,560	6,522,852
Haedicke, Mark E	MD	MNG DIR LEGAL	2,500,012	2,026,285	399,680	4,925,977
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	11,363,710	954,902	483,360	12,801,972
Hickerson, Gary J	MD	MNG DIR TRADING	503,927	1,051,682	927,680	2,483,289
Kopper, Michael J	MD	MNG DIR FIN	4,665,660	2,131,465	1,086,480	7,883,606
Meyer, Rockford G	MD	PRESIDENT CITRUS	399,755	668,131	250,160	1,318,046
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	782,449	455,769	333,120	1,571,337
Arnold, John D	VP	VP TRADING	2,024,496	2,647,186	926,560	5,598,242
Bradley, Michael W	VP	VP EQUITY TRADING	44,453	681,153	666,160	1,391,766
Gorte, David	VP	VP UNDERWRITING	75,344	701,833	239,840	1,017,017
Jones, Robert W	VP	VP HR	1,084,472	237,935	199,840	1,522,246
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	155,109	434,553	260,000	849,662
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	1,973,932	630,816	554,640	3,159,388
Mintz, Jordon	VP	VP & GEN CNSL	283,972	1,046,961	436,640	1,767,573
Oxley, David	VP	VP HR	707,840	633,541	450,000	1,791,380
Palmer, Mark A.	VP	VP COMMUNICATIONS	1,389,756	372,500	240,640	2,002,896
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	464,860	112,555	207,440	784,855
Presto, Kevin M	VP	VP TRADING	165,784	523,909	266,480	956,173
Schuler, W Lance	VP	VP & ASST GEN CNSL	720,237	436,067	199,840	1,356,144
Shively, Hunter	VP	VP TRADING	146,447	460,266	863,600	1,470,313
Sturm, Fletcher	VP	VP TRADING	142,423	247,989	532,960	923,372
Swerzbin, Michael J	VP	VP TRADING	682,066	833,250	1,460,560	2,975,875
Taylor, Mark E	VP	VP & GEN CNSL	1,357,904	424,677	159,920	1,942,501
Total			679,848,823	354,040,225	91,818,560	1,125,707,608

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LTI Current Value Analysis

Exhibit 8

Value of In-The-Money Stock Options and Restricted Stock

(At $100.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	386,670,555	81,789,958	15,194,900	483,655,413
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	44,354,134	66,180,787	14,717,700	125,252,621
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	74,192	21,126,516	599,600	21,800,308
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	3,619,874	5,630,328	3,266,700	12,516,902
Delainey, David W	Policy Committee	CHAIRMAN & CEO	4,576,371	19,093,964	2,491,800	26,162,135
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	125,063,873	9,706,443	1,866,700	136,637,015
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	13,730,315	13,905,861	2,664,500	30,300,676
Frevert, Mark A	Policy Committee	CHMN & CEO	60,193,341	51,255,943	732,800	112,182,084
Hannon, Kevin P.	Policy Committee	PRES & COO	42,644,416	45,232,733	1,265,700	89,142,849
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	16,695,900	9,607,622	2,033,300	28,336,822
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	11,468,926	4,090,946	1,457,800	17,017,671
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	41,861,563	70,819	0	41,932,381
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	66,322,489	48,248,135	1,165,700	115,736,324
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	5,986,437	26,559,442	4,958,200	37,504,079
Sherriff, John R	Policy Committee	PRESIDENT & CEO	14,521,828	20,668,800	2,972,600	38,163,228
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	3,751,435	3,428,305	1,850,200	9,029,940
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	2,194,706	3,033,893	466,300	5,694,899
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	3,317,540	2,093,264	746,400	6,157,204
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	876,719	2,137,607	999,200	4,013,526
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	388,189	5,490,812	366,400	6,245,401
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	757,315	8,017,229	666,200	9,440,744
Cline, Wade	Exec. Committee	MNG DIR	6,829,249	1,202,545	723,600	8,755,394
Cox, David	Exec. Committee	MNG DIR ORIGINATION	1,554,227	5,801,475	1,159,600	8,515,302
Dietrich, Janet	Exec. Committee	PRESIDENT	4,133,736	4,070,430	333,100	8,537,266
Glisan Jr, Ben F	Exec. Committee	MNG DIR, FINANCE & TREASURER	925,804	2,902,183	2,471,900	6,299,887
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	3,668,642	1,179,883	533,300	5,381,825
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	2,124,154	2,177,869	1,047,200	5,349,223
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	3,567,866	3,229,314	2,359,700	9,156,881
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	3,643,452	3,003,787	766,600	7,413,839
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	5,680,197	17,307,219	1,998,400	24,985,816
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	1,422,882	1,590,990	532,900	3,546,772
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	11,879,865	6,311,945	986,600	19,178,411
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	3,416,342	14,119,617	2,718,500	20,254,460
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	4,307,462	3,237,654	836,200	8,381,317
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	6,960,717	16,851,503	1,719,400	25,531,620
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	177,759	1,439,481	532,900	2,150,140
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	247,106	2,056,180	532,900	2,836,186
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	1,350,229	2,788,344	901,700	5,040,273
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	3,160,438	3,138,278	1,173,000	7,471,716

LTI Current Value Analysis

Value of In-The-Money Stock Options and Restricted Stock

Exhibit 8

(At $100.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	40,673	2,198,216	826,500	3,065,389
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	13,004,583	3,560,498	1,332,300	17,897,380
Sherrick, Jeffrey B	Exec. Committee	CEO	1,878,686	4,687,886	1,251,000	7,817,571
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	1,243,387	11,846,677	925,700	14,015,764
Allen, Phillip K	MD	MNG DIR TRADING	284,637	3,285,612	2,923,400	6,493,649
Belden, Timothy N	MD	MNG DIR TRADING	1,223,677	3,294,992	2,818,500	7,337,169
Butts, Robert H	MD	MNG DIR & CONTROLLER	3,337,726	1,447,751	537,600	5,323,077
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	2,135,367	1,134,266	445,900	3,715,533
Colwell, Wesley	MD	MNG DIR ACCTG	1,649,457	1,503,301	399,700	3,552,457
Elliott, Steven	MD	MNG DIR TRADING	1,940,641	30,861,381	3,857,200	36,659,221
Fallon, James	MD	MNG DIR TRADING	477,283	6,621,599	3,713,200	10,812,082
Haedicke, Mark E	MD	MNG DIR LEGAL	3,514,652	3,196,365	499,600	7,210,617
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	15,771,190	1,648,722	604,200	18,024,112
Hickerson, Gary J	MD	MNG DIR TRADING	846,827	1,982,702	1,159,600	3,989,129
Kopper, Michael J	MD	MNG DIR FIN	6,567,840	3,527,065	1,358,100	11,453,006
Meyer, Rockford G	MD	PRESIDENT CITRUS	624,815	1,066,391	312,700	2,003,906
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	1,211,029	1,242,697	416,400	2,870,126
Arnold, John D	VP	VP TRADING	3,118,016	4,375,546	1,158,200	8,651,762
Bradley, Michael W	VP	VP EQUITY TRADING	135,973	1,650,113	832,700	2,618,786
Gorte, David	VP	VP UNDERWRITING	149,864	1,176,773	299,800	1,626,437
Jones, Robert W	VP	VP HR	1,511,552	474,755	249,800	2,236,106
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	334,329	1,012,633	325,000	1,671,962
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	2,926,532	1,064,196	693,300	4,684,028
Mintz, Jordon	VP	VP & GEN CNSL	474,032	1,596,281	545,800	2,616,113
Oxley, David	VP	VP HR	1,067,880	1,165,921	562,500	2,796,300
Palmer, Mark A.	VP	VP COMMUNICATIONS	1,996,536	723,520	300,800	3,020,856
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	689,820	322,395	259,300	1,271,515
Presto, Kevin M	VP	VP TRADING	327,164	1,119,589	333,100	1,779,853
Schuler, W Lance	VP	VP & ASST GEN CNSL	1,044,877	781,347	249,800	2,076,024
Shively, Hunter	VP	VP TRADING	331,087	1,255,786	1,079,500	2,666,373
Sturm, Fletcher	VP	VP TRADING	310,763	873,029	666,200	1,849,992
Swerzbin, Michael J	VP	VP TRADING	1,049,386	2,129,050	1,825,700	5,004,135
Taylor, Mark E	VP	VP & GEN CNSL	2,014,444	770,837	199,900	2,985,181
Total			987,354,967	643,375,995	114,773,200	1,745,504,162

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LTI Current Value Analysis

Exhibit 9

Value of In-The-Money Stock Options and Restricted Stock

(At $120.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	491,901,395	112,255,958	18,233,880	622,391,233
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	60,834,894	94,583,567	17,661,240	173,079,701
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	133,432	27,462,396	719,520	28,315,348
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	4,798,594	7,880,208	3,920,040	16,598,842
Delainey, David W	Policy Committee	CHAIRMAN & CEO	7,772,551	30,425,544	2,990,160	41,188,255
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	154,958,493	12,994,123	2,240,040	170,192,655
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	18,095,475	19,111,001	3,197,400	40,403,876
Frevert, Mark A	Policy Committee	CHMN & CEO	81,237,381	75,302,823	879,360	157,419,564
Hannon, Kevin P.	Policy Committee	PRES & COO	57,512,796	66,485,813	1,518,840	125,517,449
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	21,502,340	13,004,242	2,439,960	36,946,542
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	14,614,846	5,780,786	1,749,360	22,144,991
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	53,318,183	154,459	0	53,472,641
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	94,981,869	69,955,815	1,398,840	166,336,524
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	10,173,157	41,474,562	5,949,840	57,597,559
Sherriff, John R	Policy Committee	PRESIDENT & CEO	21,453,128	32,792,380	3,567,120	57,812,628
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	4,909,995	4,725,265	2,220,240	11,855,500
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	2,844,926	4,729,033	559,560	8,133,519
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	4,349,700	2,910,004	895,680	8,155,384
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	1,229,319	3,537,367	1,199,040	5,965,726
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	578,429	8,377,132	439,680	9,395,241
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	1,079,215	10,714,369	799,440	12,593,024
Cline, Wade	Exec. Committee	MNG DIR	8,730,929	1,864,865	868,320	11,464,114
Cox, David	Exec. Committee	MNG DIR ORIGINATION	2,477,987	9,835,355	1,391,520	13,704,862
Dietrich, Janet	Exec. Committee	PRESIDENT	5,372,616	5,482,250	399,720	11,254,586
Glisan Jr, Ben F	Exec. Committee	MNG DIR, FINANCE & TREASURER	1,416,444	4,464,223	2,966,280	8,846,947
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	4,737,042	1,733,623	639,960	7,110,625
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	3,020,254	3,017,469	1,256,640	7,294,363
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	4,719,146	5,016,934	2,831,640	12,567,721
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	4,856,252	4,204,127	919,920	9,980,299
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	9,196,917	27,176,859	2,398,080	38,771,856
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	2,157,842	3,028,250	639,480	5,825,572
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	15,323,965	8,860,065	1,183,920	25,367,951
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	4,569,842	22,085,677	3,262,200	29,917,720
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	5,961,322	4,340,674	1,003,440	11,305,437
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	10,851,317	27,113,643	2,063,280	40,028,240
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	294,319	2,193,401	639,480	3,127,200
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	401,846	3,124,020	639,480	4,165,346
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	1,854,589	4,063,304	1,082,040	6,999,933
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	4,143,938	4,265,378	1,407,600	9,816,916

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LTI Current Value Analysis

Value of In-The-Money Stock Options and Restricted Stock

Exhibit 9

(At $120.00 stock price)

Name	Job Group	Title	Exercisable Stock Options ($)	Unexercisable Stock Options ($)	Unearned Restricted Stock ($)	Total Value ($)
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	73,293	3,331,256	991,800	4,396,349
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	16,516,743	5,179,718	1,598,760	23,295,220
Sherrick, Jeffrey B	Exec. Committee	CEO	2,536,906	6,114,086	1,501,200	10,152,191
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	1,739,787	18,185,777	1,110,840	21,036,404
Allen, Phillip K	MD	MNG DIR TRADING	512,917	5,168,112	3,508,080	9,189,109
Belden, Timothy N	MD	MNG DIR TRADING	1,740,037	5,152,352	3,382,200	10,274,589
Butts, Robert H	MD	MNG DIR & CONTROLLER	4,494,366	2,043,011	645,120	7,182,497
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	2,779,167	1,611,546	535,080	4,925,793
Colwell, Wesley	MD	MNG DIR ACCTG	2,364,577	2,161,481	479,640	5,005,697
Elliott, Steven	MD	MNG DIR TRADING	2,564,901	40,864,461	4,628,640	48,058,001
Fallon, James	MD	MNG DIR TRADING	982,983	9,906,239	4,455,840	15,345,062
Haedicke, Mark E	MD	MNG DIR LEGAL	4,529,292	4,366,445	599,520	9,495,257
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	20,178,670	2,342,542	725,040	23,246,252
Hickerson, Gary J	MD	MNG DIR TRADING	1,189,727	2,913,722	1,391,520	5,494,969
Kopper, Michael J	MD	MNG DIR FIN	8,470,020	4,922,665	1,629,720	15,022,406
Meyer, Rockford G	MD	PRESIDENT CITRUS	849,875	1,464,651	375,240	2,689,766
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	1,639,609	2,154,957	499,680	4,294,246
Arnold, John D	VP	VP TRADING	4,211,536	6,103,906	1,389,840	11,705,282
Bradley, Michael W	VP	VP EQUITY TRADING	227,493	2,619,073	999,240	3,845,806
Gorte, David	VP	VP UNDERWRITING	224,384	1,651,713	359,760	2,235,857
Jones, Robert W	VP	VP HR	1,938,632	711,575	299,760	2,949,966
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	513,549	1,590,713	390,000	2,494,262
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	3,879,132	1,497,576	831,960	6,208,668
Mintz, Jordon	VP	VP & GEN CNSL	664,092	2,145,601	654,960	3,464,653
Oxley, David	VP	VP HR	1,427,920	1,724,941	675,000	3,827,860
Palmer, Mark A.	VP	VP COMMUNICATIONS	2,603,316	1,074,540	360,960	4,038,816
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	914,780	532,235	311,160	1,758,175
Presto, Kevin M	VP	VP TRADING	488,544	1,715,269	399,720	2,603,533
Schuler, W Lance	VP	VP & ASST GEN CNSL	1,369,517	1,126,627	299,760	2,795,904
Shively, Hunter	VP	VP TRADING	515,727	2,051,306	1,295,400	3,862,433
Sturm, Fletcher	VP	VP TRADING	479,103	1,498,069	799,440	2,776,612
Swerzbin, Michael J	VP	VP TRADING	1,416,706	3,424,850	2,190,840	7,032,395
Taylor, Mark E	VP	VP & GEN CNSL	2,670,984	1,116,997	239,880	4,027,861
Total			1,295,074,967	934,994,975	137,727,840	2,367,797,782

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Potential Direct Total Compensation

Exhibit 10

Name	Job Group	Title	Base Salary	Adjusted 2000 Bonus @ 80%	Stock Value at $40.00	Total Potential Compensation
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	975,000	5,600,000	85,854,027	92,429,027
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	1,300,000	4,480,000	12,855,523	18,635,523
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	500,000	960,000	3,349,979	4,809,979
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	400,000	800,000	2,227,654	3,427,654
Delainey, David W	Policy Committee	CHAIRMAN & CEO	350,000	2,400,000	1,785,370	4,535,370
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	470,000	640,000	38,135,270	39,245,270
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	400,000	1,040,000	4,595,427	6,035,427
Frevert, Mark A	Policy Committee	CHMN & CEO	520,000	1,600,000	12,193,452	14,313,452
Hannon, Kevin P.	Policy Committee	PRES & COO	400,000	1,200,000	8,975,279	10,575,279
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	520,000	960,000	5,017,048	6,497,048
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	400,000	800,000	3,439,501	4,639,501
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	400,000	800,000	7,491,995	8,691,995
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	420,000	1,400,000	10,801,312	12,621,312
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	400,000	2,400,000	3,141,558	5,941,558
Sherriff, John R	Policy Committee	PRESIDENT & CEO	400,000	1,200,000	2,969,202	4,569,202
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	325,000	800,000	1,793,228	2,918,228
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	480,000	950,784	1,670,784
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	265,000	480,000	1,139,741	1,884,741
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	300,581	480,000	571,695	1,352,276
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	400,000	443,947	1,083,947
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	325,000	720,000	1,249,672	2,294,672
Cline, Wade	Exec. Committee	MNG DIR	300,000	400,000	1,797,911	2,497,911
Cox, David	Exec. Committee	MNG DIR ORIGINATION	300,000	640,000	574,865	1,514,865
Dietrich, Janet	Exec. Committee	PRESIDENT	225,000	240,000	1,164,708	1,629,708
Glisan Jr, Ben F	Exec. Committee	MD, FINANCE & TREASURER	300,000	480,000	1,138,242	1,918,242
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	250,000	320,000	990,681	1,560,681
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	265,000	480,000	821,039	1,566,039
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	216,765	880,000	1,794,842	2,891,607
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	300,000	560,000	826,668	1,686,668
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	300,000	2,400,000	1,846,975	4,546,975
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	265,000	560,000	240,412	1,065,412
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	300,000	300,000	3,324,838	3,924,838
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	350,000	880,000	2,058,052	3,288,052
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	390,938	480,000	940,656	1,811,593
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	350,000	880,000	1,660,100	2,890,100
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	350,000	480,000	227,586	1,057,586
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	240,000	560,000	444,461	1,244,461

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

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Potential Direct Total Compensation

Exhibit 10

Name	Job Group	Title	Base Salary	Adjusted 2000 Bonus @ 80%	Stock Value at $40.00	Total Potential Compensation
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	315,000	600,000	556,373	1,471,373
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	250,000	400,000	1,449,192	2,099,192
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	240,609	400,000	571,661	1,212,270
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	300,000	1,600,000	4,024,070	5,924,070
Sherrick, Jeffrey B	Exec. Committee	CEO	350,000	280,000	1,083,265	1,713,265
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	265,000	560,000	500,967	1,325,967
Allen, Phillip K	MD	MNG DIR TRADING	200,000	2,800,000	1,412,209	4,412,209
Belden, Timothy N	MD	MNG DIR TRADING	219,962	2,200,000	1,349,433	3,769,395
Butts, Robert H	MD	MNG DIR & CONTROLLER	250,000	300,000	746,735	1,296,735
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	252,000	240,000	667,082	1,159,082
Colwell, Wesley	MD	MNG DIR ACCTG	275,004	480,000	194,496	949,500
Elliott, Steven	MD	MNG DIR TRADING	250,000	280,000	2,463,455	2,993,455
Fallon, James	MD	MNG DIR TRADING	300,000	800,000	1,981,983	3,081,983
Haedicke, Mark E	MD	MNG DIR LEGAL	350,004	320,000	1,556,518	2,226,522
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	250,000	320,000	4,138,980	4,708,980
Hickerson, Gary J	MD	MNG DIR TRADING	200,000	800,000	651,779	1,651,779
Kopper, Michael J	MD	MNG DIR FIN	275,000	640,000	2,317,706	3,232,706
Meyer, Rockford G	MD	PRESIDENT CITRUS	260,000	240,000	336,453	836,453
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	240,000	320,000	392,451	952,451
Arnold, John D	VP	VP TRADING	160,000	520,000	1,191,998	1,871,998
Bradley, Michael W	VP	VP EQUITY TRADING	175,000	1,000,000	346,064	1,521,064
Gorte, David	VP	VP UNDERWRITING	200,000	200,000	123,669	523,669
Jones, Robert W	VP	VP HR	190,000	240,000	462,661	892,661
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	234,563	240,000	171,032	645,595
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	230,400	240,000	821,621	1,292,021
Mintz, Jordon	VP	VP & GEN CNSL	200,000	240,000	516,233	956,233
Oxley, David	VP	VP HR	204,000	320,000	393,976	917,976
Palmer, Mark A.	VP	VP COMMUNICATIONS	206,000	320,000	492,154	1,018,154
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	210,000	200,000	229,028	639,028
Presto, Kevin M	VP	VP TRADING	185,004	400,000	232,369	817,373
Schuler, W Lance	VP	VP & ASST GEN CNSL	175,000	160,000	355,401	690,401
Shively, Hunter	VP	VP TRADING	170,000	1,000,000	465,106	1,635,106
Sturm, Fletcher	VP	VP TRADING	170,000	800,000	266,480	1,236,480
Swerzbin, Michael J	VP	VP TRADING	120,000	1,600,000	973,398	2,693,398
Taylor, Mark E	VP	VP & GEN CNSL	175,000	140,000	449,062	764,062
Total			22,300,830	61,380,000	262,718,760	346,399,590

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

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Potential Direct Total Compensation

Exhibit 11

Name	Job Group	Title	Base Salary	Adjusted 2000 Bonus at 90%	Stock Value at $60.00	Total Potential Compensation
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	975,000	6,300,000	211,736,316	219,011,316
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	1,300,000	5,040,000	39,087,349	45,427,349
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	500,000	1,080,000	9,185,607	10,765,607
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	400,000	900,000	5,010,606	6,310,606
Delainey, David W	Policy Committee	CHAIRMAN & CEO	350,000	2,700,000	3,375,671	6,425,671
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	470,000	720,000	70,212,226	71,402,226
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	400,000	1,170,000	11,610,055	13,180,055
Frevert, Mark A	Policy Committee	CHMN & CEO	520,000	1,800,000	33,564,869	35,884,869
Hannon, Kevin P.	Policy Committee	PRES & COO	400,000	1,350,000	27,430,506	29,180,506
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	520,000	1,080,000	11,897,762	13,497,762
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	400,000	900,000	7,414,603	8,714,603
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	400,000	900,000	18,948,355	20,248,355
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	420,000	1,575,000	27,698,617	29,693,617
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	400,000	2,700,000	7,008,426	10,108,426
Sherriff, John R	Policy Committee	PRESIDENT & CEO	400,000	1,350,000	6,975,466	8,725,466
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	325,000	900,000	3,706,278	4,931,278
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	540,000	1,903,308	2,683,308
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	265,000	540,000	2,423,764	3,228,764
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	300,581	540,000	1,155,473	1,996,053
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	450,000	1,083,516	1,773,516
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	325,000	810,000	3,528,832	4,663,832
Cline, Wade	Exec. Committee	MNG DIR	300,000	450,000	3,583,548	4,333,548
Cox, David	Exec. Committee	MNG DIR ORIGINATION	300,000	720,000	1,171,141	2,191,141
Dietrich, Janet	Exec. Committee	PRESIDENT	225,000	270,000	3,266,355	3,761,355
Glisan Jr, Ben F	Exec. Committee	MD, FINANCE & TREASURER	300,000	540,000	2,057,174	2,897,174
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	250,000	360,000	2,128,924	2,738,924
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	265,000	540,000	1,868,674	2,673,674
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	216,765	990,000	3,422,357	4,629,122
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	300,000	630,000	2,609,309	3,539,309
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	300,000	2,700,000	3,635,987	6,635,987
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	265,000	630,000	467,895	1,362,895
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	300,000	337,500	8,194,331	8,831,831
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	350,000	990,000	4,727,565	6,067,565
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	390,938	540,000	2,843,463	3,774,401
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	350,000	990,000	3,534,787	4,874,787
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	350,000	540,000	590,626	1,480,626
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	240,000	630,000	811,230	1,681,230

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

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Potential Direct Total Compensation

Exhibit 11

Name	Job Group	Title	Base Salary	Adjusted 2000 Bonus at 90%	LT Stock Value at $60.00	Total Potential Compensation
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	315,000	675,000	1,590,025	2,580,025
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	250,000	450,000	2,994,225	3,694,225
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	240,609	450,000	1,109,190	1,799,799
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	300,000	1,800,000	7,756,618	9,856,618
Sherrick, Jeffrey B	Exec. Committee	CEO	350,000	315,000	3,148,331	3,813,331
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	265,000	630,000	1,692,110	2,587,110
Allen, Phillip K	MD	MNG DIR TRADING	200,000	3,150,000	2,363,122	5,713,122
Belden, Timothy N	MD	MNG DIR TRADING	219,962	2,475,000	2,491,591	5,186,553
Butts, Robert H	MD	MNG DIR & CONTROLLER	250,000	337,500	1,864,598	2,452,098
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	252,000	270,000	1,442,400	1,964,400
Colwell, Wesley	MD	MNG DIR ACCTG	275,004	540,000	968,243	1,783,247
Elliott, Steven	MD	MNG DIR TRADING	250,000	315,000	13,861,661	14,426,661
Fallon, James	MD	MNG DIR TRADING	300,000	900,000	4,144,790	5,344,790
Haedicke, Mark E	MD	MNG DIR LEGAL	350,004	360,000	3,001,438	3,711,442
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	250,000	360,000	8,058,047	8,668,047
Hickerson, Gary J	MD	MNG DIR TRADING	200,000	900,000	1,304,908	2,404,908
Kopper, Michael J	MD	MNG DIR FIN	275,000	720,000	4,690,768	5,685,768
Meyer, Rockford G	MD	PRESIDENT CITRUS	260,000	270,000	714,050	1,244,050
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	240,000	360,000	783,044	1,383,044
Arnold, John D	VP	VP TRADING	160,000	585,000	2,937,365	3,682,365
Bradley, Michael W	VP	VP EQUITY TRADING	175,000	1,125,000	635,030	1,935,030
Gorte, David	VP	VP UNDERWRITING	200,000	225,000	489,462	914,462
Jones, Robert W	VP	VP HR	190,000	270,000	935,571	1,395,571
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	234,563	270,000	340,467	845,030
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	230,400	270,000	1,796,218	2,296,618
Mintz, Jordon	VP	VP & GEN CNSL	200,000	270,000	1,041,868	1,511,868
Oxley, David	VP	VP HR	204,000	360,000	990,864	1,554,864
Palmer, Mark A.	VP	VP COMMUNICATIONS	206,000	360,000	1,107,771	1,673,771
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	210,000	225,000	436,380	871,380
Presto, Kevin M	VP	VP TRADING	185,004	450,000	448,607	1,083,611
Schuler, W Lance	VP	VP & ASST GEN CNSL	175,000	180,000	771,974	1,126,974
Shively, Hunter	VP	VP TRADING	170,000	1,125,000	805,481	2,100,481
Sturm, Fletcher	VP	VP TRADING	170,000	900,000	446,115	1,516,115
Swerzbin, Michael J	VP	VP TRADING	120,000	1,800,000	1,731,283	3,651,283
Taylor, Mark E	VP	VP & GEN CNSL	175,000	157,500	1,057,454	1,389,954
Total			22,300,830	69,052,500	629,822,037	721,175,367

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

Towers Perrin

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EC 002634747

Potential Direct Total Compensation

Exhibit 12

Name	Job Group	Title	Base Salary	2000 Bonus (No Adjustment)	Stock Value at $80.00	Total Potential Compensation
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	975,000	7,000,000	344,961,921	352,936,921
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	1,300,000	5,600,000	77,453,213	84,353,213
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	500,000	1,200,000	15,301,549	17,001,549
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	400,000	1,000,000	8,446,368	9,846,368
Delainey, David W	Policy Committee	CHAIRMAN & CEO	350,000	3,000,000	11,136,015	14,486,015
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	470,000	800,000	103,096,688	104,366,688
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	400,000	1,300,000	20,209,695	21,909,695
Frevert, Mark A	Policy Committee	CHMN & CEO	520,000	2,000,000	66,961,542	69,481,542
Hannon, Kevin P.	Policy Committee	PRES & COO	400,000	1,500,000	53,184,914	55,084,914
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	520,000	1,200,000	19,744,039	21,464,039
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	400,000	1,000,000	11,900,945	13,300,945
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	400,000	1,000,000	30,405,153	31,805,153
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	420,000	1,750,000	65,149,796	67,319,796
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	400,000	3,000,000	17,410,599	20,810,599
Sherriff, John R	Policy Committee	PRESIDENT & CEO	400,000	1,500,000	18,513,828	20,413,828
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	325,000	1,000,000	6,204,380	7,529,380
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	600,000	3,444,279	4,284,279
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	265,000	600,000	4,159,024	5,024,024
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	300,581	600,000	2,172,324	3,072,905
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	500,000	3,283,561	4,023,561
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	325,000	900,000	6,297,261	7,522,261
Cline, Wade	Exec. Committee	MNG DIR	300,000	500,000	6,046,674	6,846,674
Cox, David	Exec. Committee	MNG DIR ORIGINATION	300,000	800,000	3,325,742	4,425,742
Dietrich, Janet	Exec. Committee	PRESIDENT	225,000	300,000	5,819,946	6,344,946
Glisan Jr, Ben F	Exec. Committee	MD, FINANCE & TREASURER	300,000	600,000	3,752,827	4,652,827
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	250,000	400,000	3,653,025	4,303,025
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	265,000	600,000	3,404,083	4,269,083
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	216,765	1,100,000	5,811,041	7,127,806
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	300,000	700,000	4,856,332	5,856,332
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	300,000	3,000,000	11,199,776	14,499,776
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	265,000	700,000	1,518,640	2,483,640
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	300,000	375,000	13,183,871	13,858,871
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	350,000	1,100,000	10,591,200	12,041,200
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	390,938	600,000	5,457,197	6,448,134
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	350,000	1,100,000	11,035,000	12,485,000
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	350,000	600,000	1,184,486	2,134,486
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	240,000	700,000	1,582,226	2,522,226

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

Towers Perrin

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EC 002634748

Potential Direct Total Compensation

Exhibit 12

Name	Job Group	Title	Base Salary	2000 Bonus (No Adjustment)	Stock Value at $80.00	Total Potential Compensation
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	315,000	750,000	3,090,879	4,155,879
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	250,000	500,000	5,126,516	5,876,516
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	240,609	500,000	1,859,760	2,600,370
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	300,000	2,000,000	12,499,540	14,799,540
Sherrick, Jeffrey B	Exec. Committee	CEO	350,000	350,000	5,482,951	6,182,951
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	265,000	700,000	7,245,792	8,210,792
Allen, Phillip K	MD	MNG DIR TRADING	200,000	3,500,000	3,798,189	7,498,189
Belden, Timothy N	MD	MNG DIR TRADING	219,962	2,750,000	4,399,749	7,369,711
Butts, Robert H	MD	MNG DIR & CONTROLLER	250,000	375,000	3,463,657	4,088,657
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	252,000	300,000	2,505,273	3,057,273
Colwell, Wesley	MD	MNG DIR ACCTG	275,004	600,000	2,099,217	2,974,221
Elliott, Steven	MD	MNG DIR TRADING	250,000	350,000	25,260,441	25,860,441
Fallon, James	MD	MNG DIR TRADING	300,000	1,000,000	6,522,852	7,822,852
Haedicke, Mark E	MD	MNG DIR LEGAL	350,004	400,000	4,925,977	5,675,981
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	250,000	400,000	12,801,972	13,451,972
Hickerson, Gary J	MD	MNG DIR TRADING	200,000	1,000,000	2,483,289	3,683,289
Kopper, Michael J	MD	MNG DIR FIN	275,000	800,000	7,883,606	8,958,606
Meyer, Rockford G	MD	PRESIDENT CITRUS	260,000	300,000	1,318,046	1,878,046
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	240,000	400,000	1,571,337	2,211,337
Arnold, John D	VP	VP TRADING	160,000	650,000	5,598,242	6,408,242
Bradley, Michael W	VP	VP EQUITY TRADING	175,000	1,250,000	1,391,766	2,816,766
Gorte, David	VP	VP UNDERWRITING	200,000	250,000	1,017,017	1,467,017
Jones, Robert W	VP	VP HR	190,000	300,000	1,522,246	2,012,246
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	234,563	300,000	849,662	1,384,225
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	230,400	300,000	3,159,388	3,689,788
Mintz, Jordon	VP	VP & GEN CNSL	200,000	300,000	1,767,573	2,267,573
Oxley, David	VP	VP HR	204,000	400,000	1,791,380	2,395,380
Palmer, Mark A.	VP	VP COMMUNICATIONS	206,000	400,000	2,002,896	2,608,896
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	210,000	250,000	784,855	1,244,855
Presto, Kevin M	VP	VP TRADING	185,004	500,000	956,173	1,641,177
Schuler, W Lance	VP	VP & ASST GEN CNSL	175,000	200,000	1,356,144	1,731,144
Shively, Hunter	VP	VP TRADING	170,000	1,250,000	1,470,313	2,890,313
Sturm, Fletcher	VP	VP TRADING	170,000	1,000,000	923,372	2,093,372
Swerzbin, Michael J	VP	VP TRADING	120,000	2,000,000	2,975,875	5,095,875
Taylor, Mark E	VP	VP & GEN CNSL	175,000	175,000	1,942,501	2,292,501
Total			22,300,830	76,725,000	1,125,707,608	1,224,733,437

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

Towers Perrin

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EC 002634749

Potential Direct Total Compensation

Exhibit 13

Name	Job Group	Title	Base Salary	Adjusted 2000 Bonus at 115%	Stock Value at $100.00	Total Potential Compensation
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	975,000	8,050,000	483,655,413	492,680,413
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	1,300,000	6,440,000	125,252,621	132,992,621
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	500,000	1,380,000	21,800,308	23,680,308
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	400,000	1,150,000	12,516,902	14,066,902
Delainey, David W	Policy Committee	CHAIRMAN & CEO	350,000	3,450,000	26,162,135	29,962,135
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	470,000	920,000	136,637,015	138,027,016
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	400,000	1,495,000	30,300,676	32,195,676
Frevert, Mark A	Policy Committee	CHMN & CEO	520,000	2,300,000	112,182,084	115,002,084
Hannon, Kevin P.	Policy Committee	PRES & COO	400,000	1,725,000	89,142,849	91,267,849
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	520,000	1,380,000	28,336,822	30,236,822
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	400,000	1,150,000	17,017,671	18,567,671
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	400,000	1,150,000	41,932,381	43,482,381
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	420,000	2,012,500	115,736,324	118,168,824
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	400,000	3,450,000	37,504,079	41,354,079
Sherriff, John R	Policy Committee	PRESIDENT & CEO	400,000	1,725,000	38,163,228	40,288,228
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	325,000	1,150,000	9,029,940	10,504,940
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	690,000	5,694,899	6,624,899
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	265,000	690,000	6,157,204	7,112,204
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	300,581	690,000	4,013,526	5,004,107
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	575,000	6,245,401	7,060,401
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	325,000	1,035,000	9,440,744	10,800,744
Cline, Wade	Exec. Committee	MNG DIR	300,000	575,000	8,755,394	9,630,394
Cox, David	Exec. Committee	MNG DIR ORIGINATION	300,000	920,000	8,515,302	9,735,302
Dietrich, Janet	Exec. Committee	PRESIDENT	225,000	345,000	8,537,266	9,107,266
Glisan Jr, Ben F	Exec. Committee	MD, FINANCE & TREASURER	300,000	690,000	6,299,887	7,289,887
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	250,000	460,000	5,381,825	6,091,825
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	265,000	690,000	5,349,223	6,304,223
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	216,765	1,265,000	9,156,881	10,638,646
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	300,000	805,000	7,413,839	8,518,839
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	300,000	3,450,000	24,985,816	28,735,816
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	265,000	805,000	3,546,772	4,616,772
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	300,000	431,250	19,178,411	19,909,661
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	350,000	1,265,000	20,254,460	21,869,460
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	390,938	690,000	8,381,317	9,462,254
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	350,000	1,265,000	25,531,620	27,146,620
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	350,000	690,000	2,150,140	3,190,140
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	240,000	805,000	2,836,186	3,881,186

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

Towers Perrin

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EC 002634750

Potential Direct Total Compensation

Exhibit 13

Name	Job Group	Title	Base Salary	Adjusted 2000 Bonus at 115%	Stock Value at $100.00	Total Potential Compensation
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	315,000	862,500	5,040,273	6,217,773
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	250,000	575,000	7,471,716	8,296,716
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	240,609	575,000	3,065,389	3,880,998
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	300,000	2,300,000	17,897,380	20,497,380
Sherrick, Jeffrey B	Exec. Committee	CEO	350,000	402,500	7,817,571	8,570,071
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	265,000	805,000	14,015,764	15,085,764
Allen, Phillip K	MD	MNG DIR TRADING	200,000	4,025,000	6,493,649	10,718,649
Belden, Timothy N	MD	MNG DIR TRADING	219,962	3,162,500	7,337,169	10,719,631
Butts, Robert H	MD	MNG DIR & CONTROLLER	250,000	431,250	5,323,077	6,004,327
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	252,000	345,000	3,715,533	4,312,533
Colwell, Wesley	MD	MNG DIR ACCTG	275,004	690,000	3,552,457	4,517,461
Elliott, Steven	MD	MNG DIR TRADING	250,000	402,500	36,659,221	37,311,721
Fallon, James	MD	MNG DIR TRADING	300,000	1,150,000	10,812,082	12,262,082
Haedicke, Mark E	MD	MNG DIR LEGAL	350,004	460,000	7,210,617	8,020,621
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	250,000	460,000	18,024,112	18,734,112
Hickerson, Gary J	MD	MNG DIR TRADING	200,000	1,150,000	3,989,129	5,339,129
Kopper, Michael J	MD	MNG DIR FIN	275,000	920,000	11,453,006	12,648,006
Meyer, Rockford G	MD	PRESIDENT CITRUS	260,000	345,000	2,003,906	2,608,906
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	240,000	460,000	2,870,126	3,570,126
Arnold, John D	VP	VP TRADING	160,000	747,500	8,651,762	9,559,262
Bradley, Michael W	VP	VP EQUITY TRADING	175,000	1,437,500	2,618,786	4,231,286
Gorte, David	VP	VP UNDERWRITING	200,000	287,500	1,626,437	2,113,937
Jones, Robert W	VP	VP HR	190,000	345,000	2,236,106	2,771,106
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	234,563	345,000	1,671,962	2,251,525
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	230,400	345,000	4,684,028	5,259,428
Mintz, Jordon	VP	VP & GEN CNSL	200,000	345,000	2,616,113	3,161,113
Oxley, David	VP	VP HR	204,000	460,000	2,796,300	3,460,300
Palmer, Mark A.	VP	VP COMMUNICATIONS	206,000	460,000	3,020,856	3,686,856
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	210,000	287,500	1,271,515	1,769,015
Presto, Kevin M	VP	VP TRADING	185,004	575,000	1,779,853	2,539,857
Schuler, W Lance	VP	VP & ASST GEN CNSL	175,000	230,000	2,076,024	2,481,024
Shively, Hunter	VP	VP TRADING	170,000	1,437,500	2,666,373	4,273,873
Sturm, Fletcher	VP	VP TRADING	170,000	1,150,000	1,849,992	3,169,992
Swerzbin, Michael J	VP	VP TRADING	120,000	2,300,000	5,004,135	7,424,135
Taylor, Mark E	VP	VP & GEN CNSL	175,000	201,250	2,985,181	3,361,431
Total			22,300,830	88,233,750	1,745,504,162	1,856,038,741

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

Towers Perrin

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EC 002634751

Potential Direct Total Compensation

Exhibit 14

Name	Job Group	Title	Base Salary	Adjusted 2000 Bonus at 125% [illegible]	Stock Value at $120.00	Total Potential Compensation
Lay, Ken	OOC	CHAIRMAN OF THE BOARD	975,000	8,750,000	622,391,233	632,116,233
Skilling, Jeff	OOC	CHIEF EXEC OFFICER	1,300,000	7,000,000	173,079,701	181,379,701
Baxter, John C.	Policy Committee	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	500,000	1,500,000	28,315,348	30,315,348
Causey, Richard A.	Policy Committee	EVP CHIEF ACCTG OFFICER	400,000	1,250,000	16,598,842	18,248,842
Delainey, David W	Policy Committee	CHAIRMAN & CEO	350,000	3,750,000	41,188,255	45,288,255
Derrick Jr., James V.	Policy Committee	EVP GEN COUNSEL	470,000	1,000,000	170,192,655	171,662,656
Fastow, Andrew S	Policy Committee	EVP & CHIEF FINANCIAL OFFICER	400,000	1,625,000	40,403,876	42,428,876
Frevert, Mark A	Policy Committee	CHMN & CEO	520,000	2,500,000	157,419,564	160,439,564
Hannon, Kevin P.	Policy Committee	PRES & COO	400,000	1,875,000	125,517,449	127,792,449
Horton, Stanley C	Policy Committee	CHAIRMAN & CEO	520,000	1,500,000	36,946,542	38,966,542
Kean, Steven J.	Policy Committee	EVP CHIEF OF STAFF	400,000	1,250,000	22,144,991	23,794,991
Pai, Lou L	Policy Committee	CHAIRMAN AND CEO ENRON XCCELERATOR	400,000	1,250,000	53,472,641	55,122,641
Rice, Kenneth D	Policy Committee	CHIEF EXEC OFFICER	420,000	2,187,500	166,336,524	168,944,024
Whalley, Lawrence G.	Policy Committee	PRESIDENT & COO	400,000	3,750,000	57,597,559	61,747,559
Sherriff, John R	Policy Committee	PRESIDENT & CEO	400,000	1,875,000	57,812,628	60,087,628
Bibi, Philippe A	Exec. Committee	PRESIDENT & CEO	325,000	1,250,000	11,855,500	13,430,500
Blachman, Jeremy M	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	750,000	8,133,519	9,123,519
Bowen Jr, Raymond M	Exec. Committee	CHIEF OPERATING OFFICER	265,000	750,000	8,155,384	9,170,384
Brown, Michael	Exec. Committee	CHIEF OPERATING OFFICER	300,581	750,000	5,965,726	7,016,307
Buchanan, Harold G	Exec. Committee	CO-CHIEF OPERATING OFFICER EES	240,000	625,000	9,395,241	10,260,241
Buy, Richard B	Exec. Committee	EVP CHIEF RISK OFFICER	325,000	1,125,000	12,593,024	14,043,024
Cline, Wade	Exec. Committee	MNG DIR	300,000	625,000	11,464,114	12,389,114
Cox, David	Exec. Committee	MNG DIR ORIGINATION	300,000	1,000,000	13,704,862	15,004,862
Dietrich, Janet	Exec. Committee	PRESIDENT	225,000	375,000	11,254,586	11,854,586
Glisan Jr, Ben F	Exec. Committee	MD, FINANCE & TREASURER	300,000	750,000	8,846,947	9,896,947
Hayslett, Roderick J.	Exec. Committee	MNG DIR ETS FINANCE & ACCTG	250,000	500,000	7,110,625	7,860,625
Hughes, James	Exec. Committee	CHIEF OPERATING OFFICER	265,000	750,000	7,294,363	8,309,363
Kitchen, Louise	Exec. Committee	CHIEF OPERATING OFFICER	216,765	1,375,000	12,567,721	14,159,486
Koenig, Mark E	Exec. Committee	EVP INVESTOR REL	300,000	875,000	9,980,299	11,155,299
Lavorato, John J	Exec. Committee	PRESIDENT & CEO	300,000	3,750,000	38,771,856	42,821,856
Leff, Daniel P	Exec. Committee	CHIEF OPERATING OFFICER	265,000	875,000	5,825,572	6,965,572
McCarty, Danny J.	Exec. Committee	MNG DIR & CHIEF COMMERCIAL OFF	300,000	468,750	25,367,951	26,136,701
McConnell, Mike	Exec. Committee	PRESIDENT & CEO	350,000	1,375,000	29,917,720	31,642,720
McDonald, Rebecca	Exec. Committee	PRESIDENT & CEO	390,938	750,000	11,305,437	12,446,374
McMahon, Jeffrey	Exec. Committee	PRESIDENT & CEO	350,000	1,375,000	40,028,240	41,753,240
Metts, Mark	Exec. Committee	EVP CORP DEVELOPMENT	350,000	750,000	3,127,200	4,227,200
Muller, Mark S	Exec. Committee	MANAGING DIRECTOR	240,000	875,000	4,165,346	5,280,346

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

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Potential Direct Total Compensation

Exhibit 14

Name	Job Group	Title	Base Salary	Adjusted 2000 Bonus at 125%	Stock Value at $120.00	Total Potential Compensation
Olson, Cindy K	Exec. Committee	EVP HR & COMMUNITY REL	315,000	937,500	6,999,933	8,252,433
Piper, Gregory F	Exec. Committee	CHIEF OPERATING OFFICER	250,000	625,000	9,816,916	10,691,916
Scrimshaw, Mathew	Exec. Committee	PRESIDENT & CEO - EES EUROPE	240,609	625,000	4,396,349	5,261,958
Shankman, Jeffrey A.	Exec. Committee	CHIEF OPERATING OFFICER	300,000	2,500,000	23,295,220	26,095,220
Sherrick, Jeffrey B	Exec. Committee	CEO	350,000	437,500	10,152,191	10,939,691
Sunde, Martin	Exec. Committee	VICE CHAIRMAN	265,000	875,000	21,036,404	22,176,404
Allen, Phillip K	MD	MNG DIR TRADING	200,000	4,375,000	9,189,109	13,764,109
Belden, Timothy N	MD	MNG DIR TRADING	219,962	3,437,500	10,274,589	13,932,051
Butts, Robert H	MD	MNG DIR & CONTROLLER	250,000	468,750	7,182,497	7,901,247
Carter, Rebecca C.	MD	MNG DIR & CORP SECY	252,000	375,000	4,925,793	5,552,793
Colwell, Wesley	MD	MNG DIR ACCTG	275,004	750,000	5,005,697	6,030,701
Elliott, Steven	MD	MNG DIR TRADING	250,000	437,500	48,058,001	48,745,501
Fallon, James	MD	MNG DIR TRADING	300,000	1,250,000	15,345,062	16,895,062
Haedicke, Mark E	MD	MNG DIR LEGAL	350,004	500,000	9,495,257	10,345,261
Hermann, Robert J	MD	MNG DIR AND GENERAL TAX COUNSEL	250,000	500,000	23,246,252	23,996,252
Hickerson, Gary J	MD	MNG DIR TRADING	200,000	1,250,000	5,494,969	6,944,969
Kopper, Michael J	MD	MNG DIR FIN	275,000	1,000,000	15,022,406	16,297,406
Meyer, Rockford G	MD	PRESIDENT CITRUS	260,000	375,000	2,689,766	3,324,766
Sharp, Victoria T	MD	MNG DIR & GEN CNSL	240,000	500,000	4,294,246	5,034,246
Arnold, John D	VP	VP TRADING	160,000	812,500	11,705,282	12,677,782
Bradley, Michael W	VP	VP EQUITY TRADING	175,000	1,562,500	3,845,806	5,583,306
Gorte, David	VP	VP UNDERWRITING	200,000	312,500	2,235,857	2,748,357
Jones, Robert W	VP	VP HR	190,000	375,000	2,949,966	3,514,966
Joyce, Mary K	VP	VP EXECUTIVE COMPENSATION	234,563	375,000	2,494,262	3,103,825
Lynch, Drew C	VP	VICE PRESIDENT, COMMERCIAL SUPPORT	230,400	375,000	6,208,668	6,814,068
Mintz, Jordon	VP	VP & GEN CNSL	200,000	375,000	3,464,653	4,039,653
Oxley, David	VP	VP HR	204,000	500,000	3,827,860	4,531,860
Palmer, Mark A.	VP	VP COMMUNICATIONS	206,000	500,000	4,038,816	4,744,816
Perlman, Beth S.	VP	VP IT-DEVELOPMENT	210,000	312,500	1,758,175	2,280,675
Presto, Kevin M	VP	VP TRADING	185,004	625,000	2,603,533	3,413,537
Schuler, W Lance	VP	VP & ASST GEN CNSL	175,000	250,000	2,795,904	3,220,904
Shively, Hunter	VP	VP TRADING	170,000	1,562,500	3,862,433	5,594,933
Sturm, Fletcher	VP	VP TRADING	170,000	1,250,000	2,776,612	4,196,612
Swerzbin, Michael J	VP	VP TRADING	120,000	2,500,000	7,032,395	9,652,395
Taylor, Mark E	VP	VP & GEN CNSL	175,000	218,750	4,027,861	4,421,611
Total			22,300,830	95,906,250	2,367,797,782	2,486,004,861

Potential Direct Total Compensation: Current base salary; Bonus at 80% ($40), 90% ($50), 100% ($80), 115% ($100), and 125% ($120) of 2000 bonus depending upon stock price; Long-term value is value of in-the-money stock options and restricted stock.

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Stock Utilization Analysis

Exhibit 15

Overhang Projection

	$40 Shares	%	$60 Shares	%	$80 Shares	%	$100 Shares	%	$120 Shares	%
Shares Outstanding	99,477,536		99,477,536		99,477,536		99,477,536		99,477,536	
Available for Grant	13,025,920		13,025,920		13,025,920		13,025,920		13,025,920	
Actual Stock Overhang, March 31, 2001	112,503,456	13.6%	112,503,456	13.6%	112,503,456	13.6%	112,503,456	13.6%	112,503,456	13.6%
Less										
Options Exercised (Estimate)	(18,600,000)	-2.2%	(27,800,000)	-3.2%	(37,100,000)	-4.3%	(49,100,000)	-5.6%	(55,100,000)	-6.3%
Plus:										
Executive Long Term Incentive Program	7,854,167	0.9%	5,024,123	0.6%	3,806,250	0.4%	2,990,625	0.3%	2,512,061	0.3%
KEYSOP	5,416,667	0.6%	3,421,053	0.4%	2,600,000	0.3%	2,031,250	0.2%	1,710,526	0.2%
Bonus Options/Phantom Shares	2,270,833	0.3%	1,440,789	0.2%	1,093,750	0.1%	856,250	0.1%	720,395	0.1%
Ad Hoc Grants	8,000,000	0.9%	5,052,632	0.6%	1,440,000	0.2%	1,125,000	0.1%	947,368	0.1%
EnronOptions	661,538	0.1%	452,632	0.1%	330,769	0.0%	260,606	0.0%	220,513	0.0%
Share Authorization - 1991	21,000,000	2.5%	21,000,000	2.5%	21,000,000	2.4%	21,000,000	2.4%	21,000,000	2.4%
-1994	15,000,000	1.8%	7,000,000	0.8%	2,000,000	0.2%	-	0.0%	-	0.0%
Shares Outstanding	105,080,741		87,068,764		71,648,305		57,641,267		50,488,400	
Available for Grant	21,886,879		22,698,856		23,819,315		23,826,353		24,979,220	
Projected Stock Overhang, April 1, 2002	126,967,620	15.0%	109,767,620	12.8%	95,467,620	11.0%	81,467,620	9.3%	75,467,620	8.6%

Assumptions:

- Executive LTIP delivered 50% in stock options and 50% in restricted stock; total value delivered = $145,000,000 ($80,000,000 from 1991 Plan and $65,000,000 from 1994 Plan). Options are 5 year term; restricted stock cliff vests in 4 years.
- KEYSOP delivered 100% in 5 year term stock options; total value delivered = $65,000,000 from the 1994 Plan.
- Bonus deferral value delivered = $7,500,000 phantom stock and $25,000,000 5 year stock options; all from the 1994 Plan.
- Ad hoc grant value delivered = $8,000,000 per month when the stock price = $40 or $60 and $3,000,000 per month when the stock price = $80 or $100. Grants will be for 5 year term options from the 1994 Plan.
- EnronOptions value delivered = value delivered @ 12/31/99 or $8,600,000. 7 year term options from the 1994 Plan.
- Black Scholes values to be used:

	Black Scholes	
	5 year term	7 year term
Stock Price	(.321)	(.333)
$40	$12	$13
$60	$19	$19
$80	$25	$26
$100	$32	$33
$120	$38	$39

Common Shares Outstanding:

Per 3/31/01 Stock Memo	744,679,988
Series J	33,882,435
Series B	50,000,000
	828,562,423

Overhang = shares outstanding plus shares available for grant divided by common shares outstanding.
Available for grant, April 1, 2002 = available for grant, March 31, 2001 less shares/options granted plus authorization of shares less available for grant at March 31, 2001 under the 1991 Plan.
Shares Outstanding, April 1, 2002 = shares outstanding, March 31, 2001 less options exercised plus shares/options granted.

Exhibit 16

Enron Corp.
Sample Approaches to Address Underwater Stock Options

Company Name	Approach
Dell	Dell considered and did not like typical alternatives such as repricing, cancel and reissue or stock buy-backs, because of the negative message they send to shareholders and marketplace practice. Their method to address the problem is to take an annual award and deliver portions of it over the course of a year (i.e., 3 to 4 times per year). This way strike prices vary over the year and there is the potential that some of the options from an annual grant cycle will be in-the-money.
Lucent Technologies	Lucent provided 2 special stock option grants in the last half of 2000 (in addition to normal grants) that have shorter than normal terms (e.g., 2 years) and vesting restrictions (e.g., 1 year cliff vest). In addition, a special award was made in February, under which vesting is accelerated if a stock price performance goal (i.e., $50 price for 10 out of 12 consecutive days) is achieved.
Microsoft	Microsoft has responded to underwater stock options by simply granting millions of new stock options when their stock price was low with seemingly little regard for stock overhang implications.
Sprint	Excluding Board members, Sprint employees agreed to have nearly 18 million underwater stock options cancelled. In exchange, employees will be granted an equal number of options with new strike prices 6 months after the cancellation. Not surprisingly, many shareholders were less than pleased with this action, including one major shareholder that filed a proxy resolution to require the Board to get shareholder approval before Sprint can try similar actions in the future.
Cisco Systems	Cisco's approach to dealing with underwater stock options is similar to Dell's. That is, provide a normal annual award in several smaller grants throughout the year (the number of grants per year has not been determined). In addition, Cisco is planning to shorten the vesting schedule for new stock option grants (specific vesting schedule not available).

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Exhibit 17

Enron Corp.
Approaches for Dealing With Underwater Stock Options

More senior people usually

to 38 own Enron Options
to 166 officers
voluntary

	Approach 1 *Leave options intact: accelerate next grant or make additional grant*	Approach 2 *Leave options intact: supplement with "bounded" Stock Appreciation Rights (SARs)*	Approach 3 *Replace options with restricted stock*	Approach 4 *Cancel and replace more than 6 months later*	Approach 5 *Buy out options with cash*	Approach 6 *Sell options to third party*
Description	Company makes a new grant ahead of schedule, or an extra grant	Company grants SARs to fill the gap between the exercise price on the original options and the current fair market value	Company offers to replace underwater options with fewer restricted shares at an equivalent value (Black-Scholes or some other basis)	Company cancels options and agrees to replace after 6 months with options that have an exercise price equal to the stock's then-current fair market value	Company buys out underwater options with cash (e.g., at 50% of Black-Scholes value)	Employee sells options to third party at a negotiated price
Company's Accounting Expense	None	Variable (but limited) expense equal to the cash paid when the SAR is exercised	Recognize fixed cost equal to grant-date value of the restricted shares	Probably, none, although subject to debate	Recognize fixed cost equal to cash payment	Probably none, especially if options are vested
Cautions	May cause stock overhang to exceed competitive levels; results in "double payoff" if the stock price rebounds	Transaction could be interpreted as an "effective" repricing; consult your accounting adviser. To the extent possible, differentiate the SAR from the original options (e.g., through different vesting, terms, strike price)	If fewer restricted shares are granted than the number of options canceled, don't make any option grants within 6 months of cancellation (before or after) that have a lower exercise price than the replaced options	To avoid variable accounting, don't make any option grants within 6 months of cancellation (before or after) that have a lower exercise price than the canceled options	To avoid variable accounting, don't make any option grants within 6 months of cancellation (before or after) that have a lower exercise price than the canceled options	Creates a new class of nonemployee option holders
Most appropriate when . . .	Company has sufficient shares in the plan, and dilution and the potential for windfall gains are not a concern	A near-term fix is needed even though the stock price is expected to rebound after a prolonged period	The company wants to ensure employees have an ongoing tie to the stock (albeit a less risky one) and is willing to take a fixed charge to earnings	Options are so deeply underwater that participants consider them to be essentially worthless and there is little likelihood that share value will recover, or that a change in control will occur within 6 months	The company is willing to spend cash and recognize a fixed accounting expense. Especially relevant when stock options are no longer seen as an appropriate form of compensation for the individual	Company has other incentives and retention vehicles in place for employees and is willing to have outside investors hold options

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Towers Perrin

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November 16, 2000

Ms. Pam Butler
Director, Compensation
Enron Corp.
1400 Smith Street
Room EB 1668
Houston, TX 77002-7361

Dear Pam:

As requested, Towers Perrin has prepared this letter to document the results of a recent marketplace compensation analysis for the top two executives (Mr. Lay and Mr. Skilling) at Enron Corp. The following sections describe our study methodology and findings.

Methodology

In this analysis, we have prepared the following alternative **compensation** scenarios, **contingent upon the roles which both Mr. Lay and Mr. Skilling may assume with Enron in the future:**

- Mr. Lay paid as Chief Executive Officer (CEO)
- Mr. Skilling paid as Chief Operating Officer (COO)
- Mr. Lay paid as Chairman of the Board.

Towers Perrin developed marketplace compensation rates for the top 2 positions at Enron in terms of the following components of compensation:

- Base salary;
- Actual total annual compensation (base salary plus most recent annual incentive);
- Long-term incentives (annualized present value of all long-term incentive vehicles); and
- Actual total direct compensation (actual total annual compensation plus long-term incentives).

In developing compensation rates for each alternative, Towers Perrin utilized both published/private compensation survey data and peer group proxy statement data as follows:

- **Published/Private Survey Data**
  - — Towers Perrin utilized compensation data available in our 2000 Executive Compensation Database to develop one set of marketplace compensation rates.
  - — The survey data collected for each alternative are representative of pay rates for the following positions (as appropriate for each alternative):
    - Chief Executive Officers or Chief Operating Officers in general industry companies with annual revenues of $56 billion; or
    - Non-CEO Chairmen of the Board in general industry companies with annual revenues of about $5 billion (the highest revenue scope available for this position). These chairmen are executive employees.

- **Proxy Data**

  — Towers Perrin analyzed compensation data available in the 2000 proxy statements for a group of twelve comparable companies, reflecting Enron's input. Eleven of these companies were included in a peer group used to assess Board of Director compensation at Enron in April 2000. The peer group companies, along with each company's net income and revenues (for the four quarters ending June 30, 2000), and total assets and market cap (at June 30, 2000), are presented in Exhibit 4. Enron compares favorably with the selected companies in terms of the financial statistics shown.

  — The data collected for the selected positions are representative of pay rates for the first and second highest paid positions (based on total direct compensation) from each peer company. Exhibit 5 provides detailed compensation data for each company's two highest paid executives. Please note that Exhibit 5 presents 1999 compensation data as reported in 2000 proxy statements.

- All data (proxy and survey) were updated to January 2001 using an annual update factor of 4.5%, except for the raw proxy data provided in Exhibit 5.

Long-Term Incentive Valuation Methodology

The published/private survey expected present value of stock options and other long-term incentive grants has been calculated using the Black-Scholes option pricing model. This model enables Towers Perrin to calculate the estimated price a trader would pay for a stock option or other long-term incentive on a present-value basis.

The expected present value of long-term incentive grants for the comparable companies were calculated in a similar manner, except that Towers Perrin used a three-year average of awards from 1997 to 1999 as provided in 2000 proxy filings for each company. For Enron, Towers Perrin calculated a three year average as well, but utilized data from 1998 to 2000 (2000 data was provided by the Company).

No adjustment was made for risk of forfeiture during the long-term incentive vesting period for Enron or for the peer companies.

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Competitive Findings

Our competitive findings are presented in the following attached exhibit:

- Exhibit 1 presents marketplace pay data for the CEO.
- Exhibit 2 presents marketplace pay for the COO.
- Exhibit 3 presents marketplace pay for the Executive COB.

*   *   *   *   *

Pam, I hope this information meets your needs. Please call with any questions or comments.

Sincerely,

Chuck

CEE:mhm

Attachments

Enron Corp.
Competitive Compensation Analysis
Current Enron Corp. Compensation Compared to Market (Lay – Chief Executive Officer)

Exhibit 1

Proxy Peer Group Data – Highest Paid Executive

Compensation Element	Enron Current ($000)	January 2001 Marketplace Statistics 50th %ile ($000)	75th %ile ($000)	90th %ile ($000)	Enron as Percent of Marketplace 50th %ile (%)	75th %ile (%)	90th %ile (%)
Base Salary	$1,300	$960	$1,329	$2,194	135%	98%	59%
Actual Total Annual Compensation [illegible]	$5,200	$4,738	8.1 $9,406	11.3 $13,494	110%	55%	39%
Long-Term Incentive	$16,680	$16,201	$41,607	$44,149	103%	40%	38%
Actual Total Direct Compensation	$21,880	$27,892	$46,918	$54,891	78%	47%	40%

Published/Private Compensation Survey Data – Chief Executive Officer

Compensation Element	Enron Current ($000)	January 2001 Marketplace Statistics 50th %ile ($000)	75th %ile ($000)	90th %ile ($000)	Enron as Percent of Marketplace 50th %ile (%)	75th %ile (%)	90th %ile (%)
Base Salary	$1,300	$1,417	$1,729	$2,072	92%	75%	63%
Actual Total Annual Compensation	$5,200	$3,567	3.1 $4,803	4.0 $6,298	146%	108%	83%
Long-Term Incentive	$16,680	$12,246	$21,532	$35,602	136%	77%	47%
Actual Total Direct Compensation	$21,880	$15,813	$26,335	$41,900	138%	83%	52%

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Enron Corp.
Competitive Compensation Analysis
Current Enron Corp. Compensation Compared to Market (Skilling – Chief Operating Officer)

Exhibit 2

Proxy Peer Group Data – Second Highest Paid Executive

Compensation Element	Enron Current ($000)	January 2001 Marketplace Statistics			Enron as Percent of Marketplace		
		50th %ile ($000)	75th %ile ($000)	90th %ile ($000)	50th %ile (%)	75th %ile (%)	90th %ile (%)
Base Salary	$850	$614	$745	$1,064	138%	114%	80%
Actual Total Annual Compensation	$3,850	$2,509	$3,609	$6,094	153%	107%	63%
Long-Term Incentive	$12,250	$10,537	$14,612	$19,390	141%	101%	76%
Actual Total Direct Compensation	$16,100	$15,939	$20,291	$21,918	117%	92%	85%

Published/Private Compensation Survey Data – Chief Operating Officer

Compensation Element	Enron Current ($000)	January 2001 Marketplace Statistics			Enron as Percent of Marketplace		
		50th %ile ($000)	75th %ile ($000)	90th %ile ($000)	50th %ile (%)	75th %ile (%)	90th %ile (%)
Base Salary	$850	$1,059	$1,272	$1,505	80%	67%	56%
Actual Total Annual Compensation	$3,850	$2,272	$3,064	$4,024	169%	126%	96%
Long-Term Incentive	$12,250	$7,153	$12,691	$21,129	207%	117%	70%
Actual Total Direct Compensation	$16,100	$9,425	$15,755	$25,153	198%	118%	74%

Enron Corp.
Competitive Compensation Analysis
Current Enron Corp. Compensation Compared to Market (Lay – Chairman of the Board)

Exhibit 3

Proxy Peer Group Data – Second Highest Paid Executive

Compensation Element	Enron Current ($000)	January 2001 Marketplace Statistics			Enron as Percent of Marketplace		
		50th %ile ($000)	75th %ile ($000)	90th %ile ($000)	50th %ile (%)	75th %ile (%)	90th %ile (%)
Base Salary	$1,300	$614	$745	$1,064	212%	175%	122%
Actual Total Annual Compensation	$5,200	$2,509	$3,609	$6,094	207%	144%	85%
Long-Term Incentive	$16,680	$10,537	$14,612	$19,390	158%	114%	86%
Actual Total Direct Compensation	$21,880	$15,939	$20,291	$21,918	137%	108%	100%

Published/Private Compensation Survey Data – Chairman of the Board (non-CEO)

Compensation Element	Enron Current ($000)	January 2001 Marketplace Statistics			Enron as Percent of Marketplace		
		50th %ile ($000)	75th %ile ($000)	90th %ile ($000)	50th %ile (%)	75th %ile (%)	90th %ile (%)
Base Salary	$1,300	$839	$1,178	$1,603	155%	110%	81%
Actual Total Annual Compensation	$5,200	$1,534	$2,374	$3,531	339%	219%	147%
Long-Term Incentive	$16,680	$2,047	$3,817	$6,656	815%	437%	251%
Actual Total Direct Compensation	$21,880	$3,581	$6,190	$10,187	611%	353%	215%

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Enron Corp.
Peer Group Companies Financial Data
Dollars in Millions

Exhibit 4

Company Name	Revenues 4 Qtrs Ending June 2000	Company Name	Net Income 4 Qtrs Ending June 2000	Company Name	Total Assets Ending June 2000	Company Name	Market Cap Ending June 2000
Exxon Mobil	$187,802	Exxon Mobil	$12,482	GE Company	$424,040	Exxon Mobil	$273,259
GE Company	$122,217	GE Company	$11,712	Merrill Lynch	$355,108	IBM Corp	$196,427
IBM Corp	$86,325	IBM Corp	$7,311	American Express	$148,553	GE Company	$174,590
Merrill Lynch	$39,607	WorldCom	$4,928	Exxon Mobil	$146,618	Sun Microsystems	$144,265
WorldCom	$39,104	Merrill Lynch	$3,275	WorldCom	$97,373	WorldCom	$131,154
American Express	$23,984	American Express	$2,650	IBM Corp	$82,949	Merrill Lynch	$44,228
Dynegy Inc	$20,293	Sun Microsystems	$1,854	Qwest comm.	$69,848	Qwest Comm.	$43,527
Sun Microsystems	$15,721	Williams Cos	$602	AES Corp.	$29,000	Level III Comm.	$32,146
Qwest Comm.	$13,614	Qwest Comm.	$585	Williams Cos	$28,397	American Express	$23,180
Williams Cos	$9,943	AES Corp.	$455	Dynegy Inc	$15,724	Williams Cos	$18,414
AES Corp.	$4,989	Dynegy Inc	$255	Level III Comm.	$14,691	Dynegy Inc	$9,567
Level III Comm.	$718	Level III Comm.	($890)	Sun Microsystems	$14,152	AES Corp.	$9,435
75th Percentile	$51,287	**75th Percentile**	$5,524	**75th Percentile**	$147,102	**75th Percentile**	$151,846
50th Percentile	$22,139	**50th Percentile**	$2,252	**50th Percentile**	$76,399	**50th Percentile**	$43,878
25th Percentile	$12,696	**25th Percentile**	$553	**25th Percentile**	$25,229	**25th Percentile**	$21,988
Enron Corp.	$52,839	Enron Corp.	$1,176	Enron Corp.	$45,566	Enron Corp.	$47,217

Enron Corp.
Proxy Statement Compensation Analysis

Exhibit 5

Position: Highest Paid Executive

Company	Incumbent	Title	1999 Base Salary ($000)	1999 Total Cash ($000)	1999 LTI Value[1] ($000)	1999 Total Direct ($000)
Qwest Comm.	Nacchio	Chairman & CEO	$680	$1,543	$81,245	$82,788
GE Company	Welch	Chairman & CEO	$3,325	$13,325	$39,310	$52,635
IBM Corp	Gerstner, Jr.	Chairman & CEO	$2,000	$9,200	$42,350	$51,550
Level III Comm.	Crowe	President & CEO	$350	$1,350	$41,330	$42,680
WorldCom	Ebbers	President & CEO	$935	$8,435	$31,171	$39,606
Exxon Mobil	Raymond	COB & CEO	$2,110	$16,010	$17,213	$33,223
Merrill Lynch	Komansky	Chairman & CEO	$700	$8,934	$11,225	$20,159
American Express	Golub	Chairman &CEO	$1,000	$3,400	$13,794	$17,194
Dynegy Inc	Watson	COB & CEO	$1,030	$5,330	$7,193	$12,522
Sun Microsystems	McNealy	Chairman & CEO	$116	$3,739	$7,888	$11,627
AES Corp.	Bakke	CEO & President	$0	$0	$3,691	$3,691
Williams Cos	Bailey	Chairman, President & CEO	$903	$903	$2,021	$2,923
Peer Group 90th Percentile			**$2,099**	**$12,913**	**$42,248**	**$52,527**
Peer Group 75th Percentile			**$1,272**	**$9,001**	**$39,815**	**$44,897**
Peer Group 50th Percentile			**$919**	**$4,534**	**$15,503**	**$26,691**

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EC 000102305

Enron Corp.
Proxy Statement Compensation Analysis

Exhibit 5
(Page 2 of 2)

Position: Second Highest Paid Executive

Company	Incumbent	Title	1999 Base Salary ($000)	1999 Total Cash ($000)	1999 LTI Value[1] ($000)	1999 Total Direct ($000)
Qwest Comm.	Mohebbi	President & COO	$459	$770	$22,598	$23,368
WorldCom	Sidgmore	Vice COB	$600	$3,360	$17,733	$21,093
Exxon Mobil	Noto	Vice Chair	$1,048	$9,647	$10,253	$19,900
Level III Comm.	Bradbury	EVP & CFO	$260	$610	$18,646	$19,256
GE Company	Opie	Vice Chair & Executive Officer	$1,233	$3,733	$12,733	$16,466
Merrill Lynch	O'Neal	EVP & President, US Priv Client G	$300	$6,065	$9,913	$15,978
American Express	Chenault	President & COO	$700	$2,500	$12,027	$14,527
Sun Microsystems	Zander	President & COO	$750	$2,380	$9,002	$11,382
IBM Corp	Palmisano	President & COO	$575	$1,350	$7,728	$9,078
Dynegy Inc	Bergstrom	President & COO	$652	$2,422	$5,247	$7,669
Williams Cos	Janzen	Pres & CEO, Williams Comm Grp	$452	$678	$2,045	$2,723
AES Corp.	Sharp	SVP & CFO	$240	$590	$616	$1,206
Peer Group 90th Percentile			**$1,019**	**$5,832**	**$18,555**	**$20,974**
Peer Group 75th Percentile			**$713**	**$3,453**	**$13,983**	**$19,417**
Peer Group 50th Percentile			**$588**	**$2,401**	**$10,083**	**$15,252**

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EC 000102306

Charles E. Essick
Principal

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Towers Perrin

PRIVATE & CONFIDENTIAL

January 18, 2001

Dr. Charles A. LeMaistre
Chairman, Enron Compensation Committee
Enron Corp.
7 Bristol Green
San Antonio, TX 78209

Dear Dr. LeMaistre:

As requested, Towers Perrin has prepared this letter providing alternative compensation arrangements for Ken Lay, given his shift in responsibilities to Executive Chairman of the Board, with Jeff Skilling becoming CEO of Enron. In addition, I have also attached a suggested process for "stress-testing" Enron's executive compensation program under various stock price performance scenarios.

Attachment A provides three alternative compensation arrangements for Ken Lay. (Note: This Attachment also shows market compensation data for Jeff Skilling in his new CEO role as a reference point. Market compensation data for the CEO, COO, and Executive Chairman of the Board positions are presented as an Appendix to this letter.)

In reviewing the alternative arrangements for Mr. Lay, please be aware that Alternatives 1 and 2 assume the Compensation Committee wants to treat 2001 as a transition year for Enron, where the Chairman will be more actively involved in the Company's day-to-day business than he will likely be in the future. Alternative 3 assumes the Committee wants to provide competitive Executive Chairman of the Board compensation to Mr. Lay. (Note: An Executive Chairman of the Board is a non-CEO who is employed by the Company, but is less active in day-to-day affairs than a CEO.) Given our previous conversation, it would appear this alternative might be more applicable for 2002 and beyond, if Mr. Lay continues as Executive Chairman after 2001.

Towers Perrin

Finally, Attachment B provides a brief description of a proposed process to "stress-test" Enron's executive compensation program. Towers Perrin understands the objectives of this study are to examine the relationship between pay and performance given possible volatility in Enron's results, to ensure the Company has the ability to attract and retain talented people in good and bad times, and to help the Compensation Committee in understanding how changes in equity market conditions may affect executive compensation at Enron.

★ ★ ★ ★ ★

I hope this material is helpful. Please call me with any questions.

Sincerely,

Chuck

CEE:mhm

cc: John Duncan
Mary Joyce

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EC 000102235

③ Essig market #'s for LTI have been escalating dramatically over the last few years. Flat market in 2000 will most likely lead to a decline in LTI data which will be available mid-year.

Attachment A

Alternative Compensation Arrangements for Executive Chairman and Market Targeted Compensation for CEO

Data from companies Companies w/ revenues of $50 B plus ∓5B. Very conservative methodology

Pay Element	Alternative COB Compensation Arrangements (All data in $000)			CEO Compensation	
	2001 Transition Year		Not Transitional		
	Alternative 1 – No Change to Current Pay	Alternative 2 – Reduce Base Salary, Target Bonus 25%	Alternative 3 – Take Total Pay to Market for Executive COB[1]	Current for Skilling as COO ($000)	CEO Market Data[1] ($000)
Base Salary	$1,300	$975	$839	$850	$1,417
Annual Bonus	$3,900[2]	$2,925	$1,535	$3,000[2]	$3,386
Long-Term Incentive	$16,680	$16,680	$3,817	$12,250	$21,532
Total Direct Compensation	$21,880	$20,580	$6,191	$16,100	$26,335

[1] Based on Enron's philosophy of 50th percentile base salary, 75th percentile total annual compensation, and 75th percentile long-term incentives.

[2] Based on bonus paid in 2000 for 1999 results. Actual bonus may be higher or lower based on market bonus levels and actual performance each year.

① Typically have a transition year when a CEO has been very successful future years dependent upon Chairman's level of involvement

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EC 000102236

② Jaedicke asked why Alter. 1 ($16.6) LTI & LTI for CEO ($21) so different Essig
Alt. #1 is 2000 data vs CEO data is 2001

Attachment B

Proposed Process to "Stress-Test" Executive Compensation Program

Looking at relationship between pay & performance

1. Interview COB, CEO, CFO, and members of the Compensation Committee regarding Company's business direction, strategy, and possible changes in market conditions.
2. Briefly summarize current executive pay elements, how these elements relate to market and Enron's culture, and the business reason for each element (e.g., base, bonus, long-term).
3. Examine how each element of pay for three sample positions would be effected by changes in Company performance (financial and stock price). Change to 5 per Committee
4. Describe likely consequences of financial and stock price performance changes on Enron's ability to attract and retain talent, while still focusing on pay for performance.
5. Identify major impediments that may effect Enron's ability to respond to changing market conditions.
6. Meet with the Compensation and Executive Committee Chairs to review the study findings.
7. Meet with COB and CEO to review findings.
8. Meet with the Compensation Committee to review findings.

Foster: Also look at other companies where negative events have [illegible] happened to exec [illegible]

> Note: It is anticipated that Towers Perrin and Mary Joyce will work as a team to complete this assignment. We estimate it will take 6 to 8 weeks to prepare a draft report summarizing our findings.

Joyce: We'll also look at performance against the S&P and peer group

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EC 000102238

VI. COMPENSATION OF THE TOP-200 MOST HIGHLY COMPENSATED EMPLOYEES (1998, 1999, and 2000 and 2001)

ID Number	Employee Title	BONUS	DEFERRED PAYOUT	OTHER COMPENSATION	STOCK OPTIONS	RESTRICTED STOCK	TOTAL COMPENSATION	Comments
90012869	VICE CHAIRMAN.006057	$ 2,458,450.00	$ -	$ 3,475,981.20	$ 464,332.13	$ 14,222,178.14	$ 20,620,941.47	
90012923	CHMN & CEO.003971	$ 475,000.00	$ 202,910.76	$ 1,448,337.73	$ 13,094,776.16	$ 395,890.94	$ 15,616,915.59	Deferred payout represents in-service payout which was elected at time of deferral in accordance with plan provisions.
90012759	PRES & COO.003972	$ 450,000.00	$ -	$ 879,868.88	$ 6,384,798.48	$ 4,555,598.93	$ 12,270,266.29	
90013060	PRES COO & CEO.006155	$ 5,102,093.34	$ -	$ 546,100.00	$ -	$ 3,389,424.57	$ 9,037,617.91	
90036456	PRES & COO.003972	$ -	$ 551,747.04	$ 121,245.00	$ 7,860,880.00	$ -	$ 8,533,872.04	
90012712	PRESIDENT.004825	$ 1,000,000.00	$ -	$ 1,177,653.59	$ 1,255,661.61	$ 1,535,545.51	$ 4,968,860.70	
90040974	MNG DIR.005250	$ -	$ -	$ 4,102,842.37	$ -	$ -	$ 4,102,842.37	
90012828	MNG DIR.005250	$ 3,386,374.00	$ -	$ 289,568.68	$ -	$ -	$ 3,675,942.68	
90013019	MNG DIR.005250	$ 700,000.00	$ -	$ 2,065,624.49	$ 791,505.12	$ 16,626.00	$ 3,573,755.61	
90014977	PRES NPNG.002900	$ 200,000.00	$ -	$ 268,456.00	$ 2,901,087.75	$ -	$ 3,369,543.75	
90007829	CHMN & CEO GPG.003754	$ 250,000.00	$ -	$ 516,336.16	$ 2,048,952.88	$ 133,135.30	$ 2,948,424.33	
90013079	CHMN & CEO.005873	$ 850,000.00	$ -	$ 399,634.36	$ 341,085.61	$ 1,159,222.48	$ 2,749,942.45	
90011546	VP COMM SUPT.005066	$ 20,000.00	$ -	$ 158,808.00	$ 2,369,209.60	$ -	$ 2,548,017.60	
90011801	PRESIDENT.005267	$ 390,000.00	$ -	$ 258,901.14	$ 1,628,992.13	$ 196,564.88	$ 2,474,458.14	
90012713	MNG DIR.005250	$ 800,000.00	$ -	$ 1,270,012.52	$ 229,605.34	$ 27,327.57	$ 2,326,945.43	
90013080	PRES & COO.006059	$ 850,000.00	$ -	$ 499,666.22	$ 279,946.45	$ 686,437.73	$ 2,316,050.40	
90127303	VICE CHRMN & COS EOG.006076	$ 250,000.00	$ -	$ 374,354.48	$ 1,530,889.16	$ 157,685.38	$ 2,312,929.02	
90005649	SVP CAP MGMT.005849	$ 250,000.00	$ -	$ 333,448.14	$ 1,002,104.67	$ 606,002.53	$ 2,191,555.34	
90013044	VICE CHAIRMAN.006057	$ 525,000.00	$ -	$ 422,108.24	$ 331,535.20	$ 872,939.29	$ 2,151,582.73	
90012851	MNG DIR.005250	$ 600,000.00	$ -	$ 1,038,876.29	$ 423,030.17	$ -	$ 2,061,906.46	
90012864	MNG DIR.005250	$ 836,936.00	$ -	$ 954,948.48	$ -	$ 136,065.00	$ 1,927,949.48	
90012905	SVP CORP DEV.005847	$ 250,000.00	$ -	$ 376,196.88	$ 1,192,915.46	$ 50,872.62	$ 1,869,984.96	
90012861	EXEC DIR & PRES.006434	$ 525,000.00	$ -	$ 879,195.27	$ 343,318.08	$ 84,829.27	$ 1,832,342.62	
90013027	MNG DIR.005250	$ 500,000.00	$ -	$ 1,148,850.91	$ 154,495.29	$ -	$ 1,803,346.20	
90010526	MNG DIR.005250	$ 600,000.00	$ -	$ 864,446.74	$ 321,391.81	$ -	$ 1,785,838.55	
90041044	MNG DIR.005250	$ 400,000.00	$ -	$ 562,139.70	$ 269,999.93	$ 457,462.08	$ 1,689,601.72	
90013069	MNG DIR.005250	$ 510,742.00	$ -	$ 336,223.64	$ 492,931.25	$ 300,382.63	$ 1,640,279.52	
90010023	VP COMM.004170	$ 404,060.00	$ -	$ 1,155,792.57	$ 76,775.63	$ -	$ 1,636,628.20	
90040466	CHAIRMAN EOG.006646	$ -	$ -	$ 591,666.50	$ 925,339.46	$ 65,422.66	$ 1,582,428.62	
90012852	VICE CHAIRMAN EES.006217	$ 250,000.00	$ -	$ 526,604.45	$ 644,865.00	$ 155,490.95	$ 1,576,960.40	
90010080	VP COMM.004170	$ 521,630.00	$ -	$ 786,689.61	$ 146,883.27	$ 56,566.70	$ 1,511,769.58	
90012793	CHMN & CEO EES.005850	$ 300,000.00	$ -	$ 1,175,413.81	$ -	$ -	$ 1,475,413.81	
90036324	VICE CHRMN.005772	$ 100,000.00	$ 128,766.77	$ 106,920.74	$ 1,047,378.31	$ -	$ 1,383,065.82	
90012741	MNG DIR.005250	$ 500,000.00	$ -	$ 374,544.28	$ 473,859.48	$ 16,957.54	$ 1,365,361.30	
90012772	MNG DIR.005250	$ 536,092.00	$ -	$ 641,194.70	$ -	$ 139,747.02	$ 1,317,033.72	
90013111	PRES CLEAN FUELS.004853	$ 150,000.00	$ -	$ 243,460.00	$ 895,046.46	$ -	$ 1,288,506.46	
90009324	MNG DIR.005250	$ 350,000.00	$ -	$ 675,850.21	$ 232,747.08	$ 16,957.54	$ 1,275,554.83	
90012914	MNG DIR & GEN CNSL.005786	$ 591,092.00	$ -	$ 272,020.80	$ 262,599.93	$ 139,747.02	$ 1,265,459.75	
90036466	VP COMM.004954	$ 130,000.00	$ -	$ 242,275.00	$ 858,721.00	$ -	$ 1,230,996.00	
90041413	EXECUTIVE DIRECTOR.006333	$ 250,000.00	$ -	$ 437,349.08	$ 438,065.28	$ 82,197.70	$ 1,207,612.06	
90012803	VP TAX CNSL.002958	$ 220,000.00	$ -	$ 227,150.24	$ 697,592.50	$ 17,162.78	$ 1,161,905.52	
90012756	OFFICER.003978	$ 250,000.00	$ -	$ 272,937.80	$ 521,066.69	$ 16,626.00	$ 1,060,630.49	
90014531	PRES NNG.002915	$ 300,000.00	$ -	$ 288,800.00	$ 464,337.70	$ -	$ 1,053,137.70	
90014608	VP DEVELOPMENT.003040	$ 190,000.00	$ -	$ 246,335.94	$ 608,919.49	$ -	$ 1,045,255.43	
90012797	SVP INVESTOR RELATIONS.003861	$ 220,000.00	$ -	$ 235,957.20	$ 587,257.36	$ -	$ 1,043,214.56	
90040598	MNG DIR.005250	$ 250,000.00	$ -	$ 205,877.00	$ 331,490.50	$ 227,472.11	$ 1,014,839.61	
90013115	MNG DIR & ASST GEN CNSL.006516	$ 180,000.00	$ -	$ 185,928.64	$ 522,375.91	$ 108,850.11	$ 997,154.66	
90010014	VP COMM.004170	$ -	$ -	$ 996,374.58	$ -	$ -	$ 996,374.58	
90012894	MNG DIR.005250	$ 250,000.00	$ -	$ 462,746.10	$ 230,166.50	$ -	$ 942,912.60	
90036473	VP COMM.004954	$ 130,000.00	$ -	$ 726,808.88	$ 79,259.57	$ -	$ 936,068.45	
90008868	VP INFO SYSTEMS.002885	$ 160,000.00	$ -	$ 189,932.32	$ 574,795.00	$ -	$ 924,727.32	
90041412	VP COMM SUPT.005066	$ 50,000.00	$ -	$ 379,794.15	$ 486,778.25	$ -	$ 916,572.40	
90012889	VP COMM.004170	$ 186,629.86	$ -	$ 692,934.20	$ 23,795.63	$ -	$ 903,359.69	
90010306	VP CFO & TREASURER PGE.006334	$ 130,000.00	$ -	$ 700,621.68	$ 66,082.89	$ -	$ 896,704.57	
90009800	DIR COMM.004171	$ 350,000.00	$ -	$ 546,014.30	$ -	$ -	$ 896,014.30	
90013087	VP COMM.004170	$ 175,000.00	$ -	$ 703,250.48	$ -	$ 16,957.54	$ 895,208.02	
90012942	EVP.006225	$ 220,000.00	$ -	$ 274,908.51	$ 247,310.87	$ 146,831.71	$ 889,051.09	
90009922	VP COMM.004954	$ 448,697.00	$ -	$ 306,127.98	$ 67,706.52	$ 57,093.75	$ 879,625.25	
90012751	VP COMM.004954	$ 225,000.00	$ -	$ 456,703.90	$ -	$ 184,057.50	$ 865,761.40	
90012796	VP INVESTOR RELATIONS.005985	$ 115,000.00	$ -	$ 188,990.52	$ 533,706.25	$ -	$ 837,696.77	

ID Number	Employee Title	BONUS	DEFERRED PAYOUT	OTHER COMPENSATION	STOCK OPTIONS	RESTRICTED STOCK	TOTAL COMPENSATION	Comments
90009937	VP COMM.004170	$ 250,000.00	$ -	$ 559,376.43	$ -	$ 16,906.54	$ 826,282.97	
90010026	DIR COMM.004171	$ 300,000.00	$ -	$ 525,507.88	$ -	$ -	$ 825,507.88	
90010028	DIR COMM.004171	$ 125,000.00	$ -	$ 674,404.63	$ -	$ -	$ 799,404.63	
90014824	PRES & CEO.004238	$ 400,000.00	$ -	$ 271,785.36	$ -	$ 126,621.91	$ 798,407.27	
90010025	VP COMM.004170	$ 200,000.00	$ -	$ 525,384.22	$ 40,500.00	$ 16,957.54	$ 782,841.76	
90012731	MNG DIR.005250	$ 275,000.00	$ -	$ 355,786.92	$ 151,902.47	$ -	$ 782,689.39	
90010111	VP COMM.004954	$ 208,500.00	$ -	$ 367,909.11	$ 121,260.00	$ 83,490.18	$ 781,159.29	
90010024	DIR COMM.004171	$ 100,000.00	$ -	$ 648,511.84	$ 30,977.88	$ -	$ 779,489.72	
90012915	SVP & GEN COUNSEL.001040	$ 250,000.00	$ -	$ 444,085.44	$ -	$ 81,310.00	$ 775,395.44	
90010113	PRESIDENT.005267	$ 185,008.00	$ -	$ 410,706.83	$ 39,073.35	$ 122,070.01	$ 756,858.19	
90036462	MNG DIR.005250	$ 68,000.00	$ -	$ 175,299.41	$ 498,081.22	$ -	$ 741,380.63	
90012895	VP COMM.004170	$ 200,000.00	$ -	$ 400,948.30	$ 8,108.48	$ 123,125.47	$ 732,182.25	
90010160	VP COMM.004954	$ 275,000.00	$ -	$ 255,477.52	$ 196,590.91	$ -	$ 727,068.43	
90008795	VP FED GOVT AFFAIRS.001276	$ 160,000.00	$ -	$ 227,733.12	$ 331,837.50	$ -	$ 719,570.62	
90010127	VP COMM.004170	$ 300,000.00	$ -	$ 271,969.44	$ 134,071.45	$ -	$ 706,040.89	
90013517	VP COMM.004170	$ 212,077.00	$ -	$ 397,619.22	$ 32,500.00	$ 58,083.50	$ 700,279.72	
90012901	VP COMM.004954	$ 144,000.00	$ -	$ 463,804.03	$ 91,487.50	$ -	$ 699,291.53	
90010305	VP COMM.004170	$ 60,000.00	$ -	$ 250,904.12	$ 134,178.13	$ 247,380.60	$ 692,462.84	
90013064	MNG DIR.005250	$ -	$ -	$ 457,658.07	$ 232,544.00	$ -	$ 690,202.07	
90012951	MNG DIR.005250	$ 400,000.00	$ -	$ 229,578.28	$ 60,446.02	$ -	$ 690,024.30	
90010016	DIR COMM.004171	$ 150,000.00	$ -	$ 502,744.64	$ 32,312.60	$ -	$ 685,057.24	
90039759	GPMG.003976	$ 175,000.00	$ 9,185.05	$ 158,251.74	$ 342,474.80	$ -	$ 684,911.59	
90012831	VP COMM.004170	$ 150,000.00	$ -	$ 247,142.00	$ 67,060.17	$ 219,118.03	$ 683,320.20	
90009877	PRES CITRUS.002914	$ 225,000.00	$ -	$ 230,308.00	$ 224,744.86	$ -	$ 680,052.86	
90016147	VP MNG DIR.006069	$ 90,000.00	$ -	$ 588,436.70	$ -	$ -	$ 678,436.70	
90009940	VP COMM.004954	$ 225,000.00	$ -	$ 195,164.13	$ 31,762.50	$ 222,378.07	$ 674,304.70	
90009720	VP COMM SUPT.005066	$ 110,000.00	$ -	$ 516,684.36	$ 43,211.25	$ -	$ 669,895.61	
90009993	MNG DIR.005250	$ 300,000.00	$ -	$ 231,260.80	$ -	$ 135,236.88	$ 666,497.68	
90010182	VP COMM.004170	$ 300,000.00	$ -	$ 276,385.52	$ 89,962.24	$ -	$ 666,347.76	
90012875	RESOURCES.006431	$ 160,000.00	$ -	$ 193,219.06	$ 311,468.35	$ -	$ 664,687.41	
90009635	VP & ASST SECRETARY.001041	$ 200,000.00	$ -	$ 246,876.48	$ 215,862.50	$ -	$ 662,738.98	
90010334	VP COMM.004170	$ 325,000.00	$ -	$ 275,378.00	$ 61,833.17	$ -	$ 662,211.17	
90010527	VP COMM.004954	$ 500,000.00	$ -	$ 154,270.22	$ -	$ -	$ 654,270.22	
90013114	MNG DIR.005250	$ 163,697.00	$ -	$ 354,815.08	$ -	$ 134,502.38	$ 653,014.46	
90012787	DIRECTOR SR.005461	$ 75,815.00	$ -	$ 553,517.93	$ 23,443.75	$ -	$ 652,776.68	
90010064	MNG DIR.005250	$ 350,000.00	$ -	$ 196,135.01	$ 86,687.60	$ 16,957.54	$ 649,780.15	
90012698	VP COMM.004170	$ 150,000.00	$ -	$ 431,937.40	$ 57,481.88	$ -	$ 639,419.28	
90012913	VP & ASSOC GEN COUNSEL.006075	$ 155,000.00	$ -	$ 204,163.68	$ 275,603.98	$ -	$ 634,767.66	
2987	PRES & CEO EOG.006647	$ 220,000.00	$ -	$ 413,536.00	$ -	$ -	$ 633,536.00	
90009948	MNG DIR.005250	$ 150,000.00	$ -	$ 302,453.48	$ -	$ 177,891.00	$ 630,344.48	
90012877	PUBLIC REL.006430	$ 180,000.00	$ -	$ 195,743.36	$ 253,284.70	$ -	$ 629,028.06	
90013084	DIR MANAGING-INDIA.005761	$ 112,000.00	$ -	$ 515,083.43	$ -	$ -	$ 627,083.43	
90012985	SVP GOVT AFFAIRS.005846	$ 350,000.00	$ -	$ 269,526.32	$ -	$ -	$ 619,526.32	
90013030	MNG DIR.005250	$ 275,000.00	$ -	$ 308,635.00	$ 34,795.00	$ -	$ 618,430.00	
90106466	EXECUTIVE DIRECTOR.006333	$ -	$ -	$ 616,613.67	$ -	$ -	$ 616,613.67	
90012978	VP COMM.004170	$ 220,000.00	$ -	$ 145,863.49	$ 57,095.60	$ 190,813.90	$ 613,772.99	
90009925	MNG DIR.005250	$ 313,697.00	$ -	$ 183,568.52	$ -	$ 100,432.50	$ 597,698.02	
90040993	VP COMM.004170	$ 300,000.00	$ -	$ 160,127.44	$ 133,573.75	$ -	$ 593,701.19	
90105162	VP COMM.004170	$ 100,000.00	$ -	$ 482,321.73	$ -	$ -	$ 582,321.73	
90010273	VP COMM.004170	$ 100,000.00	$ -	$ 282,031.80	$ 179,812.00	$ 16,957.54	$ 578,801.34	
90012890	VP COMM SUPT.005066	$ 126,630.00	$ -	$ 431,098.57	$ 18,810.00	$ -	$ 576,538.57	
90013128	SVP COS.006282	$ 313,697.00	$ -	$ 213,182.20	$ -	$ 46,596.48	$ 573,475.68	
90010530	VP COMMERCIAL.005445	$ 40,000.00	$ -	$ 209,986.28	$ 314,088.58	$ -	$ 564,074.86	
90013075	VP.005742	$ 55,000.00	$ -	$ 300,295.29	$ 207,692.92	$ -	$ 562,988.21	
90012935	VP PROJ DEV E&C.003294	$ 135,000.00	$ -	$ 190,462.40	$ 236,416.88	$ -	$ 561,879.28	
90013109	SVP & CAO.006115	$ 175,000.00	$ -	$ 205,140.66	$ 100,681.30	$ 80,100.16	$ 560,922.12	
90009950	VP.005367	$ 375,000.00	$ -	$ 140,135.32	$ 40,765.98	$ -	$ 555,901.30	
90136448	MNG DIR.005250	$ -	$ 492,319.22	$ 1,100.78	$ 58,860.00	$ -	$ 552,280.00	
90010239	VP COMM.004170	$ 150,000.00	$ -	$ 181,304.16	$ 190,596.00	$ 28,262.57	$ 550,162.73	
90012910	VP COMM SUPT.005066	$ 153,000.00	$ -	$ 380,057.82	$ -	$ 16,957.54	$ 550,015.36	
90012699	DIR COMM.004171	$ 120,000.00	$ -	$ 397,343.19	$ 30,576.75	$ -	$ 547,919.94	
90009916	VP COMM.004954	$ 159,697.00	$ -	$ 237,178.90	$ -	$ 135,547.27	$ 532,423.17	
90041040	VP COMM.004170	$ 250,000.00	$ -	$ 281,846.13	$ -	$ -	$ 531,846.13	
90012755	VP COMM.004170	$ 125,000.00	$ -	$ 386,546.63	$ -	$ 16,957.54	$ 528,504.17	

ID Number	Employee Title	BONUS	DEFERRED PAYOUT	OTHER COMPENSATION	STOCK OPTIONS	RESTRICTED STOCK	TOTAL COMPENSATION	Comments
90012738	VP BUSINESS SERVICES.006295	$ 105,000.00	$ -	$ 170,374.81	$ 251,922.97	$ -	$ 527,297.78	
90005648	MNG DIR.005250	$ 165,000.00	$ -	$ 183,315.88	$ 94,637.89	$ 84,191.25	$ 527,145.02	
90012965	DIR COMM.004171	$ 91,600.00	$ -	$ 435,474.53	$ -	$ -	$ 527,074.53	
21664	VP GM.000658	$ 80,000.00	$ -	$ 446,549.35	$ -	$ -	$ 526,549.35	
90010233	DIR COMM.004171	$ 100,000.00	$ -	$ 226,434.71	$ 191,750.09	$ -	$ 518,184.80	
90040573	VP COMM.004170	$ 130,000.00	$ -	$ 68,392.14	$ 295,133.06	$ 16,957.54	$ 510,482.74	
90010119	VP COMM.004954	$ 100,000.00	$ -	$ 159,544.38	$ 205,520.81	$ 44,578.13	$ 509,643.31	
90106553	VP ADMIN.004841	$ 175,000.00	$ -	$ 184,873.37	$ 138,330.56	$ 10,373.71	$ 508,577.63	
90014592	VP.005367	$ 100,000.00	$ -	$ 357,191.54	$ -	$ 50,956.90	$ 508,148.44	
90041405	VP RESERVOIR ENGRG.005325	$ 100,000.00	$ -	$ 178,916.16	$ 225,326.05	$ -	$ 504,242.21	
90012845	VP COMM.004170	$ 125,815.00	$ -	$ 376,981.41	$ -	$ -	$ 502,796.41	
90010290	VP COMM.004170	$ 90,000.00	$ -	$ 409,767.12	$ -	$ -	$ 499,767.12	
90036161	SPECIAL RETIREE.003333	$ -	$ -	$ 498,215.64	$ -	$ -	$ 498,215.64	
90012733	VP & CONTROLLER.005486	$ 175,000.00	$ -	$ 185,272.72	$ 130,489.50	$ 7,060.64	$ 497,822.86	
90040468	VP & GM TRINIDAD.005031	$ 50,000.00	$ -	$ 445,584.80	$ -	$ -	$ 495,584.80	
90009782	DIR COMM.004171	$ 75,000.00	$ -	$ 376,382.72	$ 37,005.88	$ -	$ 488,388.60	
90012898	VP COMM.004170	$ 150,000.00	$ -	$ 336,459.37	$ -	$ -	$ 486,459.37	
90013007	VP COMM.004170	$ 160,000.00	$ -	$ 326,002.75	$ -	$ -	$ 486,002.75	
90014630	VP.005367	$ 35,000.00	$ -	$ 328,296.14	$ 120,695.00	$ -	$ 483,991.14	
90010520	VP COMM.004170	$ 150,000.00	$ -	$ 250,886.04	$ 80,725.86	$ -	$ 481,611.90	
90012767	VP CORP AFFAIRS.005484	$ 100,000.00	$ -	$ 227,964.13	$ 152,673.60	$ -	$ 480,637.73	
90010011	VP COMM.004954	$ 180,000.00	$ -	$ 213,283.30	$ 19,471.04	$ 67,868.12	$ 480,622.46	
90005448	GPMG.003976	$ 120,000.00	$ -	$ 207,250.70	$ 152,910.33	$ -	$ 480,161.03	
90010410	VP.005367	$ 80,000.00	$ -	$ 141,653.96	$ 255,075.50	$ -	$ 476,729.46	
90010523	VP COMM.004170	$ 125,000.00	$ -	$ 349,279.88	$ -	$ -	$ 474,279.88	
90035966	DIVERSITY.005542	$ 90,000.00	$ -	$ 165,284.76	$ 216,125.20	$ -	$ 471,409.96	
90010529	VP FINANCE & TREASURER.003260	$ 160,000.00	$ -	$ 207,300.70	$ 71,529.50	$ 29,110.88	$ 467,941.08	
90013065	DIR COMM.004171	$ 125,000.00	$ -	$ 331,798.04	$ 8,172.50	$ -	$ 464,970.54	
90040963	DIR COMM.004171	$ 100,000.00	$ -	$ 363,430.92	$ -	$ -	$ 463,430.92	
90126028	CHRMN & CEO EOGI.005974	$ 160,000.00	$ -	$ 302,864.56	$ -	$ -	$ 462,864.56	
90006189	VP TAX CNSL.005344	$ 200,000.00	$ -	$ 234,841.12	$ 24,063.00	$ -	$ 458,904.12	
90008693	ADM.005726	$ 220,000.00	$ -	$ 238,400.00	$ -	$ -	$ 458,400.00	
90040973	DIR COMM.004171	$ 120,000.00	$ -	$ 335,647.35	$ -	$ -	$ 455,647.35	
90009936	DIR COMM.004171	$ -	$ -	$ 455,184.59	$ -	$ -	$ 455,184.59	
90013041	DIR COMM.004171	$ 135,000.00	$ -	$ 314,235.34	$ 5,640.65	$ -	$ 454,875.99	
90011488	DIR FINANCE.006160	$ 22,500.00	$ -	$ 431,422.90	$ -	$ -	$ 453,922.90	
90040995	DIR COMM.004171	$ 190,000.00	$ -	$ 262,832.60	$ -	$ -	$ 452,832.60	
90010449	VP COMM.004170	$ 100,000.00	$ -	$ 352,406.24	$ -	$ -	$ 452,406.24	
90041955	VP COMM.004170	$ 225,000.00	$ -	$ 226,828.44	$ -	$ -	$ 451,828.44	
90010120	MNG DIR.005250	$ -	$ -	$ 448,942.88	$ -	$ -	$ 448,942.88	
90013020	VP COMM.004170	$ 150,000.00	$ -	$ 242,800.92	$ 54,601.75	$ -	$ 447,402.67	
90006103	VP TAX EES.006309	$ 60,000.00	$ -	$ 157,718.24	$ 226,854.38	$ -	$ 444,572.62	
4015	DIR PROJECT.004420	$ 18,625.00	$ -	$ 425,749.43	$ -	$ -	$ 444,374.43	
90012711	VP COMM.004170	$ 37,814.00	$ -	$ 405,661.29	$ -	$ -	$ 443,475.29	
90010482	VP COMM.004170	$ 100,000.00	$ -	$ 150,702.16	$ 192,758.18	$ -	$ 443,460.34	
90039790	VP BUS DEV.003784	$ 60,000.00	$ -	$ 113,402.60	$ 250,991.48	$ 18,998.36	$ 443,392.44	
90010274	VP COMM.004954	$ 250,000.00	$ -	$ 189,820.08	$ -	$ -	$ 439,820.08	
90012778	BOLIVIA.006113	$ 60,000.00	$ -	$ 350,439.17	$ 27,343.75	$ -	$ 437,782.92	
90012842	VP COMM.004170	$ 250,000.00	$ -	$ 158,642.56	$ 27,268.80	$ -	$ 435,911.36	
90036256	SPECIAL RETIREE.003333	$ -	$ 144,999.18	$ 286,762.36	$ -	$ -	$ 431,761.54	
90010139	DIR COMM.004171	$ -	$ -	$ 431,172.37	$ -	$ -	$ 431,172.37	
90012893	VP COMM SUPT.005066	$ 100,000.00	$ -	$ 311,136.08	$ 18,962.50	$ -	$ 430,098.58	
90010084	VP COMM.004170	$ 200,000.00	$ -	$ 229,722.80	$ -	$ -	$ 429,722.80	
90014564	VP OPNS RISK MGMT.005549	$ 40,000.00	$ -	$ 154,105.20	$ 234,169.97	$ -	$ 428,275.17	
90014597	VP.005367	$ 110,000.00	$ -	$ 302,527.93	$ -	$ 12,839.09	$ 425,367.02	
90012907	VP COMM.004170	$ 200,000.00	$ -	$ 224,837.33	$ -	$ -	$ 424,837.33	
90013013	VP OPNS.004609	$ 85,500.00	$ -	$ 172,076.32	$ 161,799.74	$ -	$ 419,376.06	
90041638	PRES & CEO ENRON SOLAR.005683	$ 115,000.00	$ -	$ 301,838.34	$ -	$ -	$ 416,838.34	
3995	VP & GM TRINIDAD.005031	$ 38,000.00	$ -	$ 376,069.50	$ -	$ -	$ 414,069.50	
90010257	VP COMM.004170	$ 50,000.00	$ -	$ 243,258.82	$ 118,118.70	$ -	$ 411,377.52	
90013061	VP COMM.004954	$ 135,000.00	$ -	$ 194,734.30	$ 80,318.50	$ -	$ 410,052.80	
90009796	VP COMM.004954	$ 100,000.00	$ -	$ 308,499.15	$ -	$ -	$ 408,499.15	
90014605	VP OPNS.004141	$ 100,000.00	$ -	$ 160,066.88	$ 148,306.67	$ -	$ 408,373.55	
5879	EVP EXPLORATION.006208	$ 160,000.00	$ -	$ 248,155.32	$ -	$ -	$ 408,155.32	

JOINT COMMITTEE ON TAXATION - QUESTION #13 - YEAR OF 1998

ID Number	Employee Title	BONUS	DEFERRED PAYOUT	OTHER COMPENSATION	STOCK OPTIONS	RESTRICTED STOCK	TOTAL COMPENSATION	Comments
90010398	VP COMM.004170	$ 150,000.00	$ -	$ 160,222.00	$ 96,651.25	$ -	$ 406,873.25	
90015541	PRES & COO EOGI.005975	$ 160,000.00	$ -	$ 244,533.68	$ -	$ -	$ 404,533.68	
90012736	VP RATES & CERTIFICATES.005696	$ 120,000.00	$ -	$ 171,812.24	$ 110,802.44	$ -	$ 402,614.68	
90142468	TECHNOLOGY.005417	$ 52,000.00	$ -	$ 144,407.64	$ 205,438.81	$ -	$ 401,846.45	
90009943	VP COMM.004170	$ 100,000.00	$ -	$ 153,280.36	$ 146,194.90	$ -	$ 399,475.26	
7838	EVP NORTH AMER OPNS.006207	$ 100,000.00	$ -	$ 292,627.36	$ -	$ -	$ 392,627.36	
90007994	PROJECT DIRECTOR.005725	$ 36,000.00	$ -	$ 356,052.63	$ -	$ -	$ 392,052.63	
90013112	VP COUNTRY MGR - INDIA.006092	$ 67,000.00	$ -	$ 324,005.56	$ -	$ -	$ 391,005.56	
90036222	SPECIAL RETIREE.003333	$ -	$ -	$ 390,827.52	$ -	$ -	$ 390,827.52	
90014343	DIR COMM.004171	$ 60,000.00	$ -	$ 329,733.20	$ -	$ -	$ 389,733.20	
90123954	SVP FINANCE & CFO.001845	$ 120,000.00	$ -	$ 254,045.52	$ -	$ -	$ 374,045.52	
4232	VP GM.000658	$ 40,000.00	$ -	$ 111,668.00	$ -	$ -	$ 151,668.00	

Note: Total compensation value excludes any option gains from Enron Oil and Gas stock grants made to former EOG employees which were not converted to ENE stock tracked in Enron Corp.'s stock tracking system.

Note: Total compensation has been reported from EPC (old payroll system) for cash compensation components and from CMS for stock based compensation components. Because CMS does not report dividend equivalents on restricted stock, total compensation is understated by any dividends actually paid.

JOINT COMMITTEE ON TAXATION - QUESTION #13 - YEAR OF 1999

ID NUMBER	Employee Title	BONUS	DEFERRED PAYOUT	OTHER COMPENSATION	STOCK OPTIONS	RESTRICTED STOCK	TOTAL COMPENSATION
90012759	PRES & COO.003972	$ 2,250,000.00	$ -	$ 902,284.25	$ 46,359,936.13	$ 7,028,484.88	$ 56,540,705.26
90012923	CHMN & CEO.003971	$ 3,150,000.00	$ 202,910.76	$ 1,530,006.22	$ 43,845,330.10	$ -	$ 48,728,247.08
90012869	CHMN & CEO.005873	$ 3,802,285.85	$ -	$ 836,274.53	$ 12,789,866.69	$ 490,908.00	$ 4,638,560.38
90041413	VICE CHAIRMAN.006057	$ 555,437.50	$ -	$ 448,136.58	$ 13,574,246.26	$ 331,056.00	$ 14,908,876.34
90012828	EXEC MNG DIR.006526	$ 850,000.00	$ -	$ 11,703,956.54	$ -	$ -	$ 12,553,956.54
90036456	PRES & COO.003972	$ -	$ 774,521.69	$ 121,245.00	$ 10,258,665.34	$ -	$ 11,154,432.03
90012793	CHMN & CEO EES.005850	$ 300,000.00	$ -	$ 9,200,402.30	$ 775,243.72	$ -	$ 10,275,646.02
90012712	PRESIDENT.004825	$ 1,000,000.00	$ -	$ 2,376,001.56	$ 5,517,449.04	$ 800,712.00	$ 9,694,162.60
90036466	VP COMM.004954	$ 146,000.00	$ -	$ 173,760.96	$ 7,843,132.86	$ -	$ 8,162,893.82
90007829	CHMN & CEO GPG.003754	$ 700,000.00	$ -	$ 529,521.44	$ 5,784,104.05	$ 662,112.00	$ 7,675,737.49
90013060	PRES COO & CEO.006155	$ 1,787,766.69	$ -	$ 676,263.54	$ 1,726,803.00	$ 3,204,894.00	$ 7,395,727.23
90005649	SVP CAP MGMT.005849	$ 1,000,000.00	$ -	$ 385,162.26	$ 4,301,618.09	$ 1,616,993.41	$ 7,303,773.76
90013080	PRES & COO.006059	$ 1,000,000.00	$ -	$ 370,315.36	$ 3,111,959.20	$ 1,514,856.87	$ 5,997,131.43
90012905	CHMN & CEO.005873	$ 1,000,000.00	$ -	$ 865,396.33	$ 2,055,897.20	$ 1,880,695.42	$ 5,801,988.95
90013044	VICE CHAIRMAN.006057	$ 200,000.00	$ -	$ 437,458.24	$ 1,717,899.98	$ 2,988,996.05	$ 5,344,354.27
90013079	CHMN & CEO.005873	$ 1,100,000.00	$ -	$ 478,006.74	$ 660,286.35	$ 2,375,569.49	$ 4,613,862.58
90009944	MNG DIR.005250	$ 3,620,188.62	$ -	$ 316,745.93	$ 510,609.38	$ 125,263.75	$ 4,572,807.67
90012864	DIR MNG STRUCT & TRANS MGMT.006788	$ 710,830.91	$ -	$ 1,193,483.17	$ 2,410,572.27	$ 102,960.00	$ 4,417,846.35
90012914	MNG DIR & DEPUTY GEN COUNSEL.006763	$ 762,451.52	$ -	$ 313,176.89	$ 2,090,056.25	$ 603,685.45	$ 3,769,370.11
90041044	MNG DIR.005250	$ 400,000.00	$ -	$ 615,650.78	$ 1,224,498.00	$ 1,277,668.87	$ 3,517,817.65
90012772	MNG DIR.007087	$ 954,655.00	$ -	$ 929,574.92	$ 1,334,765.67	$ 207,665.14	$ 3,426,660.73
90012861	EXEC DIR & PRES.006434	$ 725,000.00	$ -	$ 631,436.72	$ 1,607,483.19	$ 456,557.86	$ 3,420,477.78
90013069	MNG DIR.007095	$ 525,000.00	$ -	$ 269,249.52	$ 1,757,868.75	$ 766,559.44	$ 3,318,677.71
90008693	MNG DIR CORP MKTG COMM & ADM.005726	$ 230,000.00	$ -	$ 394,838.21	$ 2,003,683.59	$ 390,375.60	$ 3,018,897.40
90013019	MNG DIR.007089	$ 850,000.00	$ -	$ 411,156.18	$ 1,611,542.81	$ 128,105.54	$ 3,000,804.52
90040974	MNG DIR.005250	$ -	$ -	$ 2,781,174.00	$ 74,080.50	$ -	$ 2,855,254.50
90013109	MNG DIR.007091	$ 425,000.00	$ -	$ 233,193.15	$ 1,939,285.78	$ 160,998.50	$ 2,758,477.43
90012713	MNG DIR.007095	$ 500,000.00	$ -	$ 1,307,734.22	$ 648,016.41	$ 213,471.19	$ 2,669,221.82
90012851	PRESIDENT.004825	$ 950,000.00	$ -	$ 600,666.49	$ 1,056,713.29	$ -	$ 2,607,379.78
90127303	PRESIDENT & COS - EOG.006739	$ 350,000.00	$ -	$ 401,672.66	$ 1,366,851.58	$ 425,634.00	$ 2,544,158.24
90014824	PRES & CEO.004238	$ 540,000.00	$ -	$ 324,907.64	$ 1,648,309.05	$ -	$ 2,513,216.69
90012910	VP COMM SUPT.005066	$ 165,000.00	$ -	$ 378,110.65	$ 1,749,033.63	$ 128,105.54	$ 2,420,249.81
90012741	MNG DIR.007095	$ 750,000.00	$ -	$ 625,691.24	$ 910,509.00	$ 128,105.54	$ 2,414,305.78
90009922	VP COMM.004954	$ 420,436.70	$ -	$ 519,055.77	$ 1,351,681.25	$ 79,170.00	$ 2,370,343.72
90012731	MNG DIR.007092	$ 250,000.00	$ -	$ 381,302.72	$ 1,736,229.78	$ -	$ 2,367,532.50
90010080	MNG DIR.005250	$ 325,000.00	$ -	$ 636,421.96	$ 943,203.97	$ 426,942.37	$ 2,331,568.30
90011801	PRESIDENT.007088	$ 500,000.00	$ -	$ 266,666.60	$ 1,341,643.65	$ 166,938.75	$ 2,275,249.00
90013517	VICE PRESIDENT C.500130	$ 1,744,867.06	$ -	$ 181,466.69	$ 48,616.88	$ 152,166.88	$ 2,127,117.50
90012852	VICE CHAIRMAN EES.006217	$ 450,000.00	$ -	$ 563,461.04	$ 699,224.00	$ 378,378.00	$ 2,091,063.04
90012756	EVP CHIEF ACCTG OFFICER.006758	$ 500,000.00	$ -	$ 314,403.11	$ 843,296.07	$ 375,124.74	$ 2,032,823.92
90010113	VP COMM.004954	$ 273,584.00	$ -	$ 250,736.88	$ 1,328,925.00	$ 135,399.35	$ 1,988,645.23
90013064	MNG DIR.007095	$ 800,000.00	$ -	$ 448,211.00	$ 593,600.08	$ -	$ 1,841,811.08
90013111	PRES CLEAN FUELS.004853	$ 165,000.00	$ -	$ 252,117.60	$ 1,408,331.25	$ -	$ 1,825,448.85
90012915	EVP GEN COUNSEL.006759	$ 500,000.00	$ -	$ 606,379.75	$ 263,197.50	$ 425,634.00	$ 1,795,211.25
90009948	MNG DIR.005250	$ 130,000.00	$ -	$ 407,599.25	$ 1,059,294.71	$ 159,726.75	$ 1,756,620.71
90106466	EXECUTIVE DIRECTOR.006333	$ 200,000.00	$ -	$ 1,092,360.70	$ 452,520.00	$ -	$ 1,744,880.70
90013027	SVP FINANCE & TREASURER.006655	$ 500,000.00	$ -	$ 563,944.08	$ 667,828.25	$ -	$ 1,731,772.33
90010526	MNG DIR.005250	$ 500,810.00	$ -	$ 1,211,091.15	$ -	$ -	$ 1,711,901.15
90012951	EVP CHIEF RISK OFFICER.006757	$ 400,000.00	$ -	$ 260,932.24	$ 967,082.47	$ 66,000.00	$ 1,694,014.71
90012803	VP TAX CNSL.002958	$ 275,000.00	$ -	$ 331,755.19	$ 1,036,045.00	$ 22,955.63	$ 1,665,755.82
90014598	VP.005367	$ 100,584.99	$ -	$ 1,259,456.69	$ -	$ 298,158.39	$ 1,658,200.07
90040466	CHAIRMAN EOG.006646	$ 570,000.00	$ 172,679.96	$ 499,456.00	$ 390,624.00	$ -	$ 1,632,759.96
90009324	CEO TECHNOLOGY.006723	$ 500,000.00	$ -	$ 245,644.63	$ 669,125.76	$ 128,105.54	$ 1,542,875.93
90005648	MNG DIR STRUCTURING.006681	$ 420,851.75	$ -	$ 205,400.16	$ 788,479.99	$ 115,385.63	$ 1,530,117.52
90041638	PRES & CEO ENRON SOLAR.005683	$ 115,000.00	$ -	$ 1,409,151.27	$ -	$ -	$ 1,524,151.27
90010111	MNG DIR.007090	$ 218,000.00	$ -	$ 233,305.52	$ 933,437.04	$ 114,400.00	$ 1,499,142.56
90010160	MNG DIR.005250	$ 200,000.00	$ -	$ 530,228.89	$ 755,993.00	$ -	$ 1,486,221.89
90014531	PRES NNG.002915	$ 325,000.00	$ -	$ 304,774.40	$ 832,863.75	$ -	$ 1,462,638.15
90013115	MNG DIR & ASST GEN CNSL.006516	$ 270,000.00	$ -	$ 235,847.21	$ 842,123.00	$ 99,400.00	$ 1,447,370.21

ID NUMBER	Employee Title	BONUS	DEFERRED PAYOUT	OTHER COMPENSATION	STOCK OPTIONS	RESTRICTED STOCK	TOTAL COMPENSATION
90040598	MNG DIR.005250	$ 400,000.00	$ -	$ 57,854.10	$ 683,445.63	$ 276,525.36	$ 1,417,825.08
90041040	MNG DIR.005250	$ 325,000.00	$ -	$ 281,615.44	$ 807,219.09	$ -	$ 1,413,834.53
90012797	EVP INVESTOR REL.006761	$ 300,000.00	$ -	$ 262,468.07	$ 841,237.42	$ -	$ 1,403,705.49
90012901	VP COMM.004954	$ 170,000.00	$ -	$ 466,216.58	$ 691,188.87	$ 47,956.01	$ 1,375,361.46
90009599	MNG DIR & GEN CNSL GPG.006800	$ 150,000.00	$ -	$ 222,639.12	$ 975,369.72	$ 15,525.00	$ 1,363,533.84
90012939	MNG DIR.007094	$ 90,000.00	$ -	$ 198,324.76	$ 917,564.00	$ 148,311.61	$ 1,354,200.37
90012733	VP & CONTROLLER.005486	$ 200,000.00	$ -	$ 200,793.16	$ 949,796.05	$ -	$ 1,350,589.21
90106459	SVP ASIA DEVEL.006789	$ 150,000.00	$ -	$ 158,745.57	$ 1,029,677.84	$ -	$ 1,338,423.41
90009877	PRES CITRUS.002914	$ 250,000.00	$ -	$ 238,929.74	$ 844,367.16	$ -	$ 1,333,296.90
90009635	VP & ASST SECRETARY.001041	$ 220,000.00	$ -	$ 278,795.36	$ 815,157.19	$ -	$ 1,313,952.55
90012942	EVP.006225	$ 260,000.00	$ -	$ 282,324.12	$ 621,739.25	$ 133,568.75	$ 1,297,632.12
90013030	MNG DIR.007095	$ 175,000.00	$ -	$ 318,525.50	$ 798,628.01	$ -	$ 1,292,153.51
90010273	VP COMM.004170	$ 3,415.90	$ -	$ 499,409.00	$ 646,897.22	$ 128,105.54	$ 1,277,827.65
90012755	VP COMM.004170	$ 150,000.00	$ -	$ 725,735.76	$ 72,885.90	$ 317,349.04	$ 1,265,970.70
90014608	VP DEVELOPMENT.003040	$ 190,000.00	$ -	$ 252,551.16	$ 780,833.57	$ -	$ 1,223,384.73
90010127	MNG DIR.005250	$ 400,000.00	$ -	$ 294,699.68	$ 509,490.50	$ -	$ 1,204,190.18
90008868	VP INFO SYSTEMS.002885	$ 170,000.00	$ -	$ 198,145.61	$ 831,392.50	$ -	$ 1,199,538.11
90012889	VP COMM SUPT.005066	$ 187,473.33	$ -	$ 459,324.51	$ 549,653.88	$ -	$ 1,196,451.72
90013013	VP COMM SUPT.005066	$ 92,500.00	$ -	$ 202,615.33	$ 886,036.60	$ -	$ 1,181,151.93
90012698	VP COMM.004170	$ 550,000.00	$ -	$ 604,694.85	$ -	$ -	$ 1,154,694.85
90013020	VP COMM.004170	$ 175,000.00	$ -	$ 337,703.66	$ 640,563.00	$ -	$ 1,153,266.66
90012894	MNG DIR.007092	$ 400,000.00	$ -	$ 644,295.00	$ 105,250.40	$ -	$ 1,149,545.40
90010274	MNG DIR.005250	$ 200,000.00	$ -	$ 649,380.03	$ 294,156.75	$ -	$ 1,143,536.78
90010120	MNG DIR.005250	$ 75,000.00	$ -	$ 934,117.29	$ 126,302.85	$ -	$ 1,135,420.14
90012831	VP COMM.004170	$ 175,000.00	$ -	$ 178,740.00	$ 566,715.40	$ 213,471.19	$ 1,133,926.59
90009937	VP COMM.004170	$ 200,000.00	$ -	$ 532,126.24	$ 268,075.93	$ 128,105.54	$ 1,128,307.71
90012895	VP COMM.004170	$ 200,000.00	$ -	$ 374,304.45	$ 398,820.70	$ 141,180.00	$ 1,114,305.15
90126028	CHRMN & CEO EOGI.005974	$ 185,000.00	$ -	$ 922,692.76	$ -	$ -	$ 1,107,692.76
90010025	VP COMM.004170	$ 150,810.00	$ -	$ 708,930.53	$ 109,200.00	$ 128,105.54	$ 1,097,046.07
90013114	MNG DIR.007087	$ 517,483.24	$ -	$ 372,767.03	$ -	$ 179,855.00	$ 1,070,105.27
90012751	VP COMM.004954	$ 200,000.00	$ -	$ 434,192.38	$ 283,626.00	$ 138,645.00	$ 1,056,463.38
90012985	EVP CHIEF OF STAFF.006760	$ 400,000.00	$ -	$ 314,592.16	$ 332,548.79	$ -	$ 1,047,140.95
90106553	VP ADMIN.004841	$ 160,000.00	$ -	$ 154,899.14	$ 731,902.53	$ -	$ 1,046,801.67
90010064	MNG DIR.005250	$ 175,000.00	$ -	$ 200,184.00	$ 524,633.98	$ 128,105.54	$ 1,027,923.52
90010529	MNG DIR.005250	$ 292,588.46	$ -	$ 232,228.95	$ 468,881.73	$ -	$ 993,699.14
90009993	MNG DIR.005250	$ 540,000.00	$ -	$ 257,619.27	$ 32,882.85	$ 138,645.00	$ 969,147.12
90010239	VP COMM.004170	$ 130,000.00	$ -	$ 186,305.05	$ 416,213.00	$ 213,471.19	$ 945,989.24
90009608	VP & GEN COUNSEL.006298	$ 216,400.00	$ -	$ 592,379.16	$ 50,250.00	$ 79,388.87	$ 938,418.03
90013007	MNG DIR.007095	$ 400,000.00	$ -	$ 309,248.35	$ 191,013.00	$ -	$ 900,261.35
90012766	VP.005367	$ 359,964.03	$ -	$ 294,128.00	$ 237,829.09	$ -	$ 891,921.12
90036465	VP COMM.004954	$ -	$ -	$ 885,799.39	$ -	$ -	$ 885,799.39
90010014	VP COMM.004170	$ -	$ -	$ 127,327.68	$ 757,318.05	$ -	$ 884,645.73
2987	CHAIRMAN & CEO - EOG.006738	$ 400,000.00	$ -	$ 482,754.87	$ -	$ -	$ 882,754.87
90009925	MNG DIR.005250	$ 325,535.00	$ -	$ 462,424.32	$ -	$ 79,170.00	$ 867,129.32
90012935	MNG DIR.006537	$ 90,000.00	$ -	$ 202,056.96	$ 563,248.10	$ -	$ 855,305.06
90009916	MNG DIR.005250	$ 234,620.64	$ -	$ 250,493.12	$ 188,019.83	$ 175,500.00	$ 848,633.59
90035966	VP WORK FORCE DIVERSITY.005542	$ -	$ 17,425.40	$ 728,846.48	$ 101,802.39	$ -	$ 848,074.27
90041955	VP COMM.004170	$ 275,000.00	$ -	$ 57,643.65	$ 510,792.00	$ -	$ 843,435.65
90012711	VP COMM.004170	$ 479,612.68	$ -	$ 363,769.96	$ -	$ -	$ 843,382.64
90012867	EXEC DIR & GNL CNSL.006818	$ 275,700.00	$ -	$ 564,810.06	$ -	$ -	$ 840,510.06
90036473	VP COMM.004954	$ 300,000.00	$ -	$ 456,849.13	$ 77,794.71	$ -	$ 834,643.84
90010290	VP COMM.004170	$ 115,000.00	$ -	$ 541,749.65	$ 164,284.75	$ -	$ 821,034.40
90009800	VP COMM.004170	$ 325,000.00	$ -	$ 301,572.66	$ 192,748.75	$ -	$ 819,321.41
90010523	VP COMM.004170	$ 175,000.00	$ -	$ 503,203.16	$ -	$ 117,502.00	$ 795,705.16
90041405	VP RESERVOIR ENGRG.005325	$ 165,000.00	$ -	$ 186,407.80	$ 444,248.60	$ -	$ 795,656.40
90012877	MNG DIR PUBLIC RELATIONS.006827	$ 220,000.00	$ -	$ 234,403.94	$ 319,323.63	$ 21,710.00	$ 795,437.57
90012796	VP INVESTOR RELATIONS.005985	$ 165,000.00	$ -	$ 197,877.34	$ 420,743.66	$ -	$ 783,621.00
90014597	VP.005367	$ 130,000.00	$ -	$ 524,081.92	$ 114,343.93	$ 14,625.00	$ 783,050.85
90012767	EVP HR & COMMUNITY REL.006762	$ 160,000.00	$ -	$ 259,243.22	$ 361,302.94	$ -	$ 780,546.16

ID NUMBER	Employee Title	BONUS	DEFERRED PAYOUT	OTHER COMPENSATION	STOCK OPTIONS	RESTRICTED STOCK	TOTAL COMPENSATION
90012842	VP COMM.004170	$ 250,000.00	$ -	$ 300,264.23	$ 228,135.63	$ -	$ 778,399.86
90009720	VP & GEN CNSL.005093	$ 200,000.00	$ -	$ 383,474.26	$ 191,752.30	$ -	$ 775,226.56
90012907	VP COMM.004170	$ 200,000.00	$ -	$ 269,512.48	$ 304,838.07	$ -	$ 774,350.55
90126251	DIRECTOR SR.005461	$ 60,000.00	$ -	$ 644,389.90	$ 69,000.00	$ -	$ 773,389.90
90010449	VP COMM.004170	$ 225,000.00	$ -	$ 188,526.52	$ 357,181.38	$ -	$ 770,707.90
90012937	SVP EFS.006536	$ 55,000.00	$ -	$ 191,173.24	$ 520,653.68	$ -	$ 766,826.92
90016147	VP MNG DIR.006069	$ 100,000.00	$ -	$ 662,956.74	$ -	$ -	$ 762,956.74
90006189	VP TAX CNSL.005344	$ 225,000.00	$ -	$ 234,732.75	$ 302,469.00	$ -	$ 762,201.75
90010026	VP COMM.004170	$ 275,000.00	$ -	$ 486,956.24	$ -	$ -	$ 761,956.24
90010016	DIR COMM.004171	$ 75,000.00	$ -	$ 436,193.97	$ 248,338.99	$ -	$ 759,532.96
90010482	VP COMM.004170	$ 160,000.00	$ -	$ 150,545.19	$ 441,622.99	$ -	$ 752,168.18
90012913	VP & ASSOC GEN COUNSEL.006075	$ 202,000.00	$ -	$ 223,597.16	$ 325,578.78	$ -	$ 751,175.94
90009940	MNG DIR.005250	$ 390,000.00	$ -	$ 212,483.44	$ -	$ 144,300.00	$ 746,783.44
90010434	VP COMM.004170	$ 85,000.00	$ -	$ 249,729.89	$ 282,614.56	$ 128,105.54	$ 745,449.99
90009923	VP COMM.004954	$ 237,500.00	$ -	$ 451,273.07	$ -	$ 51,164.82	$ 739,937.89
90012986	VP COMM.004170	$ 40,000.00	$ -	$ 256,381.19	$ 441,602.36	$ -	$ 737,983.55
90012875	DIR MNG HR & ADMIN.006786	$ 175,000.00	$ -	$ 235,942.94	$ 319,323.63	$ -	$ 730,266.57
90012838	VP COMM.004170	$ 210,000.00	$ -	$ 171,153.72	$ 346,193.66	$ -	$ 727,347.38
90013041	DIR COMM.004171	$ 90,000.00	$ -	$ 382,198.04	$ 254,224.67	$ -	$ 726,422.71
90010182	VP COMM.004170	$ 225,000.00	$ -	$ 176,269.56	$ 323,856.96	$ -	$ 725,126.52
90009783	VP COMM.004170	$ 150,810.00	$ -	$ 571,966.09	$ -	$ -	$ 722,776.09
90013087	VP COMM.004170	$ 125,000.00	$ -	$ 363,309.83	$ 90,924.94	$ 128,105.54	$ 707,340.31
90105162	VP COMM.004170	$ 150,000.00	$ -	$ 550,540.94	$ -	$ -	$ 700,540.94
90010028	VP COMM.004170	$ 125,810.00	$ -	$ 444,113.13	$ 124,413.75	$ -	$ 694,336.88
90014630	VP.005367	$ 71,539.00	$ -	$ 274,297.62	$ 347,165.00	$ -	$ 693,001.62
90012948	VP.005367	$ 190,000.00	$ -	$ 295,151.81	$ 192,665.48	$ -	$ 677,817.29
90014609	VP.006326	$ 85,000.00	$ -	$ 157,593.19	$ 427,127.13	$ -	$ 669,720.32
90010528	VP COMM.004170	$ 225,000.00	$ -	$ 220,948.75	$ 223,195.49	$ -	$ 669,144.24
90012898	VP COMM.004170	$ 350,000.00	$ -	$ 315,530.92	$ -	$ -	$ 665,530.92
90012988	VP COMM SUPT.006660	$ 140,000.00	$ -	$ 305,173.42	$ 94,716.50	$ 119,542.60	$ 659,432.52
90010430	VP BUS DEV.002269	$ 342,585.29	$ -	$ 167,466.96	$ 147,570.01	$ -	$ 657,622.26
90008420	VP FED REG AFFAIRS.005759	$ 70,000.00	$ -	$ 159,840.37	$ 408,253.65	$ -	$ 638,094.02
90010011	MNG DIR.005250	$ 150,000.00	$ -	$ 222,344.25	$ 184,477.50	$ 79,040.00	$ 635,861.75
90014585	VP OPNS TECH SPT.005547	$ 90,000.00	$ -	$ 153,960.34	$ 386,683.75	$ -	$ 630,644.09
3995	VP & GM TRINIDAD.005031	$ 70,000.00	$ -	$ 555,560.81	$ -	$ -	$ 625,560.81
90010437	VP COMM.004170	$ 100,000.00	$ -	$ 165,060.00	$ 356,106.88	$ -	$ 621,166.88
90010519	VP COMM.004170	$ 75,000.00	$ -	$ 164,612.27	$ 249,973.60	$ 128,105.54	$ 617,691.41
90012810	VP.005367	$ 60,000.00	$ -	$ 501,976.93	$ -	$ 51,164.82	$ 613,141.75
90008795	VP FED GOVT AFFAIRS.001276	$ 170,000.00	$ -	$ 235,279.72	$ 206,610.00	$ -	$ 611,889.72
90009796	MNG DIR.005250	$ 200,000.00	$ -	$ 409,146.60	$ -	$ -	$ 609,146.60
90010530	VP COMMERCIAL.005445	$ 60,000.00	$ -	$ 215,268.75	$ 332,897.12	$ -	$ 608,165.87
90010520	VP COMM.004170	$ 225,000.00	$ -	$ 261,068.50	$ 113,898.35	$ -	$ 599,966.85
90012699	VP COMM.004170	$ 100,000.00	$ -	$ 318,240.46	$ 181,255.39	$ -	$ 599,495.85
90013065	VP COMM.004170	$ 120,000.00	$ -	$ 237,524.40	$ 241,042.88	$ -	$ 598,567.28
90012976	VP COMM.004170	$ 100,000.00	$ -	$ 143,759.88	$ 348,530.25	$ -	$ 592,290.13
90040993	VP COMM.004170	$ 250,000.00	$ -	$ 143,401.68	$ 198,535.00	$ -	$ 591,936.68
90013128	SVP COS.006282	$ 272,385.00	$ -	$ 225,165.87	$ -	$ 90,126.31	$ 587,677.18
90013061	VP.006326	$ 205,000.00	$ -	$ 205,646.18	$ 176,927.96	$ -	$ 587,574.14
90013106	SVP HR.006656	$ 300,000.00	$ -	$ 276,060.44	$ -	$ -	$ 576,060.44
90006103	VP TAX EES.006309	$ 35,000.00	$ -	$ 194,653.27	$ 345,984.38	$ -	$ 575,637.65
90012836	VP COMM.004170	$ 260,000.00	$ -	$ 265,943.62	$ 46,846.10	$ -	$ 572,789.72
21664	VP GM.000658	$ 80,000.00	$ -	$ 492,284.80	$ -	$ -	$ 572,284.80
90012845	VP COMM.004170	$ 175,000.00	$ -	$ 336,100.53	$ 60,000.00	$ -	$ 571,100.53
90012890	VP COMM SUPT.005066	$ 100,000.00	$ -	$ 368,355.62	$ 102,681.46	$ -	$ 571,037.08
90012738	VP BUSINESS SERVICES.006295	$ 85,000.00	$ -	$ 173,951.93	$ 304,941.95	$ -	$ 563,893.88
90010305	VP COMM.004170	$ 100,000.00	$ -	$ 185,478.51	$ 142,414.48	$ 135,866.05	$ 563,759.04
90012736	VP RATES & CERTIFICATES.005696	$ 125,000.00	$ -	$ 181,684.90	$ 255,719.81	$ -	$ 562,404.71
90012834	VP COMM.004170	$ 225,000.00	$ -	$ 229,166.68	$ 107,804.79	$ -	$ 561,971.47
90009729	VP & ASST GEN CNSL.006211	$ 200,000.00	$ -	$ 185,105.26	$ 175,968.00	$ -	$ 561,073.26

ID NUMBER	Employee Title	BONUS	DEFERRED PAYOUT	OTHER COMPENSATION	STOCK OPTIONS	RESTRICTED STOCK	TOTAL COMPENSATION
90014592	VP.005367	$ 125,000.00	$ -	$ 314,967.95	$ -	$ 115,830.00	$ 555,797.95
90010128	VP COMM.004170	$ 200,000.00	$ -	$ 156,256.00	$ 198,455.94	$ -	$ 554,711.94
90012776	VP.007105	$ 90,000.00	$ -	$ 389,737.25	$ 40,437.40	$ 32,033.44	$ 552,208.09
90041526	VP EES CORP DEV.006275	$ 67,500.00	$ -	$ 178,830.13	$ 304,910.08	$ -	$ 551,240.21
90010167	VP COMM.004170	$ 180,000.00	$ -	$ 226,811.88	$ 143,100.00	$ -	$ 549,911.88
90016474	VP OPNS & ADMIN NPNG.005473	$ 105,000.00	$ -	$ 168,162.08	$ 276,216.60	$ -	$ 549,378.68
90014590	VP.005367	$ 394,654.17	$ -	$ 149,438.15	$ -	$ -	$ 544,092.32
90008056	VP DEV ENGR.006772	$ 65,000.00	$ -	$ 146,885.60	$ 325,907.05	$ -	$ 537,792.65
90015091	LEADER TEAM INDUSTRY SEGMENT.006558	$ 29,167.00	$ -	$ 506,373.10	$ -	$ -	$ 535,540.10
90012870	DIR MNG GLOBAL OPNS & SERV.006785	$ -	$ -	$ 531,845.13	$ -	$ -	$ 531,845.13
90009687	MNG DIR & GEN CNSL.005786	$ 120,000.00	$ -	$ 334,334.96	$ 66,187.50	$ 10,855.00	$ 531,377.46
90012837	SVP & SECRETARY.006654	$ 110,000.00	$ -	$ 224,330.32	$ 196,328.31	$ -	$ 530,658.63
90009611	COUNSEL SR II.001162	$ 42,000.00	$ -	$ 487,587.95	$ -	$ -	$ 529,587.95
90014977	PRES NPNG.002900	$ 250,000.00	$ -	$ 278,025.84	$ -	$ -	$ 528,025.84
90005448	MNG DIR GPG FINANCE & ACCTG.006801	$ 210,000.00	$ -	$ 226,488.94	$ 90,641.25	$ -	$ 527,130.19
90008466	VP COMPENSATION & BENEFITS.006475	$ 125,000.00	$ -	$ 166,985.19	$ 187,425.10	$ 44,375.00	$ 523,785.29
90012946	EXEC MNG DIR.006526	$ -	$ -	$ 354,989.44	$ -	$ 168,735.71	$ 523,725.15
90012750	VP COMM SUPT.005066	$ 90,000.00	$ -	$ 146,803.52	$ 284,875.64	$ -	$ 521,679.16
90015541	PRES & CEO (CANADA).400103	$ 210,000.00	$ -	$ 310,264.38	$ -	$ -	$ 520,264.38
90012742	DIR COMM.004171	$ 200,000.00	$ -	$ 273,124.78	$ -	$ 42,575.00	$ 515,699.78
90123954	SVP FINANCE & CFO.001845	$ 135,000.00	$ -	$ 255,866.46	$ -	$ -	$ 390,866.46
90041637	SVP GM.005932	$ 110,000.00	$ 8,759.28	$ 219,137.91	$ -	$ -	$ 337,897.19
4868	VP NEW VENTURES & BUS DEV.005789	$ 20,000.00	$ -	$ 304,569.67	$ -	$ -	$ 324,569.67

Note: Total compensation has been reported from EPC (old payroll system) for cash compensation components and from CMS for stock based compensation components. Because CMS does not report dividend equivalents on restricted stock, total compensation is understated by any dividends actually paid.

Note: Total compensation value excludes any option gains from Enron Oil and Gas stock grants made to former EOG employees which were not converted to ENE stock tracked in Enron Corp.'s stock tracking system.

JOINT COMMITTEE ON TAXATION - QUESTION #13 - YEAR OF 2000

Gis Id	Job Title	Bonus	Stock Options	Restricted Stock	Defered Payout	Other Compensation	Total Compensation
90012793	CHAIRMAN AND C.E.O.ENRON XCELERATOR	$ 300,000.00	$ 161,806,789.57	$ 5,376,756.00	$ -	$ 1,257,840.52	$ 168,741,386.09
90012923	CHAIRMAN OF THE BOARD & CEO	$ 3,900,000.00	$ 96,154,470.99	$ 35,979,810.50	$ 118,364.61	$ 2,935,987.76	$ 139,088,633.86
90013060	VICE CHAIRMAN	$ 4,127,617.00	$ 70,039,235.87	$ 23,187,393.55	$ -	$ 9,873,925.14	$ 107,228,171.56
90012759	PRESIDENT AND COO	$ 3,000,000.00	$ 62,484,460.14	$ 15,615,711.05	$ -	$ 901,049.72	$ 82,001,220.91
90013081	CHMN & CEO	$ 400,000.00	$ 65,253,812.09	$ 9,859,127.06	$ -	$ 795,661.54	$ 76,308,600.69
90012712	VICE CHAIRMAN	$ 1,300,000.00	$ 28,732,712.00	$ 2,304,262.23	$ -	$ 7,515,479.06	$ 39,852,453.29
90012869	CHMN & CEO	$ -	$ 31,666,167.85	$ -	$ -	$ 0.86	$ 31,666,168.71
90010476	MD TRADING	$ 275,000.00	$ 27,330,943.75	$ 2,842,274.25	$ -	$ 214,251.95	$ 30,662,469.95
90041413	SPEC SR	$ -	$ 28,129,155.64	$ -	$ -	$ 587,240.36	$ 28,716,396.00
90013079	CHAIRMAN & CEO	$ 1,100,000.00	$ 16,226,027.37	$ 4,621,150.93	$ -	$ 4,460,681.14	$ 26,407,859.44
90007829	CHAIRMAN & CEO	$ 1,000,000.00	$ 21,077,050.89	$ -	$ -	$ 831,536.46	$ 22,908,587.35
90013080	CEO	$ 1,000,000.00	$ 15,597,901.27	$ 1,898,026.12	$ -	$ 4,371,291.71	$ 22,867,219.10
90011801	CEO	$ 1,050,000.00	$ 17,709,470.39	$ -	$ -	$ 327,698.27	$ 19,087,168.66
90010507	MANAGING DIRECTOR COMMERCIAL	$ 300,000.00	$ 16,205,075.01	$ 1,421,137.13	$ -	$ 380,975.30	$ 18,307,187.44
90010502	MNG DIR E-COMMERCE	$ 275,000.00	$ 16,102,515.39	$ 1,421,137.13	$ -	$ 235,807.90	$ 18,034,460.42
90013094	MNG DIR E-COMMERCE	$ 140,000.00	$ 16,171,893.87	$ 1,421,137.13	$ -	$ 168,977.07	$ 17,902,008.07
90012774	CO CEO	$ 850,000.00	$ 14,060,254.59	$ -	$ -	$ 1,358,496.41	$ 16,268,751.00
90129108	Stock Optionee only - QDRO	$ -	$ 15,220,611.06	$ -	$ -	0	$ 15,220,611.06
90005649	EVP & Chief Financial Officer	$ 1,000,000.00	$ 8,917,584.37	$ 985,084.28	$ -	$ 3,807,006.56	$ 14,709,675.21
90041044	MNG DIR	$ -	$ 10,561,937.50	$ 1,222,927.84	$ -	$ 1,509,816.12	$ 13,294,681.46
90014824	PRES & CEO E&C	$ 900,000.00	$ 10,928,971.92	$ 289,987.50	$ -	$ 410,825.36	$ 12,529,784.78
90012905	VICE CHAIRMAN & CHIEF STRATEGY OFFICER	$ 1,500,000.00	$ 4,755,907.97	$ 1,439,405.47		$ 4,340,383.32	$ 12,035,696.76
90036456	PRES & COO	$ -	$ 10,543,058.00	$ -	$ 801,366.61	0	$ 11,344,424.61
90013092	VP IT DEV	$ 100,000.00	$ 9,945,645.00	$ 947,473.88	$ -	$ 154,231.64	$ 11,147,350.52
90013019	PRESIDENT AND COO	$ 1,600,000.00	$ 6,657,794.51	$ 377,294.77	$ -	$ 2,350,167.28	$ 10,985,256.56
90015685	DIR ORIGINATION	$ 45,000.00	$ 9,960,948.51	$ 710,642.25	$ -	$ 125,046.85	$ 10,841,637.61
90012772	OFFICER	$ 1,890,078.00	$ 4,715,237.75	$ 1,002,306.88		$ 2,370,193.26	$ 9,977,815.89
90123556	Stock Optionee only - QDRO	$ -	$ 9,950,239.46	$ -	$ -	0	$ 9,950,239.46
90015590	VP ORIGINATION		$ 8,449,589.33	$ 828,917.55	$ -	$ 295,782.68	$ 9,574,289.56
90013100	VP ORIGINATION	$ 175,000.00	$ 8,111,330.41	$ 723,037.27	$ -	$ 240,209.86	$ 9,249,577.54
90012861	MNG DIR-AZURIX CORP		$ 4,844,344.55	$ 111,347.25		$ 3,528,475.40	$ 8,484,167.20
90012756	OFFICER	$ 750,000.00	$ 5,487,889.86	$ 907,010.75	$ -	$ 372,273.94	$ 7,517,174.55
90012713	MNG DIR & CHIEF COMMERCIAL OFFICER	$ 511,840.00	$ 3,414,466.10	$ 147,878.50		$ 3,387,558.67	$ 7,461,743.27
90041501	CHMN & CEO	$ -	$ 5,839,005.60	$ -	$ -	$ 1,556,718.67	$ 7,395,724.27
90014977	PRESIDENT NPNG	$ 225,000.00	$ 5,458,031.02	$ 532,830.45	$ 33,391.54	$ 1,132,901.24	$ 7,382,154.25
90013027	PRESIDENT AND COO	$ 750,000.00	$ 4,606,913.18	$ 95,419.65	$ -	$ 1,462,869.98	$ 6,915,202.81
90013109	Mng Dir Bus Risk Mgmt & IT Compl	$ 450,000.00	$ 5,704,227.47	$ 335,821.25	$ -	$ 331,740.66	$ 6,821,789.38
90009324	CHAIRMAN & CEO	$ 900,000.00	$ 3,962,418.80	$ 164,244.50		$ 1,689,858.25	$ 6,716,521.55
90014598	VP ORIGINATION	$ 62,499.00	$ 4,612,689.22	$ 592,085.93		$ 1,347,192.13	$ 6,614,466.28
90012797	EVP INVESTOR REL	$ 500,000.00	$ 5,481,351.93	$ 159,724.00	$ -	$ 419,112.78	$ 6,560,188.71

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JOINT COMMITTEE ON TAXATION - QUESTION #13 - YEAR OF 2000

Gis Id	Job Title	Bonus	Stock Options	Restricted Stock	Defered Payout	Other Compensation	Total Compensation
90015541	CEO	$ 350,000.00	$ 5,464,169.15	$ 321,662.62		$ 366,633.88	$ 6,502,465.65
90010160	MD ORIGINATION	$ 300,000.00	$ 3,153,114.35	$ 32,878.15	$ -	$ 3,015,972.06	$ 6,501,964.56
90013114	CEO, MIDDLE EAST & ASIA REGION	$ 4,862,500.00	$ -	$ 613,936.50	$ -	$ 920,129.38	$ 6,396,565.88
90013064	CHAIRMAN & CEO	$ 1,100,000.00	$ 3,252,377.37	$ -	$ -	$ 1,721,311.22	$ 6,073,688.59
90012895	VP TRADING	$ 250,000.00	$ 4,546,717.45	$ 348,125.97		$ 650,139.61	$ 5,794,983.03
90009993	MANAGING DIRECTOR	$ 300,000.00	$ 4,581,635.18	$ 603,756.43		$ 272,799.66	$ 5,758,191.27
90013069	WHOLESALE	$ 200,000.00	$ 4,209,351.25	$ 1,020,071.70		$ 277,679.86	$ 5,707,102.81
90010526	MD CORP DEV	$ 500,000.00	$ 3,151,954.25	$ 164,244.50	$ -	$ 1,858,681.97	$ 5,674,880.72
90009726	GEN COUNSEL ASST	$ 55,000.00	$ 4,911,040.93	$ 523,754.25		$ 74,086.59	$ 5,563,881.77
90012851	PRESIDENT &CEO	$ 1,000,000.00	$ -	$ 128,443.88	$ -	$ 4,238,227.18	$ 5,366,671.06
90013044	CHAIRMAN & CEO ENRON INVESTMENT PARTNERS	$ 200,000.00	$ 999,081.40	$ 330,242.50		$ 3,837,296.16	$ 5,366,620.06
90014608	VP DEVELOPMENT	$ 150,000.00	$ 3,967,363.85	$ 308,853.00	$ 426,125.95	$ 499,114.22	$ 5,351,457.02
90013098	VP ENG	$ 115,000.00	$ 4,330,483.05	$ 712,601.30		$ 146,571.92	$ 5,304,656.27
90012731	MNG DIR & GEN COUNSEL	$ 275,000.00	$ 2,461,451.25	$ -	$ -	$ 2,488,443.68	$ 5,224,894.93
90012915	EVP GEN COUNSEL	$ 750,000.00	$ 3,056,833.75	$ 479,308.75		$ 793,258.44	$ 5,079,400.94
90012951	EVP CHIEF RISK OFFICER	$ 600,000.00	$ 2,740,243.91	$ 265,681.38		$ 1,449,766.59	$ 5,055,691.88
90012894	PRESIDENT & CEO	$ 900,000.00	$ 2,839,860.38	$ 83,875.77	$ -	$ 1,216,346.36	$ 5,040,082.51
90013095	VP	$ 50,000.00	$ 3,312,926.39	$ 1,351,225.39		$ 147,580.63	$ 4,861,732.41
90012914	EVP GEN COUNSEL	$ 500,000.00	$ 2,205,534.44	$ 1,651,318.39		$ 448,365.23	$ 4,805,218.06
90012698	PRESIDENT & CEO	$ 1,150,000.00	$ 2,786,235.37	$ 49,974.77	$ -	$ 761,351.40	$ 4,747,561.54
90012946	CHAIRMAN & CEO	$ 565,000.00	$ 3,403,712.95	$ 350,205.63		$ 405,612.50	$ 4,724,531.08
90010064	MNG DIR TRADING	$ 150,000.00	$ 2,667,776.14	$ 178,272.50		$ 1,566,755.18	$ 4,562,803.82
90106466	EXECUTIVE DIRECTOR	$ -	$ 3,991,288.00	$ -	$ -	$ 493,673.10	$ 4,484,961.10
90016147	VP EXPLORATION	$ 150,000.00	$ 3,507,278.03	$ 120,633.04		$ 652,783.66	$ 4,430,694.73
90012901	VP ORIG WHOLESALE	$ 175,000.00	$ 3,334,705.05	$ 100,058.75	$ -	$ 765,118.14	$ 4,374,881.94
90008795	VP FED GOVT AFFAIRS	$ 150,000.00	$ 3,765,087.29	$ 69,879.25	$ -	$ 335,173.64	$ 4,320,140.18
90010274	EVP CORP DEVELOPMENT	$ 300,000.00	$ 612,166.87	$ 52,458.88	$ -	$ 3,323,228.91	$ 4,287,854.66
90010011	VP ORIG WHOLESALE	$ 80,000.00	$ 3,625,091.81	$ 233,222.48		$ 337,037.92	$ 4,275,352.21
90012767	EVP HR & COMMUNITY REL	$ 650,000.00	$ 3,159,743.09	$ 69,879.25	$ -	$ 388,424.50	$ 4,268,046.84
90009940	MNG DIR CORP DEVE	$ 300,000.00	$ 3,358,891.98	$ 356,130.88		$ 249,088.86	$ 4,264,111.72
90009599	MNG DIR & GEN CNSL ETS	$ 125,000.00	$ 3,613,456.94	$ 102,229.25	$ -	$ 385,716.42	$ 4,226,402.61
90008868	VP INFO SYSTEMS	$ 200,000.00	$ 2,279,856.86	$ 911,385.69		$ 668,223.93	$ 4,059,466.48
90010080	MNG DIR E-COMMERCE	$ 700,000.00	$ 964,154.40	$ 119,822.50		$ 2,253,334.74	$ 4,037,311.64
90012959	DEVELOPMENT	$ 15,000.00	$ 3,257,198.35	$ 73,500.88	$ -	$ 679,019.72	$ 4,024,718.95
90014531	PRESIDENT NPNG	$ 300,000.00	$ 2,922,001.25	$ 179,826.25		$ 466,233.01	$ 3,868,060.51
90101309	Wind Employee-UNKNOWN-JOB-TITLE	$ -	$ 3,852,457.96	$ -	$ -	0	$ 3,852,457.96
90008693	MNG DIR CORP MKTG COMM & ADM	$ 200,000.00	$ 2,281,559.19	$ 423,043.00		$ 821,652.42	$ 3,726,254.61
90012852	EES VICE CHAIRMAN	$ 450,000.00	$ 543,583.95	$ -	$ -	$ 2,669,015.66	$ 3,662,599.61
90012803	MNG DIR AND GENERAL TAX COUNSEL	$ 350,000.00	$ 2,775,700.00	$ 139,758.50		$ 366,395.39	$ 3,631,853.89
90012733	MNG DIR & CONTROLLER	$ 250,000.00	$ 2,909,273.13	$ 139,758.50		$ 328,168.80	$ 3,627,200.43
90012898	MNG DIR TRADING	$ 250,000.00	$ 2,758,756.25	$ -	$ -	$ 593,959.96	$ 3,602,716.21
90012942	WHOLESALE	$ 250,000.00	$ 2,670,135.77	$ 254,495.60		$ 420,503.59	$ 3,595,134.96
90013007	PRESIDENT & CEO	$ 500,000.00	$ 1,689,828.00	$ 65,025.65	$ -	$ 1,324,507.51	$ 3,579,361.16

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Gis Id	Job Title	Bonus	Stock Options	Restricted Stock	Defered Payout	Other Compensation	Total Compensation
90005648	OFFICER	$ 330,000.00	$ 2,676,804.15	$ 337,209.15		$ 234,367.80	$ 3,578,381.10
90012741	OFFICER	$ 1,000,000.00	$ 637,835.39	$ 324,982.00		$ 1,595,765.94	$ 3,558,583.33
90009937	VP ORIG WHOLESALE	$ 200,000.00	$ 839,379.48	$ 125,813.65		$ 2,378,932.96	$ 3,544,126.09
90042189	Unknown	$ -	$ 3,526,967.44	$ -	$ -	$ 11,317.23	$ 3,538,284.67
90010490	DIR PRODUCT MKTG	$ 120,000.00	$ 3,008,499.80	$ 139,858.88		$ 75,076.17	$ 3,343,434.85
90013099	VP ENG TECHNICAL	$ 100,000.00	$ 2,790,056.50	$ 229,757.63		$ 207,775.23	$ 3,327,589.36
90009923	VP CORPORATE DEVELOPMENT	$ 684,653.00	$ 1,565,253.55	$ 88,133.50	$ -	$ 943,787.91	$ 3,281,827.96
90012842	PRESIDENT EES	$ 525,000.00	$ 1,481,151.50	$ 104,917.77	$ -	$ 1,022,832.25	$ 3,133,901.52
90010014	VP ORIGINATION	$ 225,000.00	$ 2,344,320.61	$ -	$ -	$ 557,474.48	$ 3,126,795.09
90010119	SR VP INTL FIN	$ 200,000.00	$ 2,582,522.06	$ 125,579.56		$ 186,083.60	$ 3,094,185.22
90010182	VP E-COMMERCE	$ 500,000.00	$ 1,724,594.94	$ -	$ -	$ 856,787.85	$ 3,081,382.79
90010334	MD ENERGY PORTFOLIO MGMT	$ 300,000.00	$ 1,558,300.00	$ 21,042.00	$ -	$ 1,183,743.33	$ 3,063,085.33
90009509	DIR SR IT DEV	$ 1,000.00	$ 2,694,450.45	$ 236,979.00		$ 107,801.02	$ 3,040,230.47
90040974	MNG DIR	$ -	$ -	$ -	$ -	$ 2,958,962.00	$ 2,958,962.00
90012796	SECRETARY	$ 250,000.00	$ 2,312,787.70	$ 79,862.00	$ -	$ 238,578.77	$ 2,881,228.47
90010529	MNG DIR ASSET BUS DEV	$ 500,000.00	$ 1,319,339.38	$ 68,055.63	$ -	$ 840,931.90	$ 2,728,326.91
90009800	MANAGING DIRECTOR COMMERCIAL	$ 500,000.00	$ 861,900.01	$ 58,742.27	$ -	$ 1,299,270.01	$ 2,719,912.29
90012844	VP ORIG WHOLESALE	$ 50,000.00	$ 2,284,004.54	$ 180,635.07		$ 170,479.02	$ 2,685,118.63
90006201	VP STRATEGIC INITIATIVES	$ 410,000.00	$ 1,981,477.95	$ 79,862.00	$ -	$ 207,333.67	$ 2,678,673.62
90010437	MNG DIR	$ 235,000.00	$ 1,953,139.97	$ -	$ -	$ 479,358.28	$ 2,667,498.25
90010398	VP COMM	$ 300,000.00	$ 1,330,338.58	$ 252,006.77		$ 769,090.59	$ 2,651,435.94
90010273	CO-CHIEF OPERATING OFFICER EES NORTH AM	$ 15,000.00	$ 926,409.32	$ 128,443.88		$ 1,444,676.93	$ 2,514,530.13
90010127	MGR DIR FIN	$ 525,000.00	$ 743,750.00	$ 88,113.38	$ -	$ 1,152,173.64	$ 2,509,037.02
90010023	VP COMM	$ 251,610.00	$ 745,312.50	$ 95,419.65	$ -	$ 1,395,100.16	$ 2,487,442.31
90013030	MD PORTFOLIO ORIGINATION		$ 537,918.75	$ 157,230.50		$ 1,763,770.58	$ 2,458,919.83
90123530	TERMINATED EMPLOYEE	$ -	$ 2,418,383.48	$ -	$ -	0	$ 2,418,383.48
90012970	MNG DIR TRADING	$ 500,000.00	$ 1,499,170.87	$ -	$ -	$ 377,224.52	$ 2,376,395.39
90006189	MNG DIR CORP TAX	$ 250,000.00	$ 1,144,687.12	$ -	$ -	$ 973,140.10	$ 2,367,827.22
90013086	VP BUS DEV	$ 85,000.00	$ 1,954,960.28	$ 120,633.03		$ 197,684.66	$ 2,358,277.97
90010025	VP ASSET DEV	$ 150,000.00	$ 919,908.09	$ 33,608.77	$ -	$ 1,192,178.30	$ 2,295,695.16
90009727	GEN COUNSEL ASST	$ 63,000.00	$ 1,835,704.35	$ 236,979.00		$ 141,235.19	$ 2,276,918.54
90012935	MNG DIR DEV ENG	$ 100,000.00	$ 1,847,116.15	$ 59,896.50	$ -	$ 268,059.34	$ 2,275,071.99
90012910	MNG DIR RESEARCH	$ 200,000.00	$ 978,255.97	$ 62,979.88	$ -	$ 1,027,321.80	$ 2,268,557.65
90012939	CEO	$ 150,000.00	$ 1,579,880.00	$ 261,889.93		$ 272,312.82	$ 2,264,082.75
90012810	VP BUS DEV	$ 50,000.00	$ 1,583,056.38	$ 88,133.50	$ -	$ 511,914.35	$ 2,233,104.23
90010028	VP ORIG WHOLESALE	$ 175,800.00	$ 833,099.11	$ -	$ -	$ 1,208,226.45	$ 2,217,125.56
90009635	VP & ASST SECRETARY	$ 110,000.00	$ 1,629,482.26	$ 99,827.50	$ -	$ 345,285.28	$ 2,184,595.04
90012913	VP & ASSOC GEN COUNSEL	$ 250,000.00	$ 1,434,743.62	$ 129,775.75		$ 331,729.66	$ 2,146,249.03
90012834	VP TRADING	$ 375,000.00	$ 1,084,180.06	$ 115,000.38		$ 551,507.87	$ 2,125,688.31

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Gis Id	Job Title	Bonus	Stock Options	Restricted Stock	Defered Payout	Other Compensation	Total Compensation
90012948	VP OPNS	$ 320,170.00	$ 1,592,340.24	$ -	$ -	$ 208,362.42	$ 2,120,872.66
90013063	VP TRADING	$ 180,000.00	$ 911,616.82	$ 67,217.50	$ -	$ 956,819.08	$ 2,115,653.40
90012988	MNG DIR GOVT AFFAIRS	$ 225,000.00	$ 1,287,270.24	$ 267,026.23		$ 300,484.07	$ 2,079,780.54
90010290	VP ORIG WHOLESALE	$ 200,000.00	$ 765,773.98	$ -	$ -	$ 1,104,264.75	$ 2,070,038.73
90012837	MANAGING DIRECTOR	$ 200,000.00	$ 1,508,139.61	$ 99,827.50	$ -	$ 249,424.02	$ 2,057,391.13
90012751	ORIGINATION	$ 150,000.00	$ 822,500.00	$ 544,188.57		$ 527,150.71	$ 2,043,839.28
90009877	PRESIDENT CITRUS	$ 275,000.00	$ 1,374,856.19	$ 99,827.50	$ -	$ 293,260.39	$ 2,042,944.08
90010523	VP E-COMMERCE	$ 350,000.00	$ 1,069,062.50	$ 224,894.25		$ 381,118.01	$ 2,025,074.76
90010235	MNG DIR	$ 200,000.00	$ -	$ 1,197,324.52	$ -	$ 617,750.21	$ 2,015,074.73
90040993	TITLE		$ 751,981.50	$ 128,443.88		$ 1,129,440.00	$ 2,009,865.38
90009788	MNG DIR FIN	$ 225,000.00	$ 1,300,782.38	$ 31,563.00	$ -	$ 410,731.37	$ 1,968,076.75
90106225	JOB-TITLE	$ -	$ 1,954,619.00	$ -	$ -	0	$ 1,954,619.00
90012831	VP TRADING	$ 175,000.00	$ 301,375.00	$ 125,813.65		$ 1,352,300.59	$ 1,954,489.24
90013008	VP	$ 275,000.00	$ 1,249,267.11	$ 105,438.13	$ -	$ 304,409.61	$ 1,934,114.85
90012699	VP Trading	$ 25,000.00	$ 956,197.06	$ 188,310.51		$ 667,429.75	$ 1,836,937.32
90013093	VP E-COMMERCE	$ 50,000.00	$ 1,527,797.26	$ 123,205.50		$ 134,790.55	$ 1,835,793.31
90009956	VP Orig Wholesale	$ 300,000.00	$ 586,560.90	$ 62,979.88	$ -	$ 869,106.90	$ 1,818,647.68
90012734	VP & ASST CONTROLLER	$ 120,000.00	$ 1,506,113.26	$ -	$ -	$ 186,632.84	$ 1,812,746.10
90101070	JOB-TITLE	$ -	$ 1,783,919.00	$ -	$ -	0	$ 1,783,919.00
90012960	VP & GEN CNSL	$ 150,000.00	$ 1,442,399.18	$ -	$ -	$ 179,243.04	$ 1,771,642.22
90012907	VP TRADING	$ 340,000.00	$ 428,187.34	$ 115,000.38		$ 878,151.85	$ 1,761,339.57
90012838	VP ORIG WHOLESALE	$ 125,000.00	$ 622,660.94	$ 75,546.65	$ -	$ 929,039.04	$ 1,752,246.63
90013076	VP	$ 125,000.00	$ 97,800.00	$ 432,462.46		$ 1,071,690.05	$ 1,726,952.51
90013016	VP ORIG WHOLESALE	$ 100,000.00	$ 1,507,026.32	$ -	$ -	$ 106,318.05	$ 1,713,344.37
90013024	VP	$ 15,000.00	$ -	$ 1,130,775.79	$ -	$ 545,376.36	$ 1,691,152.15
90012985	EVP CHIEF OF STAFF	$ 750,000.00	$ 255,645.00	$ 304,709.52		$ 340,380.72	$ 1,650,735.24
90008216	VP ENG		$ 1,232,500.00	$ 142,745.63		$ 271,806.48	$ 1,647,052.11
90009920	VP ORIG WHOLESALE	$ 175,000.00	$ 1,232,193.29	$ 73,260.38	$ -	$ 165,130.90	$ 1,645,584.57
90013020	MNG DIR CORPORATE DEVL	$ 350,000.00	$ -	$ 62,979.88	$ -	$ 1,223,724.12	$ 1,636,704.00
90009925	MNG DIR FIN	$ 736,627.00	$ -	$ 260,373.15	$ -	$ 633,591.07	$ 1,630,591.22
90013105	MANAGING DIRECTOR	$ 150,000.00	$ 195,483.13	$ 349,758.76	$ 23,777.42	$ 903,020.63	$ 1,622,039.94
90010239	MNG DIR	$ 290,000.00	$ 267,937.50	$ 75,546.65	$ -	$ 971,410.32	$ 1,604,894.47
90015564	DIR BUS DEV	$ 50,000.00	$ 1,074,436.66	$ 285,551.13		$ 156,555.45	$ 1,566,543.24
90012773	VP REG & GOVT AFFAIRS	$ 55,000.00	$ 1,205,198.15	$ -	$ -	$ 295,449.46	$ 1,555,647.61
90009783	VP Trading	$ 150,000.00	$ 363,631.74	$ -	$ -	$ 1,035,574.05	$ 1,549,205.79
90009796	PRESIDENT & CEO	$ 300,000.00	$ -	$ -	$ -	$ 1,244,125.28	$ 1,544,125.28
90010305	WHOLESALE	$ 300,000.00	$ 412,562.50	$ 41,937.88	$ -	$ 769,133.76	$ 1,523,634.14
90014597	VP Bus Dev Orig	$ 200,000.00	$ 673,349.01	$ 29,607.19	$ -	$ 618,210.24	$ 1,521,166.44
90005611	DIR ACCOUNTING	$ 49,000.00	$ 1,256,352.46	$ 135,168.08		$ 79,191.78	$ 1,519,712.32
90012890	VP ORIG WHOLESALE	$ 101,610.00	$ 1,025,839.09	$ -	$ -	$ 385,997.66	$ 1,513,446.75
90010113	MD ORIGINATION	$ 450,170.00	$ 499,800.00	$ 244,384.80		$ 300,882.98	$ 1,495,237.78
90012807	MNG DIR CORPORATE DEVL	$ 450,000.00	$ 667,217.20	$ -	$ -	$ 367,528.08	$ 1,484,745.28
90009728	GEN COUNSEL ASST	$ 70,000.00	$ 1,134,015.63	$ 137,943.00		$ 139,457.96	$ 1,481,416.59
90012828	EVP CORP DEVELOPMENT	$ 1,000,000.00	$ -	$ -	$ -	$ 459,804.00	$ 1,459,804.00
90013115	MNG DIR	$ 250,000.00	$ 615,599.12	$ 189,518.00		$ 403,593.89	$ 1,458,711.01

Gis Id	Job Title	Bonus	Stock Options	Restricted Stock	Defered Payout	Other Compensation	Total Compensation
90005925	VP ORIGINATION	$ 210,000.00	$ 1,016,875.04	$ 92,993.63	$ -	$ 134,029.60	$ 1,453,898.27
90014592	VP Orig Wholesale	$ 464,890.95	$ -	$ 233,642.48	$ -	$ 754,475.21	$ 1,453,008.64
90012945	DIR SR	$ 70,000.00	$ 1,228,235.05	$ 69,079.50	$ -	$ 78,591.01	$ 1,445,905.56
90012786	VP SR CORPORATE SOCIAL RESPONSIBILITIES	$ 200,000.00	$ 908,912.40	$ 123,701.88		$ 208,777.02	$ 1,441,391.30
90009916	WHOLESALE	$ 625,000.00	$ 49,857.19	$ 355,366.26		$ 401,156.86	$ 1,431,380.31
90012776	VP Acctg	$ 200,000.00	$ 564,341.13	$ 53,979.75	$ -	$ 612,868.18	$ 1,431,189.06
90008759	DIR HR	$ 53,000.00	$ 1,166,399.38	$ 94,762.13	$ -	$ 109,873.91	$ 1,424,035.42
90010451	MNG DIR CORPORATE DEVL	$ 400,000.00	$ 765,919.55	$ -	$ -	$ 248,785.40	$ 1,414,704.95
90007846	VP DEV ENGR	$ 20,000.00	$ 1,230,069.59	$ -	$ -	$ 160,348.04	$ 1,410,417.63
90010520	MNG DIR PRINCIPAL INVESTMENTS	$ 450,000.00	$ 477,095.50	$ 21,042.00	$ -	$ 446,835.36	$ 1,394,972.86
90009429	DIR NETWORK	$ 65,000.00	$ 1,162,970.88	$ 85,330.13	$ -	$ 68,101.10	$ 1,381,402.11
90009687	MNG DIR & GEN CNSL	$ 250,000.00	$ 216,992.50	$ 18,196.73	$ -	$ 895,661.68	$ 1,380,850.91
90006133	VP TAX ORIGINATION	$ 400,000.00	$ 682,736.38	$ 97,205.05	$ -	$ 198,943.12	$ 1,378,884.55
90008249	DIR CONSTRUCTION	$ 45,000.00	$ 1,149,356.61	$ 75,898.13	$ -	$ 101,788.59	$ 1,372,043.33
90010522	DIR COMM	$ 125,000.00	$ 1,145,410.05	$ -	$ -	$ 96,596.49	$ 1,367,006.54
90041040	MNG DIR	$ 100,000.00	$ -	$ 44,129.77	$ -	$ 1,221,995.81	$ 1,366,125.58
90101014	Wind Employee-UNKNOWN-JOB-TITLE	$ -	$ 1,363,038.60	$ -	$ -	0	$ 1,363,038.60
90010016	VP TRADING	$ 150,000.00	$ 936,863.20	$ 65,756.27	$ -	$ 203,611.50	$ 1,356,230.97
90012889	VP Fed Govt Affairs	$ 200,800.00	$ -	$ -	$ -	$ 1,155,102.17	$ 1,355,902.17
90015601	VP Origination		$ 968,661.52	$ 139,858.88		$ 239,316.62	$ 1,347,837.02
90012961	VP & GEN CNSL	$ 125,000.00	$ 989,279.61	$ 45,667.80	$ -	$ 179,822.82	$ 1,339,770.23
90009950	SR VICE PRESIDENT	$ 200,000.00	$ 975,422.30	$ -	$ -	$ 156,523.42	$ 1,331,945.72
90012976	VP ORIG WHOLESALE	$ 40,000.00	$ 657,435.61	$ 140,900.00		$ 489,280.82	$ 1,327,616.43
90012755	VICE PRESIDENT & ORIGINATION	$ 200,000.00	$ 240,873.75	$ 208,471.03		$ 667,933.15	$ 1,317,277.93
90014564	DIR OPS RISK MGMT	$ 13,000.00	$ 1,084,492.39	$ -	$ -	$ 204,262.08	$ 1,301,754.47
90008466	VP HR	$ 150,000.00	$ 880,188.55	$ 39,931.00	$ -	$ 230,676.06	$ 1,300,795.61
90015832	DIR OUTSIDE PLANT ENGR	$ 34,500.00	$ 1,084,767.02	$ 75,898.13	$ -	$ 103,712.25	$ 1,298,877.40
90008230	DIR ENG SOFTWARE	$ 35,000.00	$ 1,003,679.31	$ 142,216.88		$ 117,614.81	$ 1,298,511.00
90041638	SOLAR	$ -	$ 1,231,822.70	$ -	$ 56,260.33	$ 8,963.44	$ 1,297,046.47
90009608	VP & Gen Counsel	$ 190,000.00	$ 332,956.50	$ 157,678.85		$ 612,555.94	$ 1,293,191.29
90012812	VP	$ 50,000.00	$ 1,013,941.16	$ 88,133.50	$ -	$ 129,798.06	$ 1,281,872.72
90036324	VICE CHAIRMAN	$ -	$ 1,050,017.62	$ -	$ 197,855.65	$ 27,798.61	$ 1,275,671.88
90010465	VP SOUTHERN DIVISION	$ 5,000.00	$ 1,018,062.20	$ -	$ -	$ 246,736.47	$ 1,269,798.67

Note: Total compensation has been reported from SAP (current payroll system). The restricted stock does contain any dividends actually paid.

Note: Total compensation value excludes any option gains from Enron Oil and Gas stock grants made to former EOG employees which were not converted to ENE stock tracked in Enron Corp.'s stock tracking system.

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JOINT COMMITTEE ON TAXATION - QUESTION #13 - YEAR OF 2001

GIS ID	Job Title	Bonus	Stock Options	Restricted Stock	Deferred Payout	Other Compensation	Total Compensation
90013026	VICE PRESIDENT, COMMERCIAL	$ 0	$ 2,269,953.00	$ 0	$ 0	$ 0	$ 2,269,953.00
90012898	MNG DIR TRADING *	$ 4,175,000.00	$ 697,934.94	$ 126,027.38	$ 2,876,276.76	$ 511,077.60	$ 8,386,316.68
90012742	VP TRADING	$ 8,650,000.00	$ 0	$ 630,136.88	$ 0	$ 459,301.20	$ 9,739,438.08
90013038	VP TRADING *	$ 800,000.00	$ 126,944.87	$ 206,200.69	$ 132,142.94	$ 236,587.02	$ 1,501,875.52
90138522	VP TRADING	$ 625,000.00	$ 0	$ 227,507.24	$ 0	$ 646,728.84	$ 1,499,236.08
90012772	CHIEF OPERATING OFFICER	$ 540,751.00	$ 4,046,156.60	$ 1,197,330.00	$ 0	$ 1,420,513.77	$ 7,204,751.37
90012905	STRATEGY OFFICER (1)*	$ 2,000,000.00	$ 6,680,543.64	$ 3,942,713.89	$ 1,295,737.50	$ 1,810,297.77	$ 15,729,292.80
90012877	MANAGING DIRECTOR	$ 0	$ 385,108.58	$ 48,189.26	$ 750,992.71	$ 1,367,909.69	$ 2,552,200.24
90012875	MANAGING DIRECTOR	$ 0	$ 1,484,141.25	$ 0	$ 684,693.92	$ 0	$ 2,168,835.17
90013015	MNG DIR TRADING *	$ 5,449,999.00	$ 953,136.20	$ 157,569.19	$ 2,144,012.87	$ 212,382.32	$ 8,917,099.58
90008694	VP HR	$ 0	$ 0	$ 569,375.15	$ 0	$ 723,706.88	$ 1,293,082.03
90013094	MNG DIR E-COMMERCE	$ 0	$ 1,624,396.31	$ 869,220.02	$ 0	$ 202,250.25	$ 2,695,866.58
90009916	MNG DIR ORIG WHOLESALE *	$ 430,250.46	$ 0	$ 659,248.87	$ 0	$ 665,090.33	$ 1,754,589.66
90013114	REGION *	$ 180,250.46	$ 15,456,289.78	$ 2,604,490.03	$ 0	$ 862,692.69	$ 19,103,722.96
90012894	PRESIDENT & CEO	$ 1,425,000.00	$ 403,374.00	$ 378,082.13	$ 0	$ 557,833.50	$ 2,764,289.63
90010334	MGMT	$ 850,000.00	$ 765,312.50	$ 189,041.06	$ 0	$ 1,081,998.29	$ 2,886,351.85
90012755	ORIGINATION *	$ 725,000.00	$ 520,818.75	$ 294,208.51	$ 1,103,348.93	$ 493,710.81	$ 3,137,087.00
90010084	VP TRADING	$ 0	$ 1,358,453.20	$ 141,833.25	$ 0	$ 523,504.31	$ 2,023,790.76
90010449	OFFICER	$ 1,350,000.00	$ 0	$ 252,054.75	$ 0	$ 944,652.46	$ 2,546,707.21
90012954	VP EQUITY TRADING	$ 1,250,000.00	$ 258,671.40	$ 504,109.50	$ 0	$ 139,281.46	$ 2,152,062.36
90010011	VP ORIG WHOLESALE *	$ 0	$ 549,687.00	$ 169,905.60	$ 256,123.25	$ 233,726.60	$ 1,209,442.45
90009788	MNG DIR FIN	$ 625,000.00	$ 45,529.32	$ 141,833.25	$ 196,077.11	$ 565,077.02	$ 1,573,516.70
90010273	OFFICER EES NORTH AM	$ 500,000.00	$ 825,463.80	$ 189,041.06	$ 0	$ 542,901.26	$ 2,057,406.12
90012733	MNG DIR & CONTROLLER	$ 750,000.00	$ 0	$ 417,618.75	$ 0	$ 590,876.32	$ 1,758,495.07
90012951	EVP CHIEF RISK OFFICER *	$ 900,000.00	$ 2,542,812.94	$ 901,656.94	$ 649,583.52	$ 1,507,041.38	$ 6,501,094.78
90009986	MNG DIR ORIG WHOLESALE	$ 1,250,000.00	$ 0	$ 126,027.38	$ 0	$ 617,694.37	$ 1,993,721.75
90013062	VP ORIG WHOLESALE	$ 0	$ 1,144,070.04	$ 13,972.50	$ 0	$ 107,394.04	$ 1,265,436.58
90012756	EVP CHIEF ACCTG OFFICER *	$ 1,000,000.00	$ 0	$ 2,502,062.63	$ 0	$ 1,072,411.56	$ 4,574,474.19
90013030	MD PORTFOLIO ORIGINATION *	$ 125,000.00	$ 0	$ 0	$ 721,916.37	$ 715,126.55	$ 1,562,042.92
90012774	CO CEO	$ 0	$ 5,127,155.38	$ 950,730.38	$ 0	$ 89,231.52	$ 6,167,117.28
90013092	VP IT DEV	$ 100,000.00	$ 0	$ 1,109,820.06	$ 0	$ 192,776.87	$ 1,402,596.93
90013115	MNG DIR *	$ 500,000.00	$ 0	$ 472,567.69	$ 0	$ 718,036.85	$ 1,690,604.54
90010049	MNG DIR ACCTG *	$ 1,200,000.00	$ 0	$ 704,191.14	$ 27,610.46	$ 389,594.62	$ 2,321,396.22
90014531	PRESIDENT NPNG *	$ 250,000.00	$ 651,850.00	$ 386,335.13	$ 0	$ 625,496.74	$ 1,913,681.87
90010482	MD ENERGY PORTFOLIO MGMT *	$ 800,000.00	$ 117,550.81	$ 378,082.13	$ 0	$ 297,755.58	$ 1,593,388.52
90013101	VP ORIGINATION *	$ 125,000.00	$ 1,744,625.00	$ 507,545.11	$ 0	$ 261,263.42	$ 2,638,433.53
90012943	VP GOV/REG AFFAIRS	$ 50,000.00	$ 785,742.10	$ 52,532.04	$ 0	$ 581,964.56	$ 1,470,238.70
90009779	VP TRADING	$ 2,150,000.00	$ 21,735.94	$ 63,013.69	$ 0	$ 354,984.30	$ 2,589,733.93
90012748	MANAGING DIRECTOR, IT	$ 350,000.00	$ 179,215.00	$ 47,277.75	$ 0	$ 599,863.54	$ 1,176,356.29
90014854	MD TREASURY	$ 625,000.00	$ 17,378.46	$ 141,833.25	$ 0	$ 544,118.71	$ 1,328,330.42
90013064	CHAIRMAN & CEO	$ 3,000,000.00	$ 2,291,113.33	$ 1,323,147.56	$ 0	$ 1,667,317.84	$ 8,281,578.73
90012915	EVP GEN COUNSEL *	$ 800,000.00	$ 6,843,401.40	$ 1,787,380.13	$ 0	$ 985,231.88	$ 10,416,013.41
90013020	MNG DIR CORPORATE DEVL *	$ 425,000.00	$ 2,027,865.27	$ 315,068.44	$ 887,142.24	$ 627,182.60	$ 4,282,258.55
90012842	PRESIDENT EES	$ 600,000.00	$ 1,550,019.00	$ 315,068.44	$ 0	$ 810,316.19	$ 3,275,403.63
90010526	MD CORP DEV	$ 1,125,000.00	$ 8,191,755.42	$ 126,027.38	$ 0	$ 958,344.75	$ 10,401,127.55

JOINT COMMITTEE ON TAXATION - QUESTION #13 - YEAR OF 2001

GIS ID	Job Title	Bonus	Stock Options	Restricted Stock	Deferred Payout	Other Compensation	Total Compensation
90010451	MNG DIR CORPORATE DEVL	$ 800,000.00	$ 0	$ 315,068.44	$ 0	$ 278,647.88	$ 1,393,716.32
90010014	VP ORIGINATION	$ 200,000.00	$ 1,340,974.12	$ 223,899.26	$ 0	$ 167,605.47	$ 1,932,478.85
90043798	VP ORIGINATION	$ 100,000.00	$ 1,163,979.35	$ 184,061.78	$ 0	$ 411,806.43	$ 1,859,847.56
90010305	MNG DIR ORIG WHOLESALE	$ 750,000.00	$ 1,451,869.37	$ 189,041.06	$ 0	$ 1,317,277.74	$ 3,708,188.17
90010160	MD ORIGINATION	$ 200,000.00	$ 601,438.00	$ 407,502.73	$ 0	$ 2,452,248.12	$ 3,661,188.85
90010507	MANAGING DIRECTOR COMMERCIAL *	$ 350,000.00	$ 2,865,344.00	$ 1,788,390.78	$ 0	$ 1,489,099.52	$ 6,492,834.30
90012982	VP TRANSACTION ACCOUNTING	$ 600,000.00	$ 153,293.58	$ 98,156.38	$ 0	$ 394,585.52	$ 1,246,035.48
90012698	PRESIDENT & CEO	$ 2,900,000.00	$ 940,256.57	$ 1,392,141.88	$ 0	$ 684,541.98	$ 5,916,940.43
90005649	EVP & CHIEF FINANCIAL OFFICER *	$ 1,300,000.00	$ 0	$ 1,794,411.91	$ 0	$ 2,394,150.03	$ 5,488,561.94
90010080	MNG DIR E-COMMERCE	$ 350,000.00	$ 664,460.55	$ 956,774.74	$ 0	$ 894,803.20	$ 2,866,038.49
90012712	VICE CHAIRMAN *	$ 2,000,000.00	$ 0	$ 4,188,666.79	$ 6,426,990.07	$ 7,912,989.56	$ 20,528,646.42
90010025	VP ASSET DEV *	$ 100,000.00	$ 691,133.36	$ 110,291.44	$ 148,781.34	$ 895,777.35	$ 1,945,983.49
90010236	MD ENRON DIRECT USA	$ 425,000.00	$ 83,236.83	$ 235,369.81	$ 73,121.74	$ 354,108.53	$ 1,170,836.91
90010520	MNG DIR PRINCIPAL INVESTMENTS	$ 910,000.00	$ 636,246.24	$ 259,906.96	$ 0	$ 598,355.41	$ 2,404,508.61
90010458	Unknown	$ 300,000.00		$ 271,077.75		$ 573,569.38	$ 1,144,647.13
90010529	MNG DIR ASSET BUS DEV *	$ 0	$ 1,669,861.06	$ 264,012.63	$ 0	$ 697,419.18	$ 2,631,292.87
90040993	EOTT-UNKNOWN-JOB-TITLE	$ 0	$ 2,218,274.50	$ 0	$ 504,610.40	$ 461,912.00	$ 3,184,796.90
90010128	MANAGING DIRECTOR & TREASURER	$ 800,000.00	$ 384,727.85	$ 393,818.06	$ 0	$ 328,674.43	$ 1,907,220.34
90009800	MANAGING DIRECTOR COMMERCIAL	$ 900,000.00	$ 243,714.56	$ 441,095.81	$ 0	$ 1,415,358.06	$ 3,000,168.43
90009937	VP ORIG WHOLESALE *	$ 600,000.00	$ 91,626.00	$ 110,291.44	$ 739,733.70	$ 1,810,989.07	$ 3,352,640.21
90013008	VP *	$ 400,000.00	$ 0	$ 201,862.47	$ 270,903.63	$ 697,764.77	$ 1,570,530.87
90010078	VP TRADING	$ 3,505,000.00	$ 84,108.75	$ 0	$ 0	$ 153,040.38	$ 3,742,149.13
90010523	VP E-COMMERCE	$ 350,000.00	$ 270,260.00	$ 452,622.08	$ 0	$ 545,061.48	$ 1,617,943.56
90012731	MNG DIR & GEN COUNSEL *	$ 1,200,000.00	$ 608,750.00	$ 524,169.31	$ 2,187,473.30	$ 1,363,143.68	$ 5,883,536.29
90013080	CEO *	$ 1,500,000.00	$ 0	$ 853,063.87	$ 0	$ 2,328,360.03	$ 4,681,423.90
90015631	VP ORIGINATION *	$ 125,000.00	$ 1,038,182.24	$ 212,712.37	$ 0	$ 205,430.99	$ 1,581,325.60
90012828	EVP CORP DEVELOPMENT	$ 5,541,378.00	$ 0	$ 2,217,298.50	$ 0	$ 553,301.59	$ 8,311,978.09
90005448	MANAGING DIRECTOR ETS FINANCE & ACCTG	$ 800,000.00	$ 0	$ 346,662.75	$ 0	$ 363,038.38	$ 1,509,701.13
90013076	VP	$ 0	$ 1,802,963.66	$ 0	$ 105,459.64	$ 439,818.23	$ 2,348,241.53
90012803	MNG DIR AND GENERAL TAX COUNSEL	$ 700,000.00	$ 187,500.00	$ 480,632.44	$ 60,218.70	$ 827,102.42	$ 2,255,453.56
90010330	VP TRADING	$ 1,400,000.00	$ 37,650.00	$ 126,027.38	$ 0	$ 254,902.96	$ 1,818,580.34
90012970	MNG DIR TRADING	$ 1,700,000.00	$ 0	$ 441,095.81	$ 0	$ 282,228.12	$ 2,423,323.93
90010519	VP PRINCIPAL INVESTMENTS	$ 100,000.00	$ 1,942,956.25	$ 74,413.50	$ 0	$ 203,396.18	$ 2,320,765.93
90010534	VP BUS DEV *	$ 185,000.00	$ 420,343.15	$ 153,685.50	$ 262,170.58	$ 280,166.88	$ 1,301,366.11
90008795	VP FED GOVT AFFAIRS	$ 0	$ 7,569,392.13	$ 354,820.01	$ 0	$ 462,168.98	$ 8,386,381.12
90013081	CHMN & CEO	$ 0	$ 18,463,224.00	$ 0	$ 10,258.53	$ 0	$ 18,473,482.53
90014592	VP Orig Wholesale *	$ 220,000.00	$ 363,587.36	$ 311,580.42	$ 0	$ 1,205,629.02	$ 2,100,796.80
90010182	VP E-COMMERCE	$ 0	$ 889,152.63	$ 315,068.44	$ 0	$ 797,765.65	$ 2,001,986.72
90007829	CHAIRMAN & CEO *	$ 1,200,000.00	$ 3,695,818.62	$ 2,046,078.94	$ 3,131,860.34	$ 1,194,830.08	$ 11,268,587.98
90005648	CHIEF OPERATING OFFICER	$ 1,100,000.00	$ 754,966.29	$ 363,428.25	$ 0	$ 274,242.86	$ 2,492,637.40
90013044	CHAIRMAN & CEO ENRON INVESTMENT PARTNERS *	$ 200,000.00	$ 1,930,561.96	$ 0	$ 3,037,723.10	$ 1,833,176.14	$ 7,001,461.20
90014824	PRES & CEO E&C	$ 0	$ 1,967,435.00	$ 3,654,807.62	$ 0	$ 1,797,096.92	$ 7,419,339.54
90014598	VP ORIGINATION *	$ 0	$ 690,294.64	$ 603,636.09	$ 0	$ 344,254.53	$ 1,638,185.26
90008748	MNG DIR HR *	$ 525,000.00	$ 133,896.25	$ 47,277.75	$ 185,494.37	$ 202,908.00	$ 1,094,576.37

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GIS ID	Job Title	Bonus	Stock Options	Restricted Stock	Deferred Payout	Other Compensation	Total Compensation
90008466	VP HR *	$ 600,000.00	$ 304,279.18	$ 173,331.38	$ 192,570.48	$ 406,785.60	$ 1,676,966.64
90012910	MNG DIR RESEARCH	$ 250,000.00	$ 850,009.97	$ 126,027.38	$ 0	$ 756,782.48	$ 1,982,819.83
90012985	EVP CHIEF OF STAFF	$ 1,000,000.00	$ 2,022,048.42	$ 4,131,593.94	$ 0	$ 711,083.80	$ 7,864,726.16
90009925	MNG DIR FIN *	$ 580,250.46	$ 0	$ 1,034,346.30	$ 0	$ 760,110.00	$ 2,374,706.76
90104420	CHIEF OPERATING OFFICER (2)	$ 3,100,000.00	$ 0	$ 462,947.29	$ 0	$ 470,294.03	$ 4,033,241.32
90012797	EVP INVESTOR REL	$ 700,000.00	$ 671,736.66	$ 1,248,317.68	$ 0	$ 761,825.02	$ 3,381,879.36
90013100	VP ORIGINATION (3) *	$ 150,000.00	$ 856,657.78	$ 781,598.68	$ 0	$ 683,060.17	$ 2,471,316.63
90010127	MGR DIR FIN	$ 800,000.00	$ 0	$ 985,032.02	$ 0	$ 1,691,959.73	$ 3,476,991.75
90106466	CONVERSION EXEMPT	$ 0	$ 0	$ 0	$ 24,538.79	$ 2,070,893.03	$ 2,095,431.82
90012831	VP TRADING	$ 575,000.00	$ 2,248,308.80	$ 0	$ 0	$ 878,637.67	$ 3,701,946.47
90009922	VP BUS DEV ORIG *	$ 667,124.15	$ 221,909.63	$ 261,696.70	$ 0	$ 558,857.75	$ 1,709,588.23
90012745	PRESIDENT & CEO	$ 8,000,000.00	$ 4,158,995.24	$ 1,008,149.06	$ 0	$ 2,380,483.42	$ 15,547,627.72
90012923	CHAIRMAN OF THE BOARD & CEO *	$ 7,000,000.00	$ 29,424,066.79	$ 14,761,694.44	$ 186,001.53	$ 4,902,598.22	$ 56,274,360.98
90013098	VP ENG	$ 100,000.00	$ 699,586.02	$ 472,009.33	$ 0	$ 205,951.39	$ 1,477,546.74
90010192	CHIEF OPERATING OFFICER	$ 1,000,000.00	$ 0	$ 360,527.81	$ 0	$ 1,662,728.74	$ 3,023,256.55
90010434	VP ANALYST/ASSOCIATE PROGRAM *	$ 200,000.00	$ 775,609.65	$ 63,013.69	$ 233,968.80	$ 445,497.32	$ 1,718,089.46
90013109	MNG DIR BUS RISK MGMT & IT COMPL	$ 200,000.00	$ 2,549,361.18	$ 514,847.19	$ 204,075.19	$ 413,435.81	$ 3,881,719.37
90009920	VP ORIG WHOLESALE	$ 1,110,000.00	$ 9,099.97	$ 282,060.85	$ 0	$ 113,776.25	$ 1,514,937.07
90014605	MANAGING DIRECTOR ETS OPERATIONS *	$ 400,000.00	$ 372,204.69	$ 153,685.50	$ 531,925.62	$ 303,437.62	$ 1,761,253.43
90012950	COO ENRON METALS *	$ 300,000.00	$ 204,967.50	$ 189,041.06	$ 0	$ 779,046.51	$ 1,473,055.07
90012864	VP COMMODITY STRUCT	$ 100,000.00	$ 1,057,051.08	$ 270,622.25	$ 0	$ 35,849.12	$ 1,463,522.45
90010437	MNG DIR	$ 575,000.00	$ 655,525.99	$ 154,081.38	$ 0	$ 570,753.50	$ 1,955,360.87
90012861	MNG DIR-AZURIX CORP	$ 0	$ 1,833,743.00	$ 0	$ 85,430.02	$ 4,820,160.18	$ 6,739,333.20
90013063	VP TRADING *	$ 1,600,000.00	$ 1,656,468.40	$ 94,555.50	$ 1,195,834.63	$ 507,897.53	$ 5,054,756.06
90006133	VP TAX ORIGINATION *	$ 800,000.00	$ 244,017.28	$ 315,068.44	$ 693,826.71	$ 203,943.12	$ 2,256,855.55
90012713	MNG DIR & CHIEF COMMERCIAL OFFICER	$ 525,000.00	$ 0	$ 94,555.50	$ 0	$ 1,778,960.43	$ 2,398,515.93
90013000	MNG DIR TRADING	$ 950,000.00	$ 506,764.53	$ 441,095.81	$ 0	$ 264,062.62	$ 2,161,922.96
90009324	CHAIRMAN & CEO	$ 1,100,000.00	$ 784,642.63	$ 1,478,268.94	$ 0	$ 919,499.86	$ 4,282,411.43
90012946	CHAIRMAN & CEO	$ 600,000.00	$ 757,300.64	$ 934,065.39	$ 0	$ 845,201.12	$ 3,136,567.15
90012816	VP ASSET BUS DEV	$ 224,653.14	$ 0	$ 137,150.42	$ 0	$ 975,829.82	$ 1,337,633.38
90013027	PRESIDENT AND COO	$ 2,600,000.00	$ 1,104,053.59	$ 558,800.63	$ 0	$ 1,456,915.77	$ 5,719,769.99
90012807	MNG DIR CORPORATE DEVL	$ 600,000.00	$ 0	$ 585,061.75	$ 0	$ 366,653.08	$ 1,551,714.83
90009877	PRESIDENT CITRUS *	$ 310,000.00	$ 493,489.08	$ 462,384.47	$ 1,848,226.60	$ 461,446.44	$ 3,575,546.59
90010167	VP FINANCE *	$ 130,000.00	$ 545,483.30	$ 126,027.38	$ 0	$ 547,535.07	$ 1,349,045.75
90006189	MNG DIR CORP TAX	$ 500,000.00	$ 741,169.68	$ 126,027.38	$ 0	$ 529,873.76	$ 1,897,070.82
90013103	VP ORIG WHOLESALE	$ 250,000.00	$ 584,440.53	$ 126,027.38		$ 156,812.38	$ 1,117,280.29
90010469	VP ORIG WHOLESALE *	$ 225,000.00	$ 231,291.25	$ 141,833.25	$ 191,239.21	$ 380,397.15	$ 1,169,760.86
90010274	EVP CORP DEVELOPMENT *	$ 1,100,000.00	$ 817,140.50	$ 360,527.81	$ 842,924.48	$ 1,977,697.44	$ 5,098,290.23
90012995	VP COMM	$ 350,000.00	$ 258,061.65	$ 131,964.08	$ 0	$ 620,183.22	$ 1,360,208.95
90012691	MNG DIR LEGAL	$ 400,000.00	$ 400,477.50	$ 196,983.38	$ 60,401.79	$ 355,414.08	$ 1,413,276.75
90012895	VP TRADING	$ 725,000.00	$ 868,237.75	$ 429,510.08	$ 815,991.07	$ 515,678.02	$ 3,354,416.92
90013087	Unknown	$ 75,000.00	$ 601,813.55			$ 428,113.83	$ 1,104,927.38
90012939	CEO *	$ 550,000.00	$ 0	$ 463,260.54	$ 779,427.18	$ 124,533.60	$ 1,917,221.32
90012834	VP TRADING *	$ 875,000.00	$ 619,238.75	$ 315,068.44	$ 22,392.84	$ 636,527.42	$ 2,468,227.45
90012767	EVP HR & COMMUNITY REL	$ 750,000.00	$ 270,154.55	$ 969,729.38	$ 77,715.90	$ 429,082.08	$ 2,496,681.91

JOINT COMMITTEE ON TAXATION - QUESTION #13 - YEAR OF 2001

GIS ID	Job Title	Bonus	Stock Options	Restricted Stock	Deferred Payout	Other Compensation	Total Compensation
90013069	MNG DIR ORIG WHOLESALE	$ 0	$ 5,266,577.50	$ 2,041,016.07	$ 0	$ 207,729.32	$ 7,515,322.89
90012824	VP ASSET BUS DEV (4)	$ 50,000.00	$ 1,296,879.13	$ 31,541.81	$ 0	$ 328,146.48	$ 1,706,567.42
90014640	VP ASSET MGMT	$ 530,000.00	$ 283,666.03	$ 126,027.38		$ 173,785.92	$ 1,113,479.33
90012793	CHAIRMAN AND C.E.O.ENRON XCELERATOR	$ 1,000,000.00	$ 15,364,180.39	$ 8,453,763.00	$ 0	$ 691,875.60	$ 25,509,818.99
90008839	MNG DIR CORP MKTG COMM & ADM	$ 600,000.00	$ 111,219.60	$ 278,540.32	$ 91,167.51	$ 226,249.36	$ 1,307,176.79
90010163	VP ORIG WHOLESALE *	$ 600,000.00	$ 94,388.20	$ 126,027.38	$ 319,589.74	$ 206,537.04	$ 1,346,542.36
90010278	VP Enron Facilities Services *	$ 161,000.00	$ 486,882.36	$ 0	$ 841,759.06	$ 205,757.84	$ 1,695,399.26
90013007	PRESIDENT & CEO *	$ 900,000.00	$ 880,290.01	$ 409,554.00	$ 1,139,791.50	$ 842,584.56	$ 4,172,220.07
90012751	VICE PRESIDENT ORIGINATION *	$ 75,000.00	$ 1,115,751.35	$ 502,146.22	$ 199,803.57	$ 209,869.54	$ 2,102,570.68
90013111	VP SR LIQUIDS OPERATIONS *	$ 165,000.00	$ 886,231.25	$ 208,809.38	$ 564,347.60	$ 481,370.90	$ 2,305,759.13
90013041	VP TRADING	$ 2,500,000.00	$ 273,607.50	$ 157,569.19	$ 0	$ 429,642.24	$ 3,360,818.93
90012968	VP TRADING ORIG	$ 100,000.00	$ 1,297,800.00	$ 166,522.13	$ 0	$ 1,360,768.35	$ 2,925,090.48
90012699	VP TRADING *	$ 800,000.00	$ 510,179.04	$ 642.00	$ 154,193.26	$ 399,759.24	$ 1,864,773.54
90013001	VP ORIG WHOLESALE	$ 733,334.00	$ 186,986.20	$ 126,027.38	$ 0	$ 179,056.39	$ 1,225,403.97
90009944	MNG DIR ASSET DEV	$ 880,250.46	$ 7,509,039.03	$ 381,284.61	$ 351,775.13	$ 210,787.36	$ 9,333,136.59
90010370	MNG DIR	$ 255,000.00	$ 342,341.35	$ 157,569.19	$ 57,071.93	$ 931,979.72	$ 1,743,962.19
90012935	MNG DIR DEV ENG *	$ 100,000.00	$ 3,322,867.95	$ 61,218.99	$ 51,365.07	$ 417,002.66	$ 3,952,454.67
90006104	VP TAX *	$ 375,000.00	$ 353,375.00	$ 126,027.38	$ 181,646.92	$ 185,264.20	$ 1,221,313.50
90013079	CHAIRMAN & CEO *	$ 1,750,000.00	$ 13,962,665.49	$ 2,748,363.60	$ 0	$ 2,107,241.64	$ 20,568,270.73
90012836	VP E-COMMERCE	$ 200,000.00	$ 1,255,067.33	$ 126,027.38	$ 0	$ 186,082.80	$ 1,767,177.51
90009781	DIR TRADING	$ 1,920,000.00	$ 0	$ 0	$ 0	$ 131,491.04	$ 2,051,491.04
90012796	MD CORPORATE SECRETARY	$ 700,000.00	$ 1,635,237.52	$ 283,649.06	$ 214,678.36	$ 250,909.00	$ 3,084,473.94
90138513	VP TRADING	$ 250,000.00	$ 0	$ 302,193.50	$ 0	$ 1,482,158.94	$ 2,034,352.44
90012913	VP & ASSOC GEN COUNSEL	$ 695,000.00	$ 0	$ 342,779.06	$ 0	$ 598,067.67	$ 1,635,846.73
90010527	VP TRADING *	$ 1,011,456.92	$ 0	$ 226,229.25	$ 635,028.84	$ 175,471.83	$ 2,048,186.84
90010028	VP ORIG WHOLESALE	$ 350,000.00	$ 310,224.19	$ 63,014.19	$ 0	$ 883,400.57	$ 1,606,638.95
90009918	MNG DIR FIN	$ 575,000.00	$ 0	$ 141,833.25	$ 0	$ 456,413.59	$ 1,173,246.84
90012907	VP TRADING	$ 490,000.00	$ 836,189.05	$ 323,554.43	$ 0	$ 758,272.22	$ 2,408,015.70
90012889	VP ORIG WHOLESALE *	$ 250,000.00	$ 326,459.00	$ 94,555.50	$ 468,331.86	$ 448,923.76	$ 1,588,270.12
90014932	VP HPL *	$ 1,150,000.00	$ 1,142,373.40	$ 63,013.69	$ 498,334.30	$ 263,111.62	$ 3,116,833.01
90010026	VP ORIGINATION *	$ 600,000.00	$ 89,203.13	$ 157,499.25	$ 142,493.92	$ 576,187.72	$ 1,565,384.02
90015590	VP ORIGINATION	$ 350,000.00	$ 697,292.29	$ 887,333.86	$ 0	$ 288,848.42	$ 2,223,474.57
90012741	CHIEF OPERATING OFFICER	$ 2,000,000.00	$ 1,441,898.44	$ 630,136.88	$ 0	$ 863,431.24	$ 4,935,466.56
90012988	MNG DIR GOVT AFFAIRS	$ 650,000.00	$ 607,837.13	$ 379,163.97	$ 12,687.19	$ 269,880.20	$ 1,919,568.49
90010239	MNG DIR *	$ 142,000.00	$ 0	$ 94,555.50	$ 0	$ 1,429,455.52	$ 1,666,011.02
90009687	MNG DIR & GEN CNSL	$ 600,000.00	$ 281,073.21	$ 213,063.34	$ 187,468.95	$ 674,366.96	$ 1,955,972.46
90010502	MNG DIR E-COMMERCE	$ 200,000.00	$ 1,624,396.31	$ 869,220.02	$ 0	$ 194,412.66	$ 2,888,028.99
90015541	CEO *	$ 717,500.00	$ 0	$ 405,999.10	$ 435,601.66	$ 365,792.76	$ 1,924,893.52
90012851	PRESIDENT &CEO	$ 1,500,000.00	$ 1,835,557.63	$ 1,293,424.13	$ 0	$ 2,963,976.08	$ 7,592,957.84
90013128	VP Asset Bus Dev	$ 280,250.46	$ 0	$ 157,070.00	$ 654,509.68	$ 240,779.68	$ 1,332,609.82
90012897	VP TRADING	$ 3,000,000.00	$ 348,204.15	$ 126,027.38	$ 0	$ 175,577.04	$ 3,649,808.57
90012759	PRESIDENT AND COO	$ 5,600,000.00	$ 0	$ 6,843,672.44	$ 0	$ 2,958,891.03	$ 15,402,563.47
90012969	DIRECTOR COMMERCIAL *	$ 80,000.00	$ 0	$ 0	$ 0	$ 1,283,675.34	$ 1,363,675.34
90009993	MANAGING DIRECTOR	$ 500,000.00	$ 0	$ 511,733.91	$ 0	$ 629,158.90	$ 1,640,892.81
90012966	VP COMM *	$ 500,000.00	$ 81,914.00	$ 152,421.38	$ 208,093.30	$ 759,841.88	$ 1,702,270.56
90012959	VP CORPORATE DEVELOPMENT *	$ 0	$ 0	$ 0	$ 3,597,332.50	$ 669,056.23	$ 4,266,388.73

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JOINT COMMITTEE ON TAXATION - QUESTION #13 - YEAR OF 2001

GIS ID	Job Title	Bonus	Stock Options	Restricted Stock	Deferred Payout	Other Compensation	Total Compensation
90012896	VP TRADING	$ 2,750,000.00	$ 234,423.93	$ 126,027.38	$ 0	$ 175,645.68	$ 3,286,096.99
90010064	MNG DIR TRADING	$ 100,000.00	$ 1,362,375.43	$ 0	$ 181,992.53	$ 706,858.09	$ 2,351,226.05
90009796	PRESIDENT & CEO	$ 700,000.00	$ 0	$ 698,919.89	$ 0	$ 821,868.24	$ 2,220,788.13
90000308	VP TRADING *	$ 4,600,000.00	$ 61,789.90	$ 0	$ 2,049,325.93	$ 617,331.42	$ 7,328,447.25
90009940	MNG DIR CORP DEVE	$ 600,000.00	$ 3,181,250.00	$ 563,798.25	$ 227,449.22	$ 265,938.88	$ 4,838,436.35
90012844	VP ORIG WHOLESALE	$ 0	$ 946,836.80	$ 248,258.56	$ 0	$ 325,797.54	$ 1,520,892.90
90012942	MNG DIR ORIG WHOLESALE	$ 0	$ 4,452,475.50	$ 110,824.40	$ 16,585.76	$ 822,262.66	$ 5,402,148.32
90008693	MNG DIR CORP MKTG COMM & ADM *	$ 300,000.00	$ 0	$ 576,791.94	$ 0	$ 674,991.09	$ 1,551,783.03
90009923	VP CORPORATE DEVELOPMENT *	$ 160,000.00	$ 1,116,514.08	$ 0	$ 276,352.37	$ 410,278.55	$ 1,963,145.00
90012914	EVP GEN COUNSEL	$ 1,390,751.37	$ 4,346,544.31	$ 992,231.44	$ 0	$ 357,696.64	$ 7,087,223.76
90010111	MNG DIR GLOBAL STRATEGIC SOURCING *	$ 325,000.00	$ 1,668,259.82	$ 388,167.25	$ 831,299.01	$ 462,228.26	$ 3,674,954.34
90016147	VP EXPLORATION	$ 235,000.00	$ 0	$ 135,979.36	$ 0	$ 1,477,406.98	$ 1,848,386.34
90013019	PRESIDENT AND COO	$ 3,300,000.00	$ 3,282,959.77	$ 2,796,176.69	$ 0	$ 1,348,153.02	$ 10,727,289.48
90012852	EES VICE CHAIRMAN	$ 450,000.00	$ 1,297,049.18	$ 13,847,073.87	$ 0	$ 1,275,358.71	$ 16,869,481.76
90010374	VP GAS LOGISTICS *	$ 50,000.00	$ 1,201,682.48	$ 31,541.51	$ 0	$ 58,788.42	$ 1,342,012.41
90014597	VP	$ 400,000.00	$ 195,148.98	$ 252,074.44	$ 174,080.32	$ 653,581.87	$ 1,674,885.61
90010476	MD TRADING	$ 0	$ 8,308,552.00	$ 3,576,206.18	$ 0	$ 288,591.14	$ 12,173,349.32
90009608	VP & GEN COUNSEL	$ 150,000.00	$ 1,595,564.65	$ 454,740.01	$ 0	$ 266,955.90	$ 2,467,260.56
90010290	VP ORIG WHOLESALE	$ 500,000.00	$ 824,616.14	$ 126,027.38	$ 0	$ 1,909,177.71	$ 3,359,821.23

(1) Total compensation does not reflect consulting fees in the amount of $1,860.000 pursuant to post-employment Consutling Agreement.
(2) Also includes compensation paid on the UK payroll of $152,078.18.
(3) Also includes $40,000 for salary paid from the UK payroll.
(4) Also includes compensation paid on the UK payroll of $263,311.57.

* Gross compensation does not reflect deferral, therefore, someone who defers during 2001 who received a payout from a deferral compensation arrangement m the same earning reflected twice.

Note: Total compensation has been reported from SAP (current payroll system). The restricted stock does contain any dividends actually paid.

Note: Total compensation value excludes any option gains from Enron Oil and Gas stock grants made to former EOG employees which were not converted to ENE stock tracked in Enron Corp.'s stock tracking system.

Note: Due to an IRS audit and an internal audit currently being done, a W-2 C maybe be issued due to changes noted from these audits.

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VII. MATERIALS RELATING TO PRE-BANKRUPTCY BONUSES

Formatted Name	Job Group Name	Retention Amount
ABEL, CHRISTOPHER B	MANAGER	15,000
ADAMIK, DARREN P	MANAGER	16,000
ADAMS, GREGORY	VICE PRESIDENT	100,000
ADAMS, THOMAS G	DIRECTOR	50,000
ALLEN, PHILLIP K	MANAGING DIRECTOR	675,000
ALLEN, THRESA A	DIRECTOR	50,000
ALONSO, THOMAS	DIRECTOR	250,000
AMES, CHARLES H	ANALYST	25,000
ANDREWS, NAVEEN C	DIRECTOR	60,000
APKE, BETH A	SENIOR DIRECTOR	60,000
APOLLO, BETH W	VICE PRESIDENT	100,000
ARNOLD, JOHN D	VICE PRESIDENT	8,000,000
ARONOWITZ, ALAN B	VICE PRESIDENT	125,000
ARORA, HARPREET S	VICE PRESIDENT	450,000
AUCOIN, BERNEY C	DIRECTOR	150,000
AULDS, SHARON F	SENIOR SPECIALIST	20,000
AUNE, STACEY A	MANAGER	28,000
BADEER, ROBERT T	DIRECTOR	1,300,000
BAKER, RON E	SENIOR DIRECTOR	55,000
BALLATO, RUSSELL W	ANALYST	25,000
BALLMER, CHARLES D	MANAGER	16,000
BARBER, MICHAEL R	MANAGER	30,000
BARRETT, MISTY	DIRECTOR	50,000
BASS, ERIC P	ASSOCIATE	400,000
BASU, NILAY K	MANAGER	20,000
BATRAK, HENNADIY	SENIOR SPECIALIST	30,000
BAXTER, ROBERT B	MANAGER	28,000
BAYER, ADAM R	ANALYST	8,250
BECK, SALLY W	BUSINESS UNIT HEAD	350,000
BEHNEY, CHRISTOPHER M	SENIOR DIRECTOR	60,000
BELDEN, TIMOTHY N	MANAGING DIRECTOR	2,499,999
BELMONT, MICHAEL	MANAGER	55,000
BELTRI, ANGELES O	MANAGER	28,000
BENCHLUCH, MOISES S	ASSOCIATE	30,000
BENNETT, STEPHEN D	MANAGER	50,000
BENSON, ROBERT C	DIRECTOR	1,750,000
BLACHMAN, JEREMY M	MANAGING DIRECTOR	250,000
BLACK, DONALD W	VICE PRESIDENT	475,000
BLAIR, GRACE L	DIRECTOR	36,000
BLANKS JR., WAYNE T	MANAGER	50,000
BOATMAN, JACK D	VICE PRESIDENT	131,000
BODE, GARY M	MANAGER	20,000
BOE, LAWRENCE A	SENIOR DIRECTOR	50,000
BOOTS, KELLY H	VICE PRESIDENT	100,000
BOSSE, KEVIN L	SPECIALIST	12,000
BOUDREAUX, KEVIN P	SENIOR SPECIALIST	50,000
BOWEN JR, RAYMOND M	MANAGEMENT COMMITTEE	750,000
BOWLING, WILLIAM C	DIRECTOR	50,000
BOYLE, DAN O	VICE PRESIDENT	125,000
BRACKETT, DEBORAH R	SENIOR DIRECTOR	100,000
BRADFORD, WILLIAM S	VICE PRESIDENT	300,000

BRASSFIELD, MORRIS	VICE PRESIDENT	70,000
BRAWNER, SANDRA F	DIRECTOR	525,000
BRESLAU, CRAIG A	VICE PRESIDENT	200,000
BREWER, CHARLES	MANAGER	20,000
BRODEUR, STEPHANE	ANALYST	25,000
BROUSSARD, THARSILLA M	SPECIALIST	15,000
BROWN, AARON M	DIRECTOR	60,000
BROWN, DANIEL S	MANAGER	15,000
BROWN, JAMES	SENIOR DIRECTOR	90,000
BROWN, WILLIAM W	MANAGING DIRECTOR	225,000
BRUCE, MICHELLE S	DIRECTOR	45,000
BRYANT, MICHAEL C	DIRECTOR	34,000
BRYSCH, JAMES P	DIRECTOR	150,000
BUTLER, PAMELA H	SENIOR DIRECTOR	60,000
BUTTS, ROBERT H	MANAGING DIRECTOR	375,000
CALDERON II, EDUARDO V	SENIOR SPECIALIST	20,000
CALGER, CHRISTOPHER F	MANAGING DIRECTOR	900,000
CALLAHAN, TIMOTHY J	DIRECTOR	30,000
CAPESTANY, MARI C	DIRECTOR	15,000
CASH, MICHELLE H	SENIOR DIRECTOR	125,000
CASTLEMAN, JERRY K	VICE PRESIDENT	180,000
CHANDLER, ROBERT F	DIRECTOR	50,000
CHANG, FANG-TZU	SPECIALIST	12,000
CHARBONNET, CLEMENT D	MANAGER	10,000
CHENG, JOHN K	MANAGER	40,000
CHERRY, RHENN	VICE PRESIDENT	50,000
CHOI, PAUL I	DIRECTOR	250,000
CHU-YANG-HEU, MOG C	ANALYST	18,000
CILIA, MARY H	SENIOR DIRECTOR	100,000
CLARK, CHAD T	ANALYST	150,000
CLARK, WILLIAM S	DIRECTOR	20,000
COATS, EDWARD R	VICE PRESIDENT	200,000
COBB JR, JOHN H	DIRECTOR	50,000
COFFING, TIMOTHY ANDREW	ANALYST	12,500
COLEMAN, TANDRA A	MANAGER	9,500
COLES, FRANK E	MANAGER	16,000
COLWELL, WESLEY	MANAGING DIRECTOR	600,000
CONNER, ANDREW R	MANAGER	75,000
CONNOR, ERIC J	SENIOR DIRECTOR	50,000
COOK, MARY H	DIRECTOR	50,000
CORMAN, SHELLEY A	MANAGING DIRECTOR	200,000
COUCH, KEITH N	DIRECTOR	40,000
COULTER, JODI M	DIRECTOR	75,000
COWAN, MICHAEL R	DIRECTOR	200,000
CRAIG, RICHARD L	VICE PRESIDENT	81,000
CRANDALL, SEAN R	DIRECTOR	350,000
CRANE JR, ROBERT J	VICE PRESIDENT	225,000
CROOM, WILLIAM C	DIRECTOR	50,000
CROSS, EDITH C	DIRECTOR	75,000
CUILLA, MARTIN L	MANAGER	325,000
CURRY, MICHAEL J	DIRECTOR	200,000
DAHLKE, ANDREA	SENIOR SPECIALIST	18,000

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DAVIES, DEREK J	VICE PRESIDENT	525,000
DAVIS JR, MARK D	VICE PRESIDENT	1,800,000
DAYAO, ANTHONY B	MANAGING DIRECTOR	200,000
DAY, MISTI LYNN	SPECIALIST	12,000
DEFFNER, JOSEPH M	MANAGING DIRECTOR	100,000
DELACEY, CHARLES	VICE PRESIDENT	125,000
DE LA OSSA, JR, MARIO	MANAGER	150,000
DENNY, JENNIFER D	MANAGER	35,000
DESPAIN, TIMOTHY A	MANAGING DIRECTOR	175,000
DETMERING, TIMOTHY J	MANAGING DIRECTOR	125,000
DEVILLE, FRANK M	SENIOR DIRECTOR	50,000
DEVRIES, PAUL	VICE PRESIDENT	250,000
DIETRICH, JANET R	MANAGEMENT COMMITTEE	300,000
DIETZ, RICHARD A	DIRECTOR	25,000
DIMICHELE, RICHARD G	MANAGING DIRECTOR	600,000
DOBLER, MARK	VICE PRESIDENT	100,000
DOLAN, MICHAEL T	SENIOR SPECIALIST	5,000
DONAHUE JR, JEFFREY M	MANAGING DIRECTOR	200,000
DOPSON, LAMETRICE D	SENIOR DIRECTOR	60,000
DORLAND, CHRISTOPHER	MANAGER	150,000
DOUCET, DAWN M	CONTRACTOR	20,000
DOUGLAS, STEPHEN H	SENIOR DIRECTOR	140,000
DRAPER, LON	ANALYST	18,000
DRISCOLL, MICHAEL	ANALYST	75,000
DUKE, CULLEN A	VICE PRESIDENT	175,000
DURAN, WILLIAM D	MANAGING DIRECTOR	200,000
DZIADEK, KEITH B	SENIOR DIRECTOR	50,000
EARNEST, SCOTT	SENIOR DIRECTOR	60,000
EDWARDS, RALPH J	DIRECTOR	15,000
EICKENROHT, ROBERT D	VICE PRESIDENT	250,000
ENGEL, THOMAS E	MANAGER	30,000
ENOCHS, FRED D	DIRECTOR	40,000
EPHROSS, JOEL N	SENIOR DIRECTOR	50,000
EPSTEIN, JAY A	MANAGER	75,000
ERMIS, FRANK J	DIRECTOR	850,000
EVANS, CASEY J	SENIOR SPECIALIST	25,000
FALDYN, RODNEY L	VICE PRESIDENT	300,000
FALIK, BRIAN A	ANALYST	5,750
FALLON, JAMES B	MANAGEMENT COMMITTEE	1,500,000
FARMER, STANLEY W	SENIOR DIRECTOR	50,000
FEHL, RICHARD P	VICE PRESIDENT	208,500
FIGUEROA, REGINA G	MANAGER	20,000
FINK, MICHAEL J	SENIOR DIRECTOR	50,000
FISCHER, JEFF K	DIRECTOR	50,000
FISCHER, MARK S	DIRECTOR	250,000
FISHER, JONI L	DIRECTOR	50,000
FITZPATRICK, AMY	MANAGER	30,000
FORTNEY, GEORGE W	MANAGER	20,000
FOSSUM, DREW J	MANAGING DIRECTOR	210,000
FOSTER, CHRISTOPHER H	VICE PRESIDENT	225,000
FOX, WHITNEY S	SENIOR SPECIALIST	50,000
FRANK, MARK H	CONTRACTOR	50,000

FRAZIER, LAMAR R	SENIOR DIRECTOR	100,000
FREELAND, CLINT C	DIRECTOR	75,000
FUHRER, PAUL E	UNKNOWN	34,000
FULLER, ROBERT P	ASSOCIATE	200,000
FUNKHOUSER, SHANNA	SENIOR DIRECTOR	30,000
GAHN, ROBERT S	MANAGING DIRECTOR	250,000
GAINES, DAVID L	UNKNOWN	34,000
GALVAN, MICHAEL S	DIRECTOR	40,000
GARCIA, PAUL D	DIRECTOR	25,000
GARCIA, SUSAN	SENIOR SPECIALIST	20,000
GASKILL, CHRISTOPHER J	DIRECTOR	150,000
GAY, RANDALL L	ASSOCIATE	15,000
GEACCONE, TRACY L	SENIOR DIRECTOR	50,000
GILBERT-SMITH, DOUGLAS	DIRECTOR	275,000
GILBERT, THOMAS W	DIRECTOR	34,000
GILCHRIST, IAN S	SENIOR DIRECTOR	75,000
GILLIS, BRIAN R	MANAGER	25,000
GINTY, JAMES A	VICE PRESIDENT	225,000
GIRON, GUSTAVO	ASSOCIATE	6,250
GOLDEN, JEFFREY R	MANAGING DIRECTOR	100,000
GONZALES, ERIC	VICE PRESIDENT	350,000
GONZALEZ, ORLANDO	VICE PRESIDENT	200,000
GORNY, VLADIMIR	DIRECTOR	75,000
GORTE, DAVID	MANAGING DIRECTOR	250,000
GOSSETT, JEFFREY C	SENIOR DIRECTOR	85,000
GOWEN, THERESA L	SPECIALIST	12,000
GRACE, REBECCA M	MANAGER	18,000
GREIF, DONNA M	DIRECTOR	28,000
GREIG, IAIN	DIRECTOR	30,000
GRIGSBY, MICHAEL D	VICE PRESIDENT	200,000
GUADARRAMA, MICHAEL D	SENIOR DIRECTOR	100,000
GUALY, JAIME E	ASSOCIATE	25,000
GUBSER, MARLIN D	SENIOR DIRECTOR	60,000
GULLION, STEVEN D	DIRECTOR	20,000
GUNTHER, DAVID T	VICE PRESIDENT	100,000
GUPTA, GAUTAM	MANAGER	150,000
HACHEN, JAMES E	DIRECTOR	50,000
HA, CUONG	SENIOR DIRECTOR	10,000
HAEDICKE, MARK E	MANAGEMENT COMMITTEE	750,000
HAGELMANN, BJORN	SENIOR DIRECTOR	75,000
HALL, D. T	SENIOR DIRECTOR	75,000
HALL, JOSEPH	SENIOR SPECIALIST	15,000
HALL, ROBERT M	MANAGER	125,000
HAMILTON, DANIEL	DIRECTOR	50,000
HANNUM, RICHARD	MANAGER	28,000
HANSON, KRISTEN J	MANAGER	16,000
HARALSON, NANCY L	DIRECTOR	28,000
HARDY, JOSEPH G	SENIOR SPECIALIST	15,000
HARDY, STACY	SENIOR SPECIALIST	15,000
HARE, BILL D	MANAGER	28,000
HARRELL, DAN E	SENIOR SPECIALIST	20,000
HARRIS, STEVEN M	VICE PRESIDENT	131,000

HART, VIVIAN C	DIRECTOR	30,000
HAYDEN, FRANK	DIRECTOR	60,000
HAYES, ROBERT E	MANAGING DIRECTOR	210,000
HAYSLETT, RODERICK J	MANAGING DIRECTOR	400,000
HEDSTROM, PEGGY E	VICE PRESIDENT	80,000
HEIZENRADER, TIMOTHY A	DIRECTOR	300,000
HERMANN, ROBERT J	MANAGEMENT COMMITTEE	300,000
HERMANS, GREGOIRE A	VICE PRESIDENT	225,000
HERNANDEZ, ANAMARIA C	ANALYST	5,000
HERNANDEZ, GUSTAVO A	SENIOR SPECIALIST	25,000
HERNANDEZ, MARLA E	SENIOR SPECIALIST	10,000
HERNDON, ROGERS	VICE PRESIDENT	800,000
HEROD, BRENDA F	VICE PRESIDENT	70,000
HICKERSON, GARY J	MANAGING DIRECTOR	700,000
HIDDLESTON, CRAIG	VICE PRESIDENT	50,000
HILLIER, BOB B	SENIOR DIRECTOR	75,000
HODGES, GEORGANNE M	VICE PRESIDENT	200,000
HOLMES, BRADLEY M	DIRECTOR	25,000
HOLMES, SEAN A	VICE PRESIDENT	250,000
HOLST, KEITH A	DIRECTOR	75,000
HOLZER, ERIC J	VICE PRESIDENT	225,000
HOTTE, STEVE	VICE PRESIDENT	200,000
HOWARD, KEVIN A	VICE PRESIDENT	175,000
HOWES, CAROL D	VICE PRESIDENT	70,000
HUDDLESON, DIANN I	DIRECTOR	50,000
HUGHES, EVAN G	VICE PRESIDENT	100,000
HUGHES, JAMES A	MANAGEMENT COMMITTEE	500,000
HUSEMAN, SANDRA L	MANAGER	20,000
IMAI, RIKA	MANAGER	30,000
IRVIN, STEVEN P	DIRECTOR	50,000
IRVIN, TRACY E	MANAGER	28,000
JACOBY, BEN F	VICE PRESIDENT	200,000
JAMES, MATTHEW E	SENIOR SPECIALIST	10,000
JANUARY, STEVEN J	SENIOR DIRECTOR	40,000
JENKINS IV, DANIEL E	ANALYST	5,750
JENSON, JAROD M	DIRECTOR	100,000
JOHNSON, CHRISTINA	MANAGER	25,000
JOHNSON, JANET B	SENIOR DIRECTOR	70,000
JOHNSON, JEFFREY M	SENIOR DIRECTOR	70,000
JOHNSON, RICK	DIRECTOR	30,000
JONES, ROBERT W	MANAGEMENT COMMITTEE	225,000
JOSEY, SCOTT D	VICE PRESIDENT	150,000
JOYCE, MARY K	VICE PRESIDENT	300,000
KANISS, JASON A	ANALYST	8,350
KAUFMAN, PAUL J	VICE PRESIDENT	100,000
KEEL, ALLAN D	VICE PRESIDENT	75,000
KEISER, KAM N	MANAGER	35,000
KEOHANE, PETER C	CONTRACTOR	150,000
KHURI, BASEM	SENIOR SPECIALIST	2,500
KILLEN, FAITH L	DIRECTOR	50,000
KILMER III, ROBERT B	VICE PRESIDENT	100,000
KINGERSKI, HARRY J	VICE PRESIDENT	60,000

KING, JEFF N	MANAGER	100,000
KINKEAD, MARK O	SENIOR SPECIALIST	16,000
KINSEY, LISA M	MANAGER	28,000
KIRK, STEVEN J	DIRECTOR	45,000
KISSNER, TIM	UNKNOWN	24,600
KITCHEN, LOUISE	MANAGEMENT COMMITTEE	2,000,000
KOBES, GLENN R	SENIOR DIRECTOR	50,000
KORTES, BARBARA A	SENIOR DIRECTOR	50,000
KRAUTZ, MICHAEL W	VICE PRESIDENT	60,000
KRISHNASWAMY, JAYANT	MANAGER	20,000
KROGMEIER, RYAN C.	DIRECTOR	50,000
LABAUME, WANDA K	SENIOR DIRECTOR	50,000
LAGRASTA, FRED D	VICE PRESIDENT	350,000
LAMADRID, VICTOR	MANAGER	28,000
LAMBIE, CHRIS D	DIRECTOR	50,000
LAMB, MARNIE	MANAGER	28,000
LARKIN, BRIAN P	MANAGER	10,000
LARKWORTHY, CARRIE E	ANALYST	5,750
LARSON, BRADFORD O	VICE PRESIDENT	100,000
LAVINE, JO ANN	MANAGER	28,000
LAVORATO, JOHN J	MANAGEMENT COMMITTEE	5,000,000
LEBEAU, DAVID R	UNKNOWN	34,000
LE DAIN, ERIC G	CONTRACTOR	200,000
LEE, PATRICIA A	SENIOR DIRECTOR	60,000
LEES, LISA	MANAGER	20,000
LEFF, DANIEL P	BUSINESS UNIT HEAD	300,000
LENHART, MATTHEW F	ANALYST	18,000
LESKOWITZ, MARK	MANAGER	28,000
LEUSCHEN, SUE A	SENIOR DIRECTOR	19,000
LEWIS, ANDREW H	DIRECTOR	650,000
LEWIS, GREGORY A	MANAGER	28,000
LEWIS, JAMES C	VICE PRESIDENT	150,000
LIESKOVSKY, JOZEF S	ASSOCIATE	10,500
LIM, FRANCIS S	MANAGER	20,000
LINDSEY, MARK E	VICE PRESIDENT	150,000
LLODRA, JOHN	DIRECTOR	200,000
LOIBL, KORI D	SPECIALIST	12,000
LOKEY, WALTER T	SENIOR DIRECTOR	45,000
LORD, PHILLIP D	VICE PRESIDENT	150,000
LOU, ZHUOMING	SENIOR SPECIALIST	5,000
LOVE, PHILLIP M	MANAGER	35,000
LOWRY, CHARLES P	MANAGING DIRECTOR	200,000
LUCCI, PAUL T	DIRECTOR	150,000
LUCE, LAURA L	VICE PRESIDENT	250,000
LUNDSTROM, BRUCE D	VICE PRESIDENT	150,000
MAGGI, MICHAEL J	DIRECTOR	850,000
MAHAN, ROSA M	MANAGING DIRECTOR	225,000
MAKKAI, PETER G	ANALYST	18,000
MALCOLM, RODNEY D	MANAGING DIRECTOR	275,000
MALLORY, PATRICK	ANALYST	75,000
MARCINKOWSKI, DANIELLE	MANAGER	20,000
MARTIN, JERRY D	VICE PRESIDENT	81,000

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MARTIN, THOMAS A	VICE PRESIDENT	1,100,000
MASSEY II, JOHN H	MANAGER	150,000
MASSEY, RACHEL M	MANAGER	28,000
MAXEY, R. DAVIS	VICE PRESIDENT	400,000
MAYES, FRANCES L	DIRECTOR	15,000
MAY, LAWRENCE J	DIRECTOR	850,000
MAYNARD, ANNE M	VICE PRESIDENT	80,000
MCAULIFFE, ROBERT H	SENIOR DIRECTOR	90,000
MCCLELLAN, GEORGE	MANAGING DIRECTOR	400,000
MCCORMICK, GEORGE M	VICE PRESIDENT	75,000
MCCULLOUGH, TRAVIS C	VICE PRESIDENT	125,000
MCGEE, JOHNNY W	DIRECTOR	30,000
MCGILLIVRAY, RODRICK R	DIRECTOR	20,000
MCGINNIS, STEPHANIE K	DIRECTOR	45,000
MCKAY, BRADLEY T	CONTRACTOR	300,000
MCKAY, JONATHAN	DIRECTOR	175,000
MCKEAN, GEORGE	VICE PRESIDENT	100,000
MCLAUGHLIN, JR., ERROL L	CONTRACTOR	25,000
MCMAHON, JEFFREY	MANAGEMENT COMMITTEE	1,500,000
MCMICHAEL JR, ALBERT E	MANAGING DIRECTOR	50,000
MCNAIR, DARREN B	MANAGER	20,000
MELENDREZ, JESUS	VICE PRESIDENT	75,000
MELLENCAMP, LISA	DIRECTOR	100,000
MEREDITH, KEVIN T	SENIOR SPECIALIST	15,000
MERRIL, DEBORAH D	VICE PRESIDENT	100,000
MERTZ, THOMAS A	UNKNOWN	34,000
MILLER, KENT E	VICE PRESIDENT	131,000
MILLER, LLOYD D	MANAGING DIRECTOR	175,000
MILLER, MARY KAY	VICE PRESIDENT	131,000
MILLER, TONY	SENIOR SPECIALIST	25,000
MILLS, SCOTT R	SENIOR DIRECTOR	70,000
MILNTHORP, PHILLIP R	MANAGING DIRECTOR	850,000
MINTZ, JORDAN H	MANAGEMENT COMMITTEE	200,000
MISRA, NARSIMHA	MANAGER	75,000
MOEHLMAN, CATHY L	SENIOR DIRECTOR	25,000
MONTAGNE, KEVIN A	SENIOR DIRECTOR	100,000
MORAN, THOMAS	DIRECTOR	45,000
MORROW, CYNTHIA L	SENIOR DIRECTOR	50,000
MORSE, BRADFORD T	DIRECTOR	50,000
MORYL, HEIDI L	SENIOR SPECIALIST	20,000
MOSCOSO, MICHAEL	DIRECTOR	28,000
MOSS, KEVIN	VICE PRESIDENT	150,000
MOTLEY, MATTHEW H	DIRECTOR	2,300,000
MUENCH, GAYLE W	VICE PRESIDENT	100,000
MULLER, MARK S	EXECUTIVE VICE PRES	400,000
MURPHY, MELISSA A	SENIOR SPECIALIST	25,000
MURRAY, JULIA H	MANAGING DIRECTOR	200,000
MYERS, THOMAS M	SENIOR DIRECTOR	90,000
NACEY, SHEILA M	DIRECTOR	23,000
NASSAB, PETER	VICE PRESIDENT	50,000
NAT, STEVE M	SENIOR DIRECTOR	60,000
NEAL, SCOTT M	VICE PRESIDENT	225,000

NEFF, JAMES B	DIRECTOR	15,000
NELSON, KIMBERLEY P	SENIOR DIRECTOR	50,000
NELSON, MICHEL E	VICE PRESIDENT	100,000
NEUBAUER, DAVID M	VICE PRESIDENT	210,000
NEVILLE, SUSAN M	DIRECTOR	75,000
NGUYEN, MICHAEL	ASSOCIATE	50,000
NICOLAY, CHRISTI L	SENIOR DIRECTOR	60,000
NIELAND, JEFFERY	DIRECTOR	50,000
NORDSTROM, MARY J	DIRECTOR	55,000
NOWLAN JR, JOHN L	VICE PRESIDENT	500,000
ODNEAL, DAVID L	UNKNOWN	38,000
OH, SEUNG-TAEK	ASSOCIATE	25,000
O'NEIL, MURRAY P	VICE PRESIDENT	70,000
OQUINN, KARI J	MANAGER	20,000
O'ROURKE, TIM	DIRECTOR	60,000
OVERTURF, ELAINE	SENIOR DIRECTOR	50,000
PAGAN, J O	VICE PRESIDENT	200,000
PALMER, MARK A	MANAGING DIRECTOR	200,000
PARQUET, DAVID J	VICE PRESIDENT	250,000
PARSONS, DAVID A	VICE PRESIDENT	75,000
PATRICK, MICHAEL K	VICE PRESIDENT	150,000
PEARCE, BARRY J	VICE PRESIDENT	100,000
PECK JR, OMAR C	DIRECTOR	50,000
PENA, JOHN M	MANAGER	15,000
PENG, GARY Y	SENIOR DIRECTOR	50,000
PENMAN, GREGG A	DIRECTOR	125,000
PERKINS, MARY A	VICE PRESIDENT	125,000
PERLMAN, BETH S	VICE PRESIDENT	200,000
PHILIP, WILLIS D	ASSOCIATE	8,750
PHILLIPS, MARC N	DIRECTOR	30,000
PIEPER, KALEN	VICE PRESIDENT	75,000
PIERCE, JOSEPH M	DIRECTOR	35,000
PIMENOV, VLADI	ASSOCIATE	15,000
PIPER, GREGORY F	MANAGEMENT COMMITTEE	400,000
PISSANETZKY, PABLO I	DIRECTOR	30,000
PLACHY, DENVER D	ANALYST	12,500
PORT, DAVID	SENIOR DIRECTOR	75,000
PORTER, J. GREGORY	SENIOR DIRECTOR	65,000
POSTLETHWAITE, JOHN D	SENIOR SPECIALIST	18,000
POSTON, DAVID A	MANAGER	20,000
POWELL, JOHN D	MANAGER	20,000
PRESTO, KEVIN M	VICE PRESIDENT	2,000,000
PRIBBLE, DANNY L	VICE PRESIDENT	81,000
QUAINTANCE, JR., ALAN C	SENIOR DIRECTOR	100,000
QUIGLEY, HENRY H	ASSOCIATE	30,000
RACICOT JR, PAUL H	CONTRACTOR	400,000
RAHAIM, CHRISTIAN D	SENIOR DIRECTOR	30,000
RAMACHANDRAN, SANDEEP	MANAGER	100,000
RAMESH, GANAPATHY V	DIRECTOR	30,000
RANGEL, RAFAEL F	SENIOR DIRECTOR	50,000
RAO, RAMESH G	SENIOR DIRECTOR	30,000
RATCLIFF, DONNA R	SENIOR SPECIALIST	20,000

RATH, MIKIE M	MANAGER	30,000
RAY, EDWARD L	MANAGER	25,000
RAY, SARA I	DIRECTOR	30,000
REASONER, MONICA N	MANAGER	45,000
REDMOND, BRIAN L	MANAGING DIRECTOR	300,000
REEVES, LESLIE K	SENIOR DIRECTOR	70,000
REITMEYER, JAMES W	ASSOCIATE	40,000
REXRODE, STUART G	MANAGING DIRECTOR	100,000
RICE, GREEK L	VICE PRESIDENT	200,000
RICE, RANDY K	VICE PRESIDENT	50,000
RICHEY, ROBERT C	UNKNOWN	40,000
RICHTER, JEFFREY S	DIRECTOR	1,300,000
RIEKER, PAULA H	MANAGING DIRECTOR	300,000
RILEY, CHRISTOPHER P	DIRECTOR	50,000
ROBERTS JR, MICHAEL A	VICE PRESIDENT	100,000
ROBINSON, MITCHELL O	DIRECTOR	125,000
ROGERS, BENJAMIN C	ASSOCIATE	25,000
ROGERS, REX R	VICE PRESIDENT	375,000
ROHAUER, TANYA S	SENIOR DIRECTOR	100,000
ROPER, KERWIN K	SENIOR DIRECTOR	50,000
ROSMAN, STEWART	DIRECTOR	250,000
ROSTANT, JUSTIN K	ASSOCIATE	15,000
RUB, JEANETTE M	VICE PRESIDENT	200,000
RUFFER, MARY L	SENIOR DIRECTOR	60,000
RUSCITTI, KEVIN	MANAGER	325,000
RYAN, DAVID J	MANAGER	75,000
SACKS, EDWARD	MANAGER	50,000
SAGER, ELIZABETH A	VICE PRESIDENT	150,000
SAIBI, ERIC E	ANALYST	18,000
SANDERS, RICHARD B	VICE PRESIDENT	150,000
SAUNDERS, JAMES M	VICE PRESIDENT	131,000
SCHIAVONE, PAUL	ASSOCIATE	36,700
SCHIELD, ELAINE P	SENIOR DIRECTOR	60,000
SCHMIDT, MARK O	SENIOR DIRECTOR	70,000
SCHNAPPER, BARRY J	MANAGING DIRECTOR	225,000
SCHNEIDER, BRYCE W	ASSOCIATE	13,750
SCHNEIDER, CHARLES E	MANAGING DIRECTOR	190,000
SCHOMER, CHRISTOPHER D	MANAGER	25,000
SCHULER, W L	MANAGING DIRECTOR	300,000
SCHULTEA, KATHRYN E	SENIOR DIRECTOR	60,000
SCHWARZ, ANGELA M	MANAGING DIRECTOR	200,000
SCHWARZBACH, STEPHEN L	SENIOR DIRECTOR	50,000
SCHWERTNER, BRIAN J	MANAGER	28,000
SCHWIEGER, JAMES E	VICE PRESIDENT	650,000
SCOTT, LAURA E	CONTRACTOR	85,000
SCOTT, SUSAN M	ANALYST	18,000
SEELIGSON, STEWART L	VICE PRESIDENT	350,000
SEKSE, PER A	VICE PRESIDENT	150,000
SEVERSON, RUSS M	CONTRACTOR	7,000
SHAFER, JOHN H	VICE PRESIDENT	81,000
SHANNON, PATRICIA L	SENIOR DIRECTOR	50,000
SHAPIRO, RICHARD S	MANAGING DIRECTOR	200,000

SHARMA, LARRISSA J	SENIOR DIRECTOR	20,000
SHARP, GREGORY L	MANAGING DIRECTOR	100,000
SHARP, VICTORIA T	MANAGING DIRECTOR	200,000
SHERMAN, RICHARD C	VICE PRESIDENT	150,000
SHISHIDO, SCOTT T	SENIOR SPECIALIST	15,000
SHIVELY, HUNTER	VICE PRESIDENT	1,750,000
SHULTS, ROBERT B	DIRECTOR	85,000
SIMON, SHAWANA E	SENIOR SPECIALIST	20,000
SIUREK, RYAN H	SENIOR DIRECTOR	100,000
SLONE, JEANNE E	MANAGER	40,000
SMIDA, EDWARD S	MANAGING DIRECTOR	225,000
SMITH, GARY P	VICE PRESIDENT	100,000
SMITH, JEFFREY E	SENIOR DIRECTOR	50,000
SMITH JR., BEN C	DIRECTOR	50,000
SMITH, MATHEW D	ASSOCIATE	40,000
SMITH, MICHAEL D	VICE PRESIDENT	80,000
SMITH, REGAN M	MANAGER	25,000
SOLDANO, LOUIS P	VICE PRESIDENT	110,000
SOMMERS, JEFFREY E	VICE PRESIDENT	200,000
SOVA, GARY L	DIRECTOR	50,000
STALFORD, ROBERT	MANAGER	100,000
ST. CLAIR, CAROL L	SENIOR DIRECTOR	100,000
STEFFES, JAMES D	VICE PRESIDENT	100,000
STEPENOVITCH, JOSEPH P	SENIOR SPECIALIST	25,000
STEPHENS, CYNTHIA	DIRECTOR	50,000
STEPHENS, LOYD D	DIRECTOR	20,000
STEVENS, MECHELLE J	SENIOR SPECIALIST	18,000
STOCK, STEPHEN	SENIOR DIRECTOR	70,000
STOKLEY, MARLIN C	ASSOCIATE	50,000
STOREY, GEOFFREY C	DIRECTOR	650,000
STRAATMANN, CHRISTINE E	DIRECTOR	50,000
STUBBLEFIELD, GREGORY W	MANAGING DIRECTOR	150,000
STUBBS, SHELLY P	DIRECTOR	50,000
STURM, FLETCHER J	VICE PRESIDENT	1,750,000
SUAREZ, JOHN D	DIRECTOR	125,000
SULLIVAN, KRISTE K	SENIOR DIRECTOR	60,000
SULLIVAN, PATRICIA E	MANAGER	25,000
SUPERTY, ROBERT A	SENIOR DIRECTOR	50,000
SUTTER, CRAIG H	VICE PRESIDENT	100,000
SWEENEY, KEVIN G	VICE PRESIDENT	70,000
SWEITZER, TARA N	SENIOR SPECIALIST	15,000
SWERZBIN, MICHAEL J	VICE PRESIDENT	2,600,000
TANG, MABLE	MANAGER	20,000
TAWNEY, MARK R	VICE PRESIDENT	300,000
TAYLOR, DIANE F	MANAGER	30,000
TAYLOR, FABIAN	CONTRACTOR	6,250
TAYLOR, MARK E	VICE PRESIDENT	200,000
TAYLOR, MITCHELL S	MANAGING DIRECTOR	200,000
TEAL, JAMES M	DIRECTOR	34,000
TERP, BRIAN T	ASSOCIATE	15,000
TERRASO, MICHAEL F	VICE PRESIDENT	100,000
THAPAR, RAJEEV	VICE PRESIDENT	250,000

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THERIOT, KIM S	DIRECTOR	30,000
THIBODEAUX, MARK J	SENIOR DIRECTOR	60,000
THOLT, JANE M	DIRECTOR	200,000
THOMAS, JACOB S	VICE PRESIDENT	300,000
THOMAS, PAUL D.	ASSOCIATE	40,000
TOMASKI, RICHARD S	DIRECTOR	100,000
TRIBOLET, MICHAEL A	VICE PRESIDENT	190,000
TYCHOLIZ, BARRY L	VICE PRESIDENT	650,000
UECKERT, ALLEN	SENIOR DIRECTOR	50,000
VANDOR, DAVID J	SENIOR SPECIALIST	15,000
VANN, SUZANNE K	MANAGER	10,000
VARGAS, ESPERANZA	DIRECTOR	50,000
VAUGHN, ANN	SENIOR DIRECTOR	45,000
VEATCH, STEPHEN T	SENIOR DIRECTOR	45,000
VERSEN, VICTORIA L	ASSOCIATE	15,000
VICKERS, FRANK W	VICE PRESIDENT	200,000
VINSON, DONALD W	SENIOR SPECIALIST	25,000
WALDEN, JOHN C	SENIOR DIRECTOR	100,000
WALLS JR, ROBERT H	MANAGEMENT COMMITTEE	300,000
WALLUMROD, ELLEN	SENIOR SPECIALIST	18,000
WALTON, SHEILA H	DIRECTOR	30,000
WANG, STEVE H	MANAGER	150,000
WARD, BOB	MANAGER	20,000
WARWICK, TODD C	MANAGER	28,000
WATSON, KIMBERLY S	DIRECTOR	50,000
WATT, RYAN C	ANALYST	25,000
WEATHERFORD, WILLIAM A	DIRECTOR	34,000
WEATHERSPOON, PATRICIA A	SENIOR DIRECTOR	20,000
WEBB, JAY C	VICE PRESIDENT	300,000
WEIDLER, PETER E	MANAGING DIRECTOR	225,000
WEISSELBERG, ALEX	DIRECTOR	50,000
WEI, ZHIYONG	SENIOR DIRECTOR	50,000
WELDON, V. CHARLES	ASSOCIATE	30,000
WERNER, JON J	SENIOR SPECIALIST	15,000
WHEELER, TERESA L	SENIOR DIRECTOR	40,000
WHITE, KENNETH R	SPECIALIST	3,500
WHITE, STACEY W	DIRECTOR	70,000
WHITING, GREGORY A	DIRECTOR	50,000
WHITT, MARK	VICE PRESIDENT	275,000
WIGGS, BRETT R	VICE PRESIDENT	150,000
WILCOTT, ROBERT J	DIRECTOR	50,000
WILLIAMS, DAVID	SENIOR DIRECTOR	50,000
WILLIAMS, JASON C	ASSOCIATE	25,000
WILLIAMS, JIMMIE L	MANAGING DIRECTOR	150,000
WILLIAMS, JO M	DIRECTOR	50,000
WILLIAMS, KAREN L	SPECIALIST	12,000
WILLIAMS, ROBERT C	MANAGING DIRECTOR	150,000
WILLIAMS, WILLIAM J	ANALYST	75,000
WILL, LLOYD J	DIRECTOR	150,000
WILSON, SHONA A	DIRECTOR	50,000
WINFREE, O'NEAL D	SENIOR SPECIALIST	18,000
WISHERT, CYNTHIA A	SENIOR DIRECTOR	50,000

WOLFE, JASON	ANALYST	18,000
WOLFE, STEPHEN D	SENIOR SPECIALIST	15,000
WONG, NGIAM W	MANAGER	20,000
WOOD, JAMES M	SENIOR DIRECTOR	100,000
WOODWARD, JASON R	DIRECTOR	50,000
WOULFE, GREGORY J	DIRECTOR	150,000
WRIGHT, GLENN T	VICE PRESIDENT	100,000
WYNNE, RITA J	MANAGER	25,000
YAWAPONGSIRI, VIRAWAN A	ASSOCIATE	15,000
YOUNG, GREGG W	DIRECTOR	50,000
ZACCOUR, DAVID L	MANAGER	10,000
ZIPPER, ANDREW A	VICE PRESIDENT	175,000
ZUFFERLI, JOHN A	VICE PRESIDENT	1,450,000

Pre-bankruptcy bonuses

50. Did any employees terminate employment with the Company before the end of the 90-day retention period? Please provide a list of such employees and identify those employees who returned their bonuses with the 25% penalty.

For Estate employees, excluding the employees who were part of the UBS/Warburg transition, and excluding involuntary terminations, only there were only 3.

Comments:	Formatted Name	Retention Amount	Termination Date	Termination Reason Description
No repayment - Employee disputes obligation - Demand letter sent by Enron to employe	MAXEY, R. DAVIS	400,000	1/11/2002	UNSATISFACTORY PERFORMANCE
No repayment - Employee disputes obligation - Demand letter sent by Enron to employe	MELLENCAMP, LISA	100,000	1/31/2002	NEW JOB (NON-COMPETR/UNKNOWN)
No repayment - Demand letter sent by Enron to employee.	LESKOWITZ, MARK	28,000	1/4/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Involuntary Termination, no repayment due based on terms of agreement.	JENKINS IV, DANIEL E	5,750	12/14/2001	REDUCTION IN FORCE
Part of UBS/Warburg Transition	SEVERSON, RUSS M	7,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WINFREE, O'NEAL D	18,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	DOLAN, MICHAEL T	5,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SWERZBIN, MICHAEL J	2,600,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GARCIA, PAUL D	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	IRVIN, TRACY E	28,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	KILLEN, FAITH L	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WARWICK, TODD C	28,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	AUNE, STACEY A	28,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HARDY, JOSEPH G	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WOLFE, STEPHEN D	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HARDY, STACY	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	VARGAS, ESPERANZA	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BELTRI, ANGELES O	28,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BRACKETT, DEBORAH R	100,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	REASONER, MONICA N	45,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WHITE, STACEY W	70,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MCLAUGHLIN, JR., ERROL L	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	QUIGLEY, HENRY H	30,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	REITMEYER, JAMES W	40,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GOSSETT, JEFFREY C	85,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	KEISER, KAM N	35,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	VINSON, DONALD W	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LOVE, PHILLIP M	35,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BAXTER, ROBERT B	28,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	DOUGLAS, STEPHEN H	140,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SLONE, JEANNE E	40,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	YAWAPONGSIRI, VIRAWAN A	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BASS, ERIC P	400,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MALLORY, PATRICK	75,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	STEFFES, JAMES D	100,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	OQUINN, KARI J	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)

Part of UBS/Warburg Transition	MCAULIFFE, ROBERT H	90,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	RUB, JEANETTE M	200,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	NAT, STEVE M	60,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WONG, NGIAM W	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WEI, ZHIYONG	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	KRISHNASWAMY, JAYANT	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	KINKEAD, MARK O	16,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SCHOMER, CHRISTOPHER D	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SMITH, REGAN M	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	JOHNSON, JEFFREY M	70,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	RAMESH, GANAPATHY V	30,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	POWELL, JOHN D	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MONTAGNE, KEVIN A	100,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BELMONT, MICHAEL	55,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GUADARRAMA, MICHAEL D	100,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SHISHIDO, SCOTT T	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	DZIADEK, KEITH B	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WERNER, JON J	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	ADAMIK, DARREN P	16,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BARBER, MICHAEL R	30,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MARCINKOWSKI, DANIELLE	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	COLES, FRANK E	16,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BALLMER, CHARLES D	16,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MCNAIR, DARREN B	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GUBSER, MARLIN D	60,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HALL, JOSEPH	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HILLIER, BOB B	75,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BOWLING, WILLIAM C	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	RAY, EDWARD L	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LARKIN, BRIAN P	10,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HARRELL, DAN E	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BODE, GARY M	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BEHNEY, CHRISTOPHER M	60,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SAGER, ELIZABETH A	150,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	ST. CLAIR, CAROL L	100,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	CASH, MICHELLE H	125,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	CURRY, MICHAEL J	200,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GILBERT-SMITH, DOUGLAS	275,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	DAVIS JR, MARK D	1,800,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	RICHTER, JEFFREY S	1,300,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	STOREY, GEOFFREY C	650,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	REDMOND, BRIAN L	300,000	2/10/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	VICKERS, FRANK W	200,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	CALGER, CHRISTOPHER F	900,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	COLWELL, WESLEY	600,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BRAWNER, SANDRA F	525,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LEWIS, ANDREW H	650,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	THOLT, JANE M	200,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)

Part of UBS/Warburg Transition	ERMIS, FRANK J	850,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GRIGSBY, MICHAEL D	200,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	CROSS, EDITH C	75,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BRYSCH, JAMES P	150,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HEIZENRADER, TIMOTHY A	300,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	CRANDALL, SEAN R	350,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	FOSTER, CHRISTOPHER H	225,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WILL, LLOYD J	150,000	2/21/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GASKILL, CHRISTOPHER J	150,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GORNY, VLADIMIR	75,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	RYAN, DAVID J	75,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LLODRA, JOHN	200,000	2/10/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SAIBI, ERIC E	18,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SUPERTY, ROBERT A	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SCHIELD, ELAINE P	60,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	FORTNEY, GEORGE W	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LIM, FRANCIS S	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	THERIOT, KIM S	30,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MURPHY, MELISSA A	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	ALLEN, THRESA A	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SHERMAN, RICHARD C	150,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HODGES, GEORGANNE M	200,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HANSON, KRISTEN J	16,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	KINSEY, LISA M	28,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SULLIVAN, PATRICIA E	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GAY, RANDALL L	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	STEVENS, MECHELLE J	18,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BOSSE, KEVIN L	12,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	REEVES, LESLIE K	70,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MCGINNIS, STEPHANIE K	45,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LOIBL, KORI D	12,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LAMADRID, VICTOR	28,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	DAY, MISTI LYNN	12,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	STOKLEY, MARLIN C	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WILLIAMS, WILLIAM J	75,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	TANG, MABLE	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WEBB, JAY C	300,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	JENSON, JAROD M	100,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	CHENG, JOHN K	40,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HARE, BILL D	28,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WILLIAMS, JASON C	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HAEDICKE, MARK E	750,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BLACK, DONALD W	475,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BRESLAU, CRAIG A	200,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	NEAL, SCOTT M	225,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	STURM, FLETCHER J	1,750,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SHIVELY, HUNTER	1,750,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	ALLEN, PHILLIP K	675,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)

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Part of UBS/Warburg Transition	BECK, SALLY W	350,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	TAYLOR, MARK E	200,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BELDEN, TIMOTHY N	2,499,999	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	PRESTO, KEVIN M	2,000,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MARTIN, THOMAS A	1,100,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	THOMAS, JACOB S	300,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LENHART, MATTHEW F	18,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	RICHEY, ROBERT C	40,000	2/10/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	VANDOR, DAVID J	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SACKS, EDWARD	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	EVANS, CASEY J	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	COOK, MARY H	50,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MAY, LAWRENCE J	850,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	OH, SEUNG-TAEK	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WELDON, V. CHARLES	30,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MAGGI, MICHAEL J	850,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	KITCHEN, LOUISE	2,000,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	TERP, BRIAN T	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	ZIPPER, ANDREW A	175,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	JAMES, MATTHEW E	10,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BASU, NILAY K	20,000	2/20/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	KING, JEFF N	100,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	HAYDEN, FRANK	60,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LIESKOVSKY, JOZEF S	10,500	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	IMAI, RIKA	30,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	POSTON, DAVID A	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BATRAK, HENNADIY	30,000	2/20/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	FITZPATRICK, AMY	30,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	THOMAS, PAUL D.	40,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	AMES, CHARLES H	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	PIMENOV, VLADI	15,000	2/20/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BALLATO, RUSSELL W	25,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	STALFORD, ROBERT	100,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	MAKKAI, PETER G	18,000	2/20/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WOLFE, JASON	18,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	RAO, RAMESH G	30,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	CHU-YANG-HEU, MOG C	18,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	PENA, JOHN M	15,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	WANG, STEVE H	150,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SMITH, MATHEW D	40,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	CHANG, FANG-TZU	12,000	2/20/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	DAHLKE, ANDREA	18,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LOU, ZHUOMING	5,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BREWER, CHARLES	20,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SCHIAVONE, PAUL	36,700	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	BAYER, ADAM R	8,250	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	KANISS, JASON A	8,350	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	CHARBONNET, CLEMENT D	10,000	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)

Part of UBS/Warburg Transition	PHILIP, WILLIS D	8,750	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	LARKWORTHY, CARRIE E	5,750	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	SCHNEIDER, BRYCE W	13,750	2/8/2002	NEW JOB (NON-COMPETR/UNKNOWN)
Part of UBS/Warburg Transition	GIRON, GUSTAVO	6,250	2/24/2002	NEW JOB (NON-COMPETR/UNKNOWN)

Confidential Interoffice Memorandum

Expires if not accepted by close of business on the date this memo is given to recipient

To:

From: John Lavorato and Louise Kitchen **Department:**

Subject: Performance Bonus **Date:** November 29, 2001

This memorandum describes a Performance Bonus to be provided to you under the Enron Corp. Bonus Plan for calendar year 2001 performance, subject to the terms and conditions of this memorandum. This memorandum replaces and supersedes the November 17, 2001 Performance Bonus Memorandum to you from John Lavorato and Louise Kitchen. You understand and agree that you will not receive any other cash performance bonus for calendar year 2001, whether described in a Company incentive plan, contract, letter, or otherwise, other than the Performance Bonus described in this memorandum.

I am pleased to inform you that you shall receive a cash Performance Bonus in the amount of $75,000.00 as soon as practicable after you have accepted the terms of this Performance Bonus Memorandum by signing below. To accept the terms of this Performance Bonus memorandum, you must sign this memorandum by the close of business on the day you receive it, which is November 30, 2001; after that time, this memorandum expires and the offer to pay a Performance Bonus is revoked.

You agree to repay 125% of the Performance Bonus in the event you voluntarily terminate your employment with Company within ninety (90) days after receipt of the Performance Bonus, or if you disclose the terms of the Performance Bonus to any other person or entity, except your spouse, attorney, or financial advisor; such repayment shall be made within thirty (30) days after your last date of employment at Company. By accepting the payment of the Performance Bonus, you also authorize the Company to deduct from any wage or other amounts owed to you by the Company such amounts as may be necessary to satisfy your obligation to make repayment hereunder.

YOU UNDERSTAND AND AGREE THAT YOUR RECEIPT OF THIS CASH PERFORMANCE BONUS IS CONFIDENTIAL. ANY DISCLOSURE OF THE TERMS OR CONDITIONS OF THIS MEMORANDUM WILL RESULT IN CORRECTIVE ACTION, INCLUDING THE FORFEITURE OF THE PERFORMANCE BONUS PREVIOUSLY PAID; THE FORFEITED PERFORMANCE BONUS MUST BE REPAID WITHIN THIRTY (30) DAYS OF COMPANY'S REQUEST. Any bonus received is neither intended nor should be construed as being an addition to base salary or included in calculations of benefits or salary increases. This agreement does not provide you with any rights to continued employment of any specified duration.

The parties acknowledge their agreement and acceptance of the terms of this memorandum by signing below.

Enron North America Corp.

EC 002679700

By: ______________________
Name: ______________________
Title: ______________________
This 1 day of Dec, 2001

____
This 30 day of Nov, 2001

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ENRON

Confidential Interoffice Memorandum

Expires if not accepted by close of business on the November 30, 2001

To:

Department:

Subject: Performance Bonuses

Date: November 29, 2001

This memorandum describes Performance Bonuses to be provided to you under the Enron Corp. Bonus Plan for calendar year 2001 performance, subject to the terms and conditions of this memorandum. You understand and agree that you will not receive any other cash performance bonus for calendar year 2001, whether described in a Company incentive plan, contract, letter, or otherwise, other than the Performance Bonus described in this memorandum.

I am pleased to inform you that you shall receive a cash Performance Bonus in the amount of $30,000, less applicable taxes, as soon as practicable after you have accepted the terms of this Performance Bonus memorandum by signing below. To accept the terms of this Performance Bonus memorandum, you must sign this memorandum by the close of business on November 30, 2001; after that time, this memorandum expires and the offer to pay a Performance Bonus is revoked.

You agree to repay 125% of the Performance Bonus in the event you voluntarily terminate your employment with Company within ninety (90) days after receipt of the Performance Bonus, or if you disclose the terms of the Performance Bonus to any other person or entity, except your spouse, attorney, or financial advisor; such repayment shall be made within thirty (30) days after your last date of employment at Company. By accepting the payment of the Performance Bonus, you also authorize the Company to deduct from any wages or other amounts owed to you by the Company such amounts as may be necessary to satisfy your obligation to make repayment hereunder.

YOU UNDERSTAND AND AGREE THAT YOUR RECEIPT OF THIS CASH PERFORMANCE BONUS IS CONFIDENTIAL. ANY DISCLOSURE OF THE TERMS OR CONDITIONS OF THIS MEMORANDUM WILL RESULT IN CORRECTIVE ACTION, INCLUDING THE FORFEITURE OF THE PERFORMANCE BONUS PREVIOUSLY PAID; THE FORFEITED PERFORMANCE BONUS MUST BE REPAID WITHIN THIRTY (30) DAYS OF COMPANY'S REQUEST. Any bonus received is neither intended nor should be construed as being an addition to base salary or included in calculations of benefits or salary increases. This agreement does not provide you with any rights to continued employment of any specified duration.

The parties acknowledge their agreement and acceptance of the terms of this memorandum by signing below.

Enron Corp.

By: ______________________

Name: Mary K. Joyce
Title: Vice President
This 30 day of November, 2001

This 30 day of November, 2001 ______________________

EC 002679701

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MINUTES
SPECIAL MEETING OF THE BOARD OF DIRECTORS
ENRON CORP.
October 24, 2001

Minutes of a special meeting of the Board of Directors of Enron Corp. ("Company"), noticed to begin at 11:00 a.m., C.D.T., but actually begun at 11:10 a.m., C.D.T., on October 24, 2001 at the Enron Building in Houston, Texas.

The following Directors were present, constituting a quorum, either in person or by telephone conference connection whereby each of the participants could hear the comments and discussions by the other participants and join in the discussions, as follows:

Mr. Kenneth L. Lay, Chairman
Mr. Robert A. Belfer
Mr. Norman P. Blake, Jr.
Mr. Ronnie C. Chan
Mr. John H. Duncan
Dr. Wendy L. Gramm
Dr. Charles A. LeMaistre
Mr. Paulo V. Ferraz Pereira
Mr. Frank Savage
Lord John Wakeham
Mr. Herbert S. Winokur, Jr.

Directors Robert K. Jaedicke and Dr. John Mendelsohn were absent from the meeting. Messrs. James V. Derrick, Jr., Mark A. Frevert, and L. Greg Whalley and Ms. Paula H. Rieker, all of the Company, also attended the meeting.

The Chairman, Mr. Lay, presided at the meeting, and the Secretary, Ms. Rieker, recorded the proceedings.

Mr. Lay called the meeting to order. He then provided an update on recent market activity for the debt and equity securities of the Company. He noted that credit spreads for the Company's debt remained high and demand for the debt remained low. He advised that negotiation and due diligence were in process for a significant additional credit facility to further improve the liquidity of the Company.

Mr. Lay provided a report on the current effectiveness of Mr. Andrew S. Fastow as the Chief Financial Officer of the Company and on perceptions of Mr. Fastow in the financial marketplace. He presented a recommendation by management that Mr. Fastow be replaced by Mr. Jeffrey McMahon, and a discussion ensued. Mr. Duncan provided information obtained from Mr. Fastow related to Mr. Fastow's earnings from certain financial arrangements and indicated that Mr. Fastow had not yet provided earnings of limited partners with interests in the same financial arrangements.

Following a discussion, upon a motion duly made by Mr. Blake, seconded by Mr. Savage, and carried, the following resolutions were approved:

> RESOLVED, that the Board approves the request by Mr. Andrew S. Fastow for a leave of absence from his responsibilities as Executive Vice President and Chief Financial Officer of the Company; and
>
> RESOLVED FURTHER, that the following person be, and hereby is, elected, effective as of the date set forth below, to the position set forth opposite his name, to serve for the ensuing year and until his successor is duly elected and qualified, unless he shall sooner resign or be removed, in accordance with the Bylaws of the Company:

Jeff McMahon	Executive Vice President and Chief Financial Officer, Enron Corp. (effective as of the leave of absence from the Company of Mr. Fastow, an Executive Vice President and previously Chief Financial Officer of the Company, on October 24, 2001)

Mr. Duncan left the meeting.

Mr. Whalley then provided an update on recent inquiries by commercial counterparties regarding the credit position of the Company. He also provided a briefing on steps being taken to insure adequate financial liquidity for the Company.

Mr. Lay discussed the importance of retaining personnel and presented a recommendation by management to guarantee payment in January of 2002 of minimum bonuses totaling $22.9 million to 29 key commercial personnel. Following a discussion, upon motion duly made by Dr. LeMaistre, seconded by Ms. Gramm, and carried, the Board approved the guarantee of minimum bonuses to be paid to key commercial personnel in January of 2002.

There being no further business to come before the Board, the meeting was adjourned at 12:00 p.m., C.D.T.

Paula H. Rieker
Secretary

APPROVED:

Kenneth L. Lay
Chairman

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MINUTES
MEETING OF THE COMPENSATION AND MANAGEMENT
DEVELOPMENT COMMITTEE
OF THE BOARD OF DIRECTORS
ENRON CORP.
November 16, 2001

Minutes of a meeting of the Compensation and Management Development Committee ("Committee") of the Board of Directors of Enron Corp. ("Company"), noticed to begin at 11:15 a.m., C.S.T., but actually begun at 11:18 a.m., C.S.T., on November 16, 2001 at the Enron Building in Houston, Texas.

The following Committee members were present, constituting a quorum, either in person or by telephone conference connection whereby each of the participants could hear the comments and discussions by the other participants and join in the discussions, as follows:

Dr. Charles A. LeMaistre, Chairman
Mr. John H. Duncan
Dr. Robert K. Jaedicke
Mr. Frank Savage

Director Norman P. Blake, Jr. did not attend the meeting. Director Kenneth L. Lay and Mesdames Mary J. Joyce and Paula H. Rieker, both of the Company, also attended the meeting. Mr. L. Greg Whalley, also of the Company, joined the meeting in progress as noted below.

The Chairman, Dr. LeMaistre, presided at the meeting, and the Secretary, Ms. Rieker, recorded the proceedings.

Dr. LeMaistre called the meeting to order and called upon Mr. Lay to provide a summary of management's recommendation to retain key employees of the Company. Mr. Lay reported that competitors were aggressively pursuing key employees of the Company, including teams of employees who had made very significant contributions to the profitability of the Company's wholesale gas and power operations.

Mr. Whalley joined the meeting.

Mr. Whalley reported on concerns by key employees that annual bonuses either would not be awarded or, if awarded, may not be funded by the Company. Mr. Whalley reviewed a summary of the recommendation, a copy of which is included with the records of the meeting. He reviewed the terms of a proposed bonus trust and noted that, separate from the trust, additional commitments for bonus payments may be made but would not be funded as part of the trust. A discussion ensued on the benefits of the proposed trust. Mr. Whalley clarified that the trust excluded executive level officers and that the proposal had been discussed with Mr. Stephen W. Bergstrom of Dynegy, Inc. ("Dynegy"), who agreed on the importance of retaining key employees. Ms. Joyce advised that Towers Perrin ("Towers") had been consulted and agreed with the recommendation of management.

Ms. Joyce also reported that Towers was preparing a written report of any impact of the merger agreement with Dynegy on the role of the Committee and considerations for employee bonuses planned for early 2002, retention devices, and other items. Mr. Lay then provided a brief update on the Company's wholesale and retail operations.

There being no further business to come before the Committee, the meeting was adjourned at 11:36 a.m., C.S.T.

Paula H. Rieker

Secretary

APPROVED:

Charles A. LeMaistre

Chairman

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Charles A. LeMaistre - Chairman
Norman P. Blake, Jr.
John H. Duncan
Robert K. Jaedicke
Frank Savage

AGENDA
MEETING OF THE COMPENSATION AND
MANAGEMENT DEVELOPMENT COMMITTEE
OF THE BOARD OF DIRECTORS
ENRON CORP.

NOVEMBER 16, 2001
Enron Center North – EB-5001
11:15 a.m. (C.S.T.)

1. Discussion of Bonus Trust

2. Other Business

3. Adjournment

Agenda Item
Compensation and Management Development Committee Meeting
November 16, 2001
Bonus Trust

- Enron North America desires to establish a grantor trust to fund the payment of 2001 performance bonuses to certain key personnel of Enron North America as well as Enron Energy Services and Enron Canada (assuming the trust is effective in Canada.)

- Payments will be made as long as the employee is actively employed on the designated payment dates of January 4, 2002 and February 5, 2002. Payments will be made directly from the Trust.

- Approximately $50 million will be contributed to the Trust on Monday, November 19, 2001, for payment of performance bonuses for up to 100 key traders and originators.

- Based on a projection of Enron Americas' restated September 30, 2001 IBIT ($1.961 billion) and After-Tax Net Income ($1.354 billion), the $50 million represents 2.5% and 3.7% of earnings, respectively.

- This arrangement has been discussed and agreed to by Greg Whalley and Steve Bergstrom of Dynegy.

- Management recommends the Enron Corp. Compensation and Management Development Committee approve and recommend to the ENA Board approval of this bonus Trust and bonus compensation arrangement.

EC2 000026925

MINUTES
MEETING OF THE BOARD OF DIRECTORS
ENRON CORP.
November 18, 2001

Minutes of a meeting of the Board of Directors of Enron Corp. ("Company"), noticed to begin at 5:00 p.m., C.S.T., but actually begun at 5:15 p.m., C.S.T. on November 18, 2001, at the Enron Building in Houston, Texas.

The following Directors were present, constituting a quorum, either in person or by telephone conference connection whereby each of the participants could hear the comments and discussions by the other participants and join in the discussion, as follows:

Mr. Kenneth L. Lay, Chairman
Mr. Robert A. Belfer
Mr. Norman P. Blake, Jr.
Mr. Ronnie C. Chan
Mr. John H. Duncan
Dr. Wendy L. Gramm
Dr. Robert K. Jaedicke
Dr. Charles A. LeMaistre
Dr. John Mendelsohn
Mr. William C. Powers, Jr.
Mr. Frank Savage
Lord John Wakeham
Mr. Herbert S. Winokur, Jr.

Director Paulo V. Ferraz Pereira was absent from the meeting. Messrs. Raymond M. Bowen, Jr., Richard B. Buy, Angus H. Davis, James V. Derrick, Jr., Mark A. Frevert, Mark E. Haedicke, Jeffrey McMahon, L. Greg Whalley, and Rex R. Rogers and Ms. Paula H. Rieker, all of the Company or affiliates thereof, Messrs. Joseph C. Dilg, C. Michael Harrington, William E. Joor, and Charles W. Schwartz, all of Vinson & Elkins, LLP, Mr. William R. McLucas, of Wilmer, Cutler & Pickering LLP, Mr. Greg A. Danilow, of Weil, Gotshal & Manges LLP, and Messrs. Peter A. Atkins, Eric L. Cochran, and Jonathan J. Lerner, all of Skadden, Arps, Slate, Meagher & Flom, LLP, and Mr. Stephen D. Susman, of Susman Godfrey, also attended the meeting. Mr. Thomas Roberts, of Weil, Gotshal & Manges LLP, joined the meeting in progress as noted below.

The Chairman, Mr. Lay, presided at the meeting, and the Secretary, Ms. Rieker, recorded the proceedings.

EC2 000028074

After calling the meeting to order, Mr. Lay asked Mr. McMahon to provide an update on the current status of the Company's liquidity, financings, and credit ratings. Mr. McMahon reported liquidity was very tight. He reported that management was pursuing private equity sources, including J. P. Morgan Chase & Co. and Solomon Smith Barney, as well as other sources. He also noted the need to extend the debt maturities of the Company. Mr. Bowen reviewed a report, a copy of which is included in the records of the meeting, of the projected sources and uses of cash through year-end 2001, including a $1.5 billion cash infusion associated with the proposed Dynegy merger and $1.0 billion associated with Transwestern Pipeline Company and Northern Natural Gas Company secured financings. He noted, however, that without extending the maturity of approximately $1.0 billion in debt securities for which work was underway, the Company could end the year with inadequate liquidity for its operations. He also discussed the potential significant negative impact to liquidity related to certain surety agreements that included on-demand call features for collateral. Mr. McMahon reported that the Company's credit rating remained investment grade and that all three rating agencies had maintained their negative watch. He stated that asset sales, the level of trade credit available to the Company, success at extending certain current debt maturities, ability to secure additional private equity, and the general health of the business must all remain on track in order for the Company to retain its investment grade rating. He reviewed the status of current asset sales, including the exploration and production operations in India, certain gas distribution companies in Brazil, and a power plant in Puerto Rico.

Mr. Buy reported that wholesale transactions conducted on Enron Online had recovered somewhat from the low point ten days previously but had not returned to long-term average levels. Mr. Whalley stated that it currently was difficult to attract long-term business and, in some regions, to participate in the physical commodity markets due to counterparty concerns regarding the Company's credit. Mr. McMahon noted that management had scheduled meetings on November 19, 2001 with approximately seventy-five banks and 280 bankers to present a full financial review and an operations and merger update. He stated that the meeting would include discussions to achieve a coordinated, comprehensive orderly debt restructuring.

Mr. Roberts joined the meeting.

Mr. Whalley reported that the Company's European operations had been more severely impacted by recent developments than the North American operations. He stated that the retail energy operations also were experiencing difficulties in executing longer-term contracts with customers.

Mr. Lay then reported on restructuring efforts by the Company in order to satisfy rating agency requirements related to the Dynegy merger agreement. Mr. Joor confirmed that a number of merger-related regulatory filings were in preparation and that the Hart Scott Rodino anti-trust filing was planned to be filed soon.

Mr. Lay called upon Mr. McMahon to discuss management's recommendation to amend the Company's Amended and Restated Articles of Incorporation to increase the number of authorized shares of common stock by 300 million shares up to 1.5 billion shares. Mr. McMahon stated that the Company currently had minimal flexibility to issue additional shares if private equity could be sold. He noted that, in addition to Board authorization, shareholder approval was required. Mr. Rogers discussed the authorization procedures necessary under Oregon law, noting that a vote could be targeted in late December 2001. Following discussion, upon motion duly made by Mr. Blake, seconded by Dr. Gramm, and carried, the following resolutions were adopted:

> WHEREAS, the Board has determined that it is in the best interest of Enron Corp. (the "Company") to amend the Company's Amended and Restated Articles of Incorporation to increase the total number of authorized shares of Common Stock from 1,200,000,000 to 1,500,000,000;
>
> NOW, THEREFORE, BE IT RESOLVED, that the Amended and Restated Articles of Incorporation of the Company are hereby amended by amending the first paragraph of Article IV thereof to read in its entirety as follows:
>
>> The total number of shares of all classes of stock which the corporation shall have authority to issue is 1,516,500,000 shares of capital stock, of which 16,500,000 shares are Preferred Stock (the "Preferred Stock"), and 1,500,000,000 shares are Common Stock (the "Common Stock"); and
>
> RESOLVED FURTHER, that, upon receipt of the requisite approval of shareholders, the officers of the Company are hereby authorized to execute and file with the Secretary of State of the State of Oregon the Articles of Amendment related to such proposed amendment; and
>
> RESOLVED FURTHER, that a special meeting of shareholders of the Company (the "Special Meeting") shall be held on a date to be determined by the Chairman and Chief Executive Officer of the Company for the purpose of submitting such proposed amendment to a vote of the shareholders of the Company; and

RESOLVED FURTHER, that the close of business on a date to be determined by the Chairman and Chief Executive Officer of the Company is hereby fixed as the record date for the determination of shareholders of the Company entitled to notice of and to vote at the Special Meeting and at any adjournment(s) thereof (the "Record Date"); and

RESOLVED FURTHER, that the Board recommends to the shareholders of the Company that they vote in favor of such proposed amendment; and

RESOLVED FURTHER, that the appropriate officers of the Company are hereby authorized and directed to take, or cause to be taken, any and all action with reference to such Special Meeting, including the preparation and filing with the Securities and Exchange Commission of a proxy statement, as in such officers' judgment is necessary, desirable, or appropriate; and

RESOLVED FURTHER, that the Secretary of the Company hereby is authorized and directed to cause a copy of notice of Special Meeting, proxy statement, and proxy to be mailed to each shareholder of the Company entitled to notice of and to vote at the Special Meeting at his or her address as it appears on the records of the Company at the close of business on the Record Date; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel be, and each of them hereby is, authorized, empowered, and directed (any one of them acting alone) to take any and all such further action, to amend, execute, and deliver all such further instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their discretion appear to be necessary, proper, or advisable to carry into effect the purposes and intentions of this and each of the foregoing resolutions.

Messrs. Bowen and McMahon left the meeting.

Mr. Lay asked Dr. Jaedicke to report on a recent meeting of the Audit and Compliance Committee. Dr. Jaedicke reported that the Company planned to file a non-compliant Form 10-Q for the quarter ended September 30, 2001. He stated that Arthur Andersen LLP ("AA") was not prepared to issue a limited review report for the period because of the involvement of another "Big Five" accounting firm working with the Special Committee of the Board ("Special Committee") and because of the need to rely on management representations which they believed management would not be able to make. Dr. Jaedicke noted that the Committee reviewed a draft of the Form 10-Q for the third quarter of 2001, even though it was expected to be a non-compliant filing, and received a briefing on changes expected but not yet incorporated in the draft. Mr. Lay noted that no action by the Board was necessary prior to filing of the Form 10-Q.

MATERIAL
REDACTED

. Mr. Powers discussed a memo that had been distributed to Directors regarding findings by the Special Committee concerning Mr. Andrew Fastow. He stated that the full report of the Special Committee would likely take two additional months and that attempts were being made to expedite the report.

Mr. Lay called for an executive session. Messrs. Buy, Derrick, Frevert, Haedicke, Rogers, and Whalley left the meeting. Messrs. Danilow, Dilg, Harrington, Joor, McLucas, Roberts, and Schwartz also left the meeting.

MATERIAL
REDACTED

Mr. Lay reiterated the need to elect an additional independent director who was not involved with any of the current litigation to satisfy the requirements related to the creation of a Special Litigation Committee as was discussed by Mr. Susman. Mr. Lay said that he had approached Mr. Philip J. Carroll, Jr., a very qualified candidate for consideration for election to the Board and to the Special Litigation Committee. Following a discussion and upon motion duly made by Dr. Gramm, seconded by Mr. Blake, and carried, the following resolution was adopted:

> RESOLVED, that the number of directors be, and hereby is, increased by one and that Philip J. Carroll, Jr. be, and hereby is, elected a director of the Company, subject to and effective upon his acceptance of the nomination, to serve during the ensuing year until the next Annual Meeting of Shareholders and until his successor shall have been duly elected and qualified.

Mr. Lay led a discussion regarding consideration of the election of Mr. L. Greg Whalley, President and Chief Operating Officer of the Company, to the Board of Directors, which included a review of Mr. Whalley's credentials, the rationale for electing him at this time, and the benefits and potential issues associated with his election. Mr. Winokur registered his reservations related to the timing of Mr. Whalley's election and a discussion ensued on electing Mr. Whalley subject to Mr. Carroll's acceptance of election to the Board. Upon motion duly made by Mr. Blake, seconded by Mr. Savage, and carried, the following resolution was adopted:

> RESOLVED, that L. Greg Whalley be, and hereby is, elected a director of the Company, subject to and effective upon the acceptance of Philip J. Carroll, Jr.'s election to the Board, to serve during the ensuing year until the next Annual Meeting of Shareholders and until his successor shall have been duly elected and qualified.

Mr. Lay stated that management recommended the election of William W. Brown to the position of Deputy Treasurer of the Company. Upon motion duly made by Mr. Savage, seconded by Dr. Gramm, and carried the following resolution was adopted:

> RESOLVED, that the following person be, and hereby is, elected to the position set forth opposite his name, to serve for the ensuing year and until his successor is duly elected and qualified.

William W. Brown	Deputy Treasurer

MATERIAL REDACTED

Directors Chan and Wakeham left the meeting.

Mr. Lay called upon Dr. LeMaistre to discuss the Company's Severance Pay Plans. Dr. LeMaistre stated that the Board had previously approved an Amended and Restated Severance Plan (the "Amended Severance Plan") to be effective July 1, 2002, or earlier at the discretion of the Chairman. He discussed the reduced benefits included in the Amended and Restated Severance Plan and noted that, because of pending staff reductions related to the proposed restructuring of the Company, the Compensation and Management Development Committee (the "Compensation Committee") recommended that the Board authorize the Office of the Chairman to determine and to execute an appropriate Amended and Restated Severance Plan utilizing either the existing or the new formula or some combination thereof, subject to the cost not exceeding the existing Severance Pay Plan restated as of January 1, 1993, after obtaining advise from advisors and counsel that such determination was proper. Following a discussion, upon motion duly made by Dr. Mendelsohn, seconded by Mr. Duncan, and carried, the following resolutions were adopted:

WHEREAS, the Company desires to restate the Enron Corp. Severance Pay Plan (the "Severance Pay Plan");

NOW, THEREFORE, IT IS RESOLVED that Kenneth L. Lay (Chairman and Chief Executive Officer), L. Greg Whalley (President and Chief Operating Officer), and Mark A. Frevert (Vice Chairman), are hereby authorized, directed, and given complete discretion to act on behalf of the Company, with respect to establishing a revised severance pay plan for the Company, to either restate the terms and payment formula of the Severance Pay Plan or take such necessary action to adopt an Amended and Restated Severance Pay Plan as they, in their sole and complete discretion, deem to be in the best interest of the Company, subject to obtaining advise from advisors and legal counsel that such revised terms and payment formula was appropriate and provided that their actions result in no increase in total costs to the Company beyond the existing severance pay formula provided in the Severance Pay Plan; and

RESOLVED FURTHER, that upon execution of a final plan document, either restated or amended, by such officers, the actual plan embodied therein or amended thereby shall be deemed adopted by this Board and is hereby ratified and approved; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered, and directed to take all such further action, to amend, execute, and deliver all such instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their judgment may be necessary, appropriate, or advisable in order fully to carry into effect the purposes and intentions of this and each of the foregoing resolutions, including the execution of any further amendments, forms, or documents recommended by counsel or required by any governmental agency, and to do anything necessary to effect compliance with applicable law or regulation.

Dr. LeMaistre reported that at a meeting of the Compensation Committee held on November 16, 2001, Committee members had reviewed and approved for recommendation to the Board a bonus trust plan for up to 100 key employees, primarily relating to the wholesale trading operations of the Company. He summarized the terms and costs of the plan, which was expected not to exceed $50 million. Mr. Lay discussed current competitive pressures regarding key employees and suggested that this bonus plan was being proposed as a means of enticing key employees to remain with the Company in order to receive the enhanced bonus in February 2002. Following motion duly made by Dr. LeMaistre, seconded by Mr. Blake, and carried, the special bonus plan, as discussed, was approved by the Board and recommended for subsequent approval by the affected subsidiary Boards.

A discussion ensued regarding actions taken by the Company to reduce costs, including elimination of the annual employee and Board holiday functions.

Mr. Davis left the meeting.

Mr. Lay called upon Mr. Powers for an update from the Special Committee of the Board ("Special Committee"). Mr. Powers reported on recent findings of the Special Committee regarding Mr. Andrew S. Fastow, Mr. Ben L. Glisan, Jr., and Ms. Kristina Mourdant. A discussion then ensued regarding Mr. Andrew S. Fastow and his status of employment with the Company.

There being no further business to come before the Board, the meeting was adjourned at 7:07 p.m., C.S.T.

Paula H. Rieker

Secretary

APPROVED:

Kenneth L. Lay

Chairman

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MINUTES
SPECIAL MEETING OF THE BOARD OF DIRECTORS
ENRON CORP.
November 25, 2001

Minutes of a special meeting of the Board of Directors of Enron Corp. ("Company"), noticed to begin at 10:00 p.m., C.S.T., but actually begun at 10:08 p.m., C.S.T., on November 25, 2001 by teleconference.

The following Directors were present, constituting a quorum, by telephone conference connection whereby each of the participants could hear the comments and discussions by the other participants and join in the discussions, as follows:

Mr. Kenneth L. Lay, Chairman
Mr. Robert A. Belfer
Mr. Norman P. Blake, Jr.
Mr. Ronnie C. Chan
Mr. John H. Duncan
Dr. Wendy L. Gramm
Dr. Robert K. Jaedicke
Dr. Charles A. LeMaistre
Dr. John Mendelsohn
Mr. William C. Powers, Jr.
Mr. Herbert S. Winokur, Jr.

Directors Paulo V. Ferraz Pereira, Frank Savage, and John Wakeham were absent from the meeting. Messrs. Raymond M. Bowen, Jr., James V. Derrick, Jr., Mark E. Haedicke, Jeffrey McMahon, and Mark S. Muller and Ms. Paula H. Rieker, all of the Company or affiliates thereof, Messrs. Robert L. Friedman and Steven M. Zelin, both of The Blackstone Group ("Blackstone"), Messrs. Peter A. Atkins and Jack Butler, both of Skadden, Arps, Slate, Meagher & Flom LLP ("Skadden"), and Messrs. Martin J. Bienenstock and Thomas A. Roberts, both of Weil, Gotshal & Manges ("WG&M"), attended the meeting. Mr. Mark A. Frevert and Ms. Elizabeth A. Tilney, both of the Company or affiliates thereof, joined the meeting in progress as noted below.

The Chairman, Mr. Lay, presided at the meeting, and the Secretary, Ms. Rieker, recorded the proceedings.

Mr. Lay provided an update on recent business discussions. He reported that the Company had engaged Blackstone as an independent investment advisor. He reported on recent meetings held with representatives from Blackstone, Skadden, and WG&M to discuss a range of ideas under consideration to increase confidence in the Company by its wholesale trading counterparties. He reported on concerns of wholesale trading counterparties in transacting with the Company in the prior week following publication of the Company's Form 10-Q for the third quarter of 2001 and on concerns expressed by the marketplace regarding potential uncertainty of completion of the merger transaction with Dynegy, Inc. ("Dynegy"). He further reported that specific ideas had been generated in the recent meetings and that a number of alternatives were being discussed with J.P. Morgan Securities Inc. ("JP Morgan") and Salomon Smith Barney Inc. ("SSB"), two of the Company's lead banks.

Mr. Lay called upon Mr. McMahon to outline a proposal to significantly improve the perception in the marketplace of the Company's financial strength. Mr. McMahon detailed key elements of the proposal, including statements by Dynegy indicating strong support for the merger transaction, their full understanding of the Company's financial condition, and a resumption of normal trading terms and activity between them and the Company. He stated that an additional element of the proposal was a restructuring by the banks of the Company's scheduled debt maturities in 2002. He indicated that several important matters had been agreed to in principle between JP Morgan, and SSB (collectively, the "Banks"), the Company, and Dynegy. He detailed the agreements, including a $500 million preferred stock issuance by the Company's Transwestern Pipeline Company, previously expected to be evenly split between the Banks and not to include Dynegy and now to be evenly split between the three parties; an additional $500 million line of credit to be secured by certain assets of the Company and also to be evenly split between the three parties; a public announcement by the Banks regarding the restructuring of the Company's debt; and a revision to the previously agreed upon fixed exchange ratio in the merger transaction based on the last closing prices of the common stocks of Dynegy and the Company, noting that the new ratio resulted in 0.12 shares of stock of the new merged company for each common share held by the Company's investors. Mr. Atkins stated that a significant change in the merger agreement would include a favorable revision to a material adverse change clause such that changes related to the financial condition of the Company would be measured from the Company's latest Form 10-Q disclosures. Mr. McMahon reported that the proposal had been discussed preliminarily with all three major rating agencies, noting that each agency had viewed the proposal as positive to the assessment of the Company's credit. He stressed that the merger transaction was critical to maintaining an investment-grade rating for the Company.

Mr. Lay stated the importance in regaining the confidence of the Company's wholesale trading counterparties and in increasing the Company's business activity. He also stated the value in regaining market confidence of strong statements of support by Dynegy for the merger transaction and by the Banks on a favorable outlook for additional secured financings by the Company. Mr. McMahon added that, in addition to careful monitoring of the capital structure of the Company, Moody's Investment Service ("Moody's") was very watchful of the trends in the Company's business activity and in the extension of trade credit to the Company. A discussion ensued regarding discussions with the Banks on raising additional capital for the Company and possible conversion of some of the Company's debt obligations to equity following completion of the merger with Dynegy.

Mr. Lay called upon the representatives from Blackstone, as an independent investment advisor to the Company, to address the Board regarding the fairness of the revised fixed exchange ratio. Mr. Friedman commented on the downward revision in the ratio, the conflicts of the Banks in providing opinions of fairness at this time, and the stage of Blackstone's analysis.

Mr. Frevert and Ms. Tilney joined the meeting.

Mr. Friedman summarized the strategic alternatives available to the Company and cited that, even with the revised exchange ratio, the merger transaction with Dynegy was the best alternative to preserve enterprise value for all debt and equity stakeholders of the Company. Mr. Lay called for comments on Mr. Friedman's assessment. Mr. Atkins summarized the fiduciary obligations of the Board. Mr. Bienenstock advised that other alternatives had been thoroughly analyzed and none were more favorable than the proposed merger transaction. A discussion ensued on certain terms of the merger transaction precluding the Company from issuing additional equity. Mr. Lay summarized valuation analyses performed separately by the Company and the Banks, noting similar conclusions drawn by each. He then provided an update on pending asset sales by the Company. A discussion ensued, concluding that the market's reaction to the proposal presented at the meeting would be able to be quickly assessed.

Mr. Roberts provided an update on recent discussions with Dynegy regarding the merger, the additional line of credit, and the potential timing of a public announcement.

Mr. Lay provided a report on new independent candidates under consideration for membership to the Board and called upon Mr. Atkins to comment on recent discussions in which he had participated.

Mr. Lay then called for an executive session. Messrs. Bowen, Derrick, Frevert, Haedicke, McMahon, and Muller and Ms. Tilney left the meeting. Messrs. Atkins, Bienenstock, Butler, Friedman, Roberts, and Zelin also left the meeting.

Mr. Lay called upon Dr. LeMaistre to present management's recommendation for establishment of the Enron Corp. Retention Plan ("Retention Plan"). Dr. LeMaistre presented the recommendation, noting that the recommendation should be modified to require any awards to officers of the Company who are subject to the provisions of Section 16 of the Securities

Exchange Act of 1934 ("Section 16 Officers") be submitted for approval by the Compensation and Management Development Committee prior to an award. He also noted that the Retention Plan should be thoroughly reviewed by legal counsel prior to implementation to insure all strategic alternatives under consideration by the Company at the time of implementation have been properly considered. Following a discussion and upon a motion duly made by Mr. Blake, seconded by Dr. Gramm, and carried, the following resolutions were approved:

> WHEREAS, it is the desire of Enron Corp. ("the Company") to establish and adopt a retention plan (the "Plan"), which incorporates the design reflected in the Award Schedule attached to and made a part of this resolution (the "Award Schedule");
>
> NOW, THEREFORE, IT IS RESOLVED that any member of the Office of the Chair of the Company is authorized and directed to prepare and execute a Plan document, which reflects the Award Schedule and which incorporates such other provisions not inconsistent with such Award Schedule which the Office of the Chairman of the Company, in consultation with Towers Perrin, deems appropriate;
>
> RESOLVED FURTHER, that upon execution of such Plan document prepared according to the above provisions, the Plan shall be deemed adopted by this Board and is hereby ratified and approved; and
>
> RESOLVED FURTHER, that any awards to officers of the Company who are subject to the provisions of Section 16 of the Securities Exchange Act of 1934 will be submitted for approval by the Compensation and Management Development Committee prior to an award; and
>
> RESOLVED FURTHER, that the Plan will be thoroughly reviewed by legal counsel prior to implementation to insure all strategic alternatives under consideration by the Company at the time of implementation have been properly considered; and
>
> RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered, and directed to take all such further action, to amend, execute, and deliver all such instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses, as in their judgment may be necessary, appropriate, or advisable in order to fully effect the purposes and intentions of this and the foregoing resolutions, including the execution of any further

amendments, forms, or documents recommended by counsel or required by any governmental agency, and to do anything necessary to effect compliance with applicable law or regulation.

Mr. Lay called for a vote to approve the merger transaction with Dynegy and the revised terms discussed at the meeting. Following a discussion and upon a motion duly made by Mr. Blake, seconded by Dr. Gramm, and carried, the following resolutions were adopted:

WHEREAS, Enron Corp., an Oregon corporation (the "Company"), Dynegy Inc., an Illinois corporation ("Dynegy"), Stanford, Inc., a Delaware corporation and wholly-owned subsidiary of Dynegy ("Newco"), Sorin, Inc., an Oregon corporation and wholly-owned subsidiary of Newco ("Enron Merger Sub"), and Badin, Inc., an Illinois corporation and wholly-owned subsidiary of Newco ("Dynegy Merger Sub"), have entered into an Agreement and Plan of Merger, dated as of November 9, 2001 (the "Merger Agreement"); and

WHEREAS, pursuant to section 10.5 of the Merger Agreement, the Company, Dynegy, Newco, Enron Merger Sub and Dynegy Merger Sub propose to enter into an Amendment to the Merger Agreement, (the "Amendment") which shall, among other things, condition the Amendment on the receipt by Enron or its subsidiaries of $500 million in cash financing and the receipt of consent to the Amendment from Chevron U.S.A. Inc.; provide that the exchange ratio in the merger shall be reduced to 0.12 shares of Dynegy common stock for each share of Company common stock; eliminate the $2 billion dollar basket up to which Enron or its subsidiaries may issue additional equity securities without the approval of Dynegy; require that, as a condition to effectuating the transactions contemplated in the Merger Agreement, the Company adopt a comprehensive liability management plan to stabilize its credit rating; and amend the definition of Material Adverse Effect in the Merger Agreement to provide, for the purpose of determining whether an Enron Material Adverse Effect has occurred, that changes related to the financial condition of the Company shall be measured against the Company's latest Form 10-Q disclosures; and

WHEREAS, the Board of Directors of the Company, having reviewed the terms of the Amendment, and having discussed the provisions thereof with counsel, deems it desirable and in the best interest of the Company that the Company approve the Amendment and any other documents or agreements contemplated thereby, and that the transactions contemplated thereby are in the best interests of the Company;

NOW, THEREFORE, BE IT RESOLVED, that the proper officers of the Company and its counsel are hereby authorized, empowered, and directed to take all such further action, to amend, execute, and deliver all such instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay such expenses, as in their judgment may be necessary, appropriate or advisable in order to fully carry into effect the purposes and intentions of this and each of the foregoing resolutions, including the execution of any further amendments, forms, or documents recommended by counsel or required by any governmental agency, and to do anything necessary to effect compliance with applicable law or regulation; and

RESOLVED FURTHER, that any and all actions taken by or on behalf of the Company prior to the adoption of these resolutions which are within the authority conferred hereby be, and hereby are, in all respects ratified, confirmed, and approved as the acts and deeds of the Company.

Mr. Lay then reported on certain changes in Company management recently requested by Dynegy and not a part of the formal merger agreement and on the different views of the Banks from those of Dynegy. He called upon Mr. Winokur to comment. Mr. Winokur suggested that the Compensation and Management Development Committee meet with Dynegy management to discuss the matter further, and a discussion ensued.

There being no further business to come before the Board, the meeting was adjourned at 11:17 p.m., C.S.T.

Paula H. Rieker
Secretary

APPROVED:

Kenneth Lay
Chairman

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Agenda Item 2 (cont.)

Enron Corp. Retention Plan
Award Schedule

- Purpose of the Plan is to retain critical and key employees through the current transitional period of Enron Corp.
- Number of employees included in the Plan is approximately 1,350.
- Total Value of the Plan is capped at $115 Million.
- The Plan has been reviewed and supported by Chuck Essick of Towers Perrin as market-based. He noted that this plan should be in addition to any potential annual bonus payments and values awarded to employees should be reduced by future retention or guaranteed severance payments. Towers Perrin will be consulted on the Final implementation of the Plan.
- Therefore, Management recommends approval of the Plan as set forth in the attached resolution

	Key Employees Only
CORE Business Units	One Year Plan: 20% 3/1 - 20% 6/1 20% 9/1 - 40% 12/1/2002 (or as frequently as bi-weekly if business requirements dictate)
Management Committee	200% of Base
COMMERCIAL	
MD	200% of Base
VP	150% of Base
Director	100% of Base
Other	50% of Base
NON-COMMERCIAL	
MD	150% of Base
VP	100% of Base
Director	75% of Base
Other	40% of Base

NON-CORE Business Units	6 Month Plan: Pay 1/2 on 3/1, pay 1/2 on earlier of project completion, invol term, unit shut down, 6/1/2002 (or as frequently as bi-weekly if business requirements dictate)
Management Committee	150% of Base
COMMERCIAL	
MD	150% of Base
VP	100% of Base
Director	75% of Base
Other	40% of Base
NON-COMMERCIAL	
MD	125% of Base
VP	75% of Base
Director	50% of Base
Other	30% of Base

Summary of Headcount and Costs

Group	Approx. Headcount	Max Cost (Thousands)
Domestic Core BU	800	$70,000
Domestic Non-Core BU	200	$18,000
Europe	350	$27,000
Total	1,350	$115,000

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EC2 00027128

MINUTES
SPECIAL MEETING OF THE BOARD OF DIRECTORS
ENRON CORP.
November 28, 2001

Minutes of a special meeting of the Board of Directors of Enron Corp. ("Company"), noticed to begin at 6:00 p.m., C.S.T., but actually begun at 6:15 p.m., C.S.T., on November 28, 2001 at the Enron Building in Houston, Texas.

The following Directors were present, constituting a quorum, either in person or by telephone conference connection whereby each of the participants could hear the comments and discussions by the other participants and join in the discussions, as follows:

Mr. Kenneth L. Lay, Chairman
Mr. Robert A. Belfer
Mr. Norman P. Blake, Jr.
Mr. John H. Duncan
Dr. Wendy L. Gramm
Dr. Robert K. Jaedicke
Dr. Charles A. LeMaistre
Dr. John Mendelsohn
Mr. Paulo V. Ferraz Pereira
Mr. William C. Powers, Jr.
Mr. Raymond S. Troubh
Lord John Wakeham
Mr. Herbert S. Winokur, Jr.

Directors Ronnie C. Chan and Frank Savage were absent from the meeting. Messrs. Raymond M. Bowen, Jr., James V. Derrick, Jr., Mark A. Frevert, Mark E. Haedicke, Jeffrey McMahon, and L. Greg Whalley and Ms. Paula H. Rieker, all of the Company or affiliates thereof, Messrs. Robert L. Friedman, Raffiq Nathoo, Bruce Haggerty, and Steven M. Zelin, all of The Blackstone Group ("Blackstone"), Messrs. Peter A. Atkins, Jack Butler, and Eric L. Cochran, all of Skadden, Arps, Slate, Meagher & Flom LLP ("Skadden"), Messrs. Greg D. Danilow, Brian S. Rosen, Thomas A. Roberts, and Glenn D. West, all of Weil, Gotshal & Manges ("WG&M"), and Mr. William R. McLucas, of Wilmer, Cutler & Pickering ("WC&P"), also attended the meeting. Mr. Stephen D. Susman, of Susman Godfrey, and Mr. Martin J. Beinenstock, of WG&M, joined the meeting in progress as noted below.

The Chairman, Mr. Lay, presided at the meeting, and the Secretary, Ms. Rieker, recorded the proceedings.

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Mr. Lay called the meeting to order. He reported that the merger agreement had been terminated by Dynegy, Inc. ("Dynegy") earlier that day. He further reported that Dynegy based the merger termination on the material adverse change clause and certain non-specific representation and warranty provisions in the merger agreement. He also stated that Dynegy was expected to request the transfer of the ownership of Northern Natural Gas Company ("Northern Natural") after an approximate fifteen-day notice period, although the Company did not agree that Dynegy had the right to such a request. He noted that Dynegy's termination removed the non-solicitation provision of the agreement as well.

Mr. Whalley left the meeting. Mr. Susman entered the meeting.

Mr. Lay indicated that the Company had the right to repurchase Northern Natural. Mr. Roberts commented on the structure used by Dynegy for the purchase option on Northern Natural and on the basis for the Company's dispute of Dynegy's right to exercise the option it claimed.

Mr. Lay welcomed Mr. Troubh to the Board, noting that Mr. Troubh had participated in the last Board meeting as well.

Mr. Whalley entered the meeting.

Mr. Lay called upon Mr. Bowen for a report on the Company's liquidity. Mr. Bowen provided the report, noting that the Company had ended the day with $10 million more cash than at the start of the day for an ending daily balance of $514 million, including the funding of payroll for the two-week period. He noted that one of the financial institutions with which the Company transacts had retained some of the Company's funds, which were planned to have been accessible by the Company. He recommended that a new cash management banking relationship be established and stated that the bank may require use of its own standard banking resolution rather than the Company's standard banking resolution. He read excerpts from the bank's resolution, noting that there was no material difference from the Company's standard resolution and that the proposed resolution had been reviewed by an attorney in the Company. He also recommended that temporarily surplus funds of the Company be housed in an account of a newly-formed subsidiary of the Company. He then discussed the Company's Investment Policy ("Policy"), noting that the Policy included a maximum investment limit of $50 million per financial institution. He cited the need for flexibility to temporarily consolidate up to $300 million of investments at a single financial institution, noting that the monies would be invested pursuant to the Policy's requirements. Following a discussion and upon a motion duly made by Dr. Gramm, seconded by Mr. Blake, and carried, management's recommendation to open new accounts utilizing a bank's standard resolution rather than the Company's standard resolution and to provide temporary flexibility to exceed Policy's the maximum investment limit at a single financial institution was approved.

Mr. Lay provided an update on assets sales in process, noting that British Gas may not be able to complete its purchase of the Company's exploration and production assets in India. He also reported that Petrobras may not be prepared to fund its purchase from the Company of distribution businesses in Brazil.

MATERIAL REDACTED

Mr. Zelin provided a discussion on alternatives to bankruptcy, the status of the development of such alternatives, and the near-term evaluation of alternatives and establishment of the best alternative structure. He further described the likelihood of funding new financings based on well-developed term sheets. He also reported that Blackstone had contacted a number of firms who might be interested in competing with J.P. Morgan Securities Inc. ("JP Morgan") and Salomon Smith Barney Inc. ("SSB") on financing or purchasing an interest in the Company's wholesale trading operations. A discussion ensued on the interest and capabilities of each firm.

Mr. Whalley entered the meeting.

Mr. Zelin advised that the Company set priorities in holding any additional discussions, noting that JP Morgan and SSB were both logical candidates to participate in the transactions.

Mr. Bienenstock entered the meeting. Mr. Bowen left the meeting. Messrs. Haggerty and Rosen also left the meeting.

Dr. LeMaistre presented matters for discussion related to the Enron Corp. 1994 Deferral Plan. Following a discussion and upon a motion duly made by Dr. LeMaistre, seconded by Mr. Duncan, and carried, the following resolutions were approved:

WHEREAS, the Company has heretofore established the Enron Corp. 1994 Deferral Plan (As Restated Effective October 6, 2000) (the "Deferral Plan"); and

WHEREAS, the Company desires to amend the Deferral Plan;

NOW, THEREFORE, IT IS RESOLVED, that the Deferral Plan is amended to suspend deferrals effective at the end of business November 29, 2001. Deferrals to the Deferral Plan shall remain suspended until such time as the Board of Directors of the Company removes such suspension; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered, and directed to take all such further action, to amend, execute, and deliver all such instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses, as in their judgment may be necessary, appropriate, or advisable in order fully to carry into effect the purposes and intentions of this and each of the foregoing resolutions, including the execution of any further amendments, forms, or documents recommended by counsel or required by any governmental agency, and to do anything necessary to effect compliance with applicable law or regulation.

Dr. LeMaistre then presented matters for discussion related to the Enron Corp. Savings Plan. Following a discussion and upon a motion duly made by Dr. LeMaistre, seconded by Mr. Blake, and carried, the following resolutions were approved:

WHEREAS, the Company desires to amend the Enron Corp. Savings Plan (the "Savings Plan");

NOW, THEREFORE, IT IS RESOLVED that effective November 28, 2001, the Savings Plan is amended as follows:

Section 3.4 of the Savings Plan regarding Company Matching Contributions is deleted and all other sections of the Savings Plan in which Company Matching Contributions are referenced are revised to exclude reference to Company Matching Contributions, except as may be necessary to continue the tax qualified status of the Savings Plan. Further, any Company Matching Contribution made after the date of this resolution shall be made in cash. This amendment to Section 3.4 does affect certain benefits as described under Section XXII.

Section 5.1 of the Savings Plan regarding Investment of Company Contribution Accounts is amended to provide that paragraph (b) of Section 5.1 shall apply to any Participant in the Savings Plan, regardless of age.

RESOLVED, that the officers of the Company are hereby authorized and directed to proceed toward finalizing a formal amendment to the Savings Plan; and

RESOLVED, that upon execution of the amendment, it shall be deemed adopted by this Board and is hereby ratified and approved; and

RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered, and directed to take all such further action, to amend, execute, and deliver all such instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses as in their judgment may be necessary, appropriate, or advisable in order fully to carry into effect the purposes and intentions of this and each of the foregoing resolutions, including the execution of any further amendments, forms, or documents recommended by counsel or required by any governmental agency, and to do anything necessary to effect compliance with applicable law or regulation.

Dr. LeMaistre then presented a recommendation to establish the Enron Corp. Bonus Plan ("Bonus Plan") for the purposes of retaining key people given the uncertainty surrounding the Company's business and the need to maximize the value of the Company. A full discussion ensued on the Bonus Plan, including the number of people to be awarded bonuses, total payments both including and excluding members of executive management, the provision designed to retain people for at least ninety days, advice from WC&P, and the advice from Towers Perrin.

Messrs. Derrick and McMahon entered the meeting. Mr. Whalley stated the importance of retaining people to preserve and maximize the value of the Company. He indicated that the number of people to be included and the respective payments had not yet been finalized. Additional discussion ensued, including a discussion of the Bonus Plan and the process planned to determine people to be awarded bonuses, the purpose of the retention provision, the number of people included, the maximum total payment, and a consensus that management's final plan be reviewed by the Compensation and Management Development Committee of the Board.

Mr. Haggerty entered the meeting. Messrs. Derrick and McMahon left the meeting.

Following the discussion and upon a motion duly made by Dr. LeMaistre, seconded by Dr. Jaedicke, and carried, the following resolutions were approved:

> WHEREAS, it is the desire of Enron Corp. (the "Company") to establish and adopt a bonus plan for calendar year 2001 (the "Plan") to pay bonuses to certain key employees who are not eligible to participate in the Enron Corp. Annual Incentive Plan, in recognition for their performance in calendar year 2001;
>
> NOW, THEREFORE, IT IS RESOLVED that the authorized officers of the Company are authorized and directed to prepare and execute a Plan document substantially in the form presented at this meeting; and
>
> RESOLVED FURTHER, that upon execution of such Plan document and review of the Plan by the Compensation and Management Development Committee of the Board, the Plan shall be deemed adopted by this Board and is hereby ratified and approved; and
>
> RESOLVED FURTHER, that the proper officers of the Company and its counsel are hereby authorized, empowered, and directed to take all such further action, to amend, execute, and deliver all such instruments and documents, for and in the name and on behalf of the Company, under its corporate seal or otherwise, and to pay all such expenses, as in their judgment may be necessary, appropriate, or advisable in order fully to carry into effect the purposes and intentions of this and the foregoing resolutions, including the execution of any further amendments, forms, or documents recommended by counsel or required by any governmental agency, and to do anything necessary to effect compliance with applicable law or regulation.

Mr. Whalley left the meeting.

Mr. Lay asked for a discussion on previous actions to form a Special Litigation Committee of the Board and on the composition of the Special

Investigative Committee of the Board ("Committee). A discussion ensued, concluding that it would be beneficial to reduce the number of members on the Committee to three, to include a majority of members who had not been on the Board at the time of the transactions subject to investigation by the Securities and Exchange Commission, and to include one member with a strong historical perspective of the Company and the Board. Following a discussion and upon a motion duly made by Mr. Blake, seconded by Dr. Gramm, and carried, the following resolutions were approved:

WHEREAS, on October 28, 2001, a special committee of the Board of Directors (referred to herein as the "Special Investigative Committee") of Enron Corp. (the "Company") was appointed for a number of purposes, including (i) to conduct an independent review and investigation of certain transactions between the Company and certain of its current and former officers and employees (the "Transactions"), (ii) to litigate claims on behalf of the Company that arise in connection with any derivative litigation resulting from the Transactions, (iii) to take disciplinary action against any director, officer, or employee of the Company that improperly participated in the Transactions, (iv) to report on its review to the appropriate regulatory authorities, including the Securities and Exchange Commission (the "SEC"), and (v) to recommend to the Board of Directors any other appropriate action that the Company should take in response to the Transactions;

WHEREAS, in view of the foregoing, the Board of Directors has determined that it is in the best interests of the Company that the Special Investigative Committee be comprised of a majority of members who were not members of the Board of Directors at the time of any of the Transactions while still continuing the work the Special Investigative Committee has begun and still benefitting from the knowledge of existing members; and

WHEREAS, the scope of the authority granted to the Special Investigative Committee should be co-extensive with its focus on all Transactions and other matters previously entrusted to it other than the matters assigned to the Special Litigation Committee as set forth in the resolutions approved by the Board of Directors on November 27, 2001.

Resolutions Relating to Special Investigative Committee

RESOLVED, that the following resolutions shall supercede and replace the resolutions of the Board of Directors of the

Company adopted on October 28, 2001 establishing the Special Investigative Committee and defining the scope of its authority; and it is

FURTHER RESOLVED, that the Board of Directors hereby appoints Raymond S. Troubh to serve as a member of the Special Investigative Committee; and it is

FURTHER RESOLVED, that Frank Savage and Paulo Ferraz Pereira shall no longer serve as members of the Special Investigative Committee; and

FURTHER RESOLVED, that William C. Powers Jr. is and remains a member and chairperson of the Special Investigative Committee; and it is

FURTHER RESOLVED, that the Special Investigative Committee is hereby authorized to perform only the following duties:

> The Special Investigative Committee is authorized to conduct an independent investigation, review, and evaluation of the inquiries made by the SEC in connection with its currently pending investigation of the Transactions (the "SEC Investigation");
>
> In connection with its investigation, the Special Investigative Committee shall have the right to avail itself of any and all materials, work product, and other information prepared or collected by the Board of Directors or any committee thereof, or their respective advisers;
>
> The Special Investigative Committee is charged with reaching its own independent determinations and conclusions and, accordingly, shall be not be bound by any determinations or conclusions reached by the Board of Directors or any committee thereof;
>
> The Special Investigative Committee is authorized to review and make recommendations to the Board of Directors of the Company concerning disclosures made by the Company in its publicly filed reports, and

any other disclosures required under state or federal law, relating to the SEC Investigation;

The Special Investigative Committee is authorized to report on its review to appropriate regulatory authorities, including the SEC;

The Special Investigative Committee shall recommend to the entire Board of Directors any other appropriate action that the Company should take in response to the SEC Investigation as the Special Investigative Committee deems appropriate and in the best interests of the Company and its shareholders, in accordance with applicable law; and

Notwithstanding the foregoing, the Special Investigative Committee shall have no authority or responsibility to conduct any investigation, review, or evaluation of, or report to the Board of Directors or the Company or any other person or entity regarding, the Derivative Actions; and it is

FURTHER RESOLVED, that the Special Investigative Committee is authorized to engage such experts, consultants, and advisers, including its own independent legal counsel, as the Special Investigative Committee shall deem necessary or desirable in order to assist it in the discharge of its responsibilities; and that any member of the Special Investigative Committee is hereby authorized, on behalf of the Company and in its name, to execute and deliver engagement letters with such experts, consultants, and advisers; and it is

FURTHER RESOLVED, that the Special Investigative Committee is authorized to cause its legal counsel to retain a big five accounting firm (the "Accounting Firm") to assist the counsel in advising it in connection with the discharge of its duties; and it is

FURTHER RESOLVED, that the Company shall pay the fees and expenses incurred by the Special Investigative Committee in discharging its duties, including the fees and expenses of the Special Investigative Committee's legal counsel and other experts, consultants, and advisers (if any), and the Accounting Firm; and it is

FURTHER RESOLVED, that the Company shall fund the estimated compensation and fees and expenses of the members of the Special Investigative Committee and those incurred by the Special Investigative Committee in discharging its duties as described above; and it is

FURTHER RESOLVED, that officers and directors of the Company (other than the members of the Special Litigation Committee who may do so at their sole discretion) are hereby directed to provide the Special Investigative Committee and its advisers with such business, financial, and other information regarding the Company as may be reasonably requested by them in conjunction with the performance of their duties hereunder; and it is

FURTHER RESOLVED, that the Special Investigative Committee and the officers and directors of the Company be, and they hereby are, authorized, empowered, and directed to take any and all actions that may be necessary or appropriate in order to carry out the purposes and intent of the foregoing resolutions; and it is

FURTHER RESOLVED, that all actions previously taken by any executive officer or director of the Company in connection with the actions contemplated by the foregoing resolutions are hereby approved, adopted, and ratified in all respects as if such actions had been presented to the Board of Directors for its approval prior to such actions being taken.

Messrs. Haedicke and Whalley entered the meeting.

Mr. Whalley commented on the Bonus Plan, noting that it excluded employees of Enron Europe. He stated that it was expected that the directors of Enron Europe would vote soon to place Enron Europe into receivership, which would reduce the exposure to personal liability associated with incurring debt with no known ability to pay.

Mr. Lay noted that the common stock of the Company would ordinarily begin trading ex-dividend on November 29, 2001. He advised that a press release was expected to be issued that stated that the Company is considering whether to pay the common stock dividend on the payment date previously established. He reported on an inquiry from the New York Stock Exchange regarding the Company's plans. He also noted the consistency of the Company's statement with the previous decision to selectively pay bills and obligations that would maximize the value of the Company.

MATERIAL
REDACTED

Mr. Lay called for an executive session. Messrs. Derrick, Haedicke, Frevert, and Whalley left the meeting. Messrs. Haggerty and West also left the meeting.

Mr. Lay advised the Board that they continued to have the right to choose another chief executive officer for the Company and indicated that the Board should take whatever action it determined to be in the best interest of the Company. He stated the importance of the Board and the chief executive officer being very aligned going forward and stated his willingness to serve in that capacity.

Mr. Lay left the meeting.

MATERIAL
REDACTED

Ms. Rieker left the meeting, and no minutes were taken for the remainder of the meeting.

There being no further business to come before the Board, the meeting was adjourned at 8:35 p.m., C.S.T.

Paula H Rieker
Secretary

APPROVED:

Chairman

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Agenda Item Number 3
(5 Pages Total)
November 28, 2001

Enron Corp. Bonus Plan and Enron Corp. Annual Incentive Plan

- Purpose – to recognize, motivate and reward performance for Calendar Year 2001.
- While not stated specifically in the Plan, it is the Company's intent to pay 2001 Bonus Payments for key and critical employees (approximately 10% of the population) as soon as practicable after approval of the Plan. The remaining eligible employees may receive a bonus payment after the end of Calendar Year 2001.
- Employees receiving these 2001 bonus payments soon after approval of the Plan must return 125% of the payment if they voluntarily leave within 90 days following receipt of such payment.
- The total amount to be paid as soon as practicable following approval of the Plan is $__________________. Any additional amount paid later under this plan will be reviewed and subject to approval by the Board of Directors.
- Weil, Gotshal, and Manges commented that it is not a legal decision to implement this type of plan, but that it is an issue of business judgment that may be second-guessed. However, Weil Gotshal thought that based on Enron's analysis of the criticality of our personnel and the need to protect our key personnel, it is a compensation design for which reasonable justification exists.
- Therefore, management recommends approval of the Enron Corp. Bonus Plan.
- This Plan excludes 16b officers; they are covered separately under the Enron Corp. Annual Incentive Plan approved by shareholders. One or more 16b officers as approved by the Board of Directors will be handled in the manner as second and third bullets above.
- This Plan excludes employees eligible for payments under the Performance Bonus Trust, a grantor trust established by Enron North America Corp.

MINUTES
MEETING OF THE COMPENSATION AND MANAGEMENT DEVELOPMENT COMMITTEE OF THE BOARD OF DIRECTORS ENRON CORP.
November 29, 2001

Minutes of a meeting of the Compensation and Management Development Committee ("Committee") of the Board of Directors of Enron Corp. ("Company"), noticed to begin at 9:00 a.m., C.S.T., but actually begun at 9:40 a.m., C.S.T., on November 29, 2001 at the Enron Building in Houston, Texas.

All of the Committee members were present either in person or by telephone conference connection whereby each of the participants could hear the comments and discussions by the other participants and join in the discussions, as follows:

Dr. Charles A. LeMaistre, Chairman
Mr. Norman P. Blake, Jr.
Mr. John H. Duncan
Dr. Robert K. Jaedicke
Mr. Frank Savage

Director Kenneth L. Lay and Mr. Mark A. Frevert and Mesdames Mary J. Joyce and Paula H. Rieker, all of the Company, also attended the meeting.

The Chairman, Dr. LeMaistre, presided at the meeting, and the Secretary, Ms. Rieker, recorded the proceedings.

Dr. LeMaistre called the meeting to order and reported that, at a Board meeting held on the prior day, the Board engaged in extensive discussions regarding the importance of establishing a bonus and incentive program for key employees. He provided a summary of management's recommendation for payments to retain key employees pursuant to the Enron Corp. Bonus Plan and the Enron Corp. Annual Incentive Plan (collectively, the "Plans") that was recently reviewed and approved by the Board. He noted that the most recent proposal included potential payments totaling $54.2 million, which remained under the total amount of $60 million recently approved by the Board, and included 528 employees compared to 512 employees at the time of the presentation to the Board. He stated that the report provided to the Committee, a copy of which is included in the records of the meeting, complied with the administrative requirements of the Plans. He confirmed that the total payments to be offered to selected key employees remained below the approved level of $60 million.

Mr. Blake stated the importance of insuring that compensation was not awarded to employees who may have been deemed to either not have adequately complied with the Company's Code of Ethics or may have been partly responsible for inappropriate transactions with certain parties related to the Company. A discussion ensued regarding the status of the investigation being conducted by the Special Committee of the Board ("Special Committee"), including research by the Special Committee regarding compliance by employees with the Code of Ethics and participation by employees in any inappropriate transactions. Following the discussion, upon motion duly made by Mr. Duncan, seconded by Mr. Blake, and carried, the Committee authorized Mr. Lay to confirm with the chairman of the Special Committee that the Special Committee had no knowledge related to the employees for which bonus payments were contemplated that would cause management to withhold such payments and further, if such knowledge existed, authorized Mr. Lay to withhold payments to such employees.

Ms. Joyce clarified that the number of employees to be offered payments pursuant to the Plans may increase by a small number, noting that the total payments would remain below the $60 million approved by the Board. Mr. Lay commented on a few employees that may be reviewed for revised awards. Following a discussion, upon motion duly made by Dr. LeMaistre, seconded by Mr. Blake, and carried, a total of up to $60 million of payments pursuant to the Plans were approved, management was authorized to modify the list of employees and payment amounts as deemed appropriate, and it was confirmed that any awards to employees subject to Section 16 of the Securities Exchange Act of 1934 would be presented for approval by the Committee prior to such awards being made.

Mr. Lay stated the significant accomplishments and critical importance to the Company of Mr. Jeffrey McMahon, the Chief Financial Officer and a Section 16 officer. He recommended a payment to Mr. McMahon pursuant to the Plans, a summary of which is included in the records of the meeting. Following a discussion, upon motion duly made by Mr. Blake, seconded by Mr. Savage, and carried, the payment to Mr. McMahon was approved.

A discussion followed regarding the review of the proposed payments and confirmation by Towers Perrin ("Towers") that the approved payments were consistent with industry practices and with the past practices of the Company to retain key employees. Ms. Joyce stated that Towers had verbally confirmed such and that she would seek to obtain written documentation reflecting their confirmation.

Dr. LeMaistre summarized the previous discussions and action taken by the Board related to management's recommendation regarding payments under the

Plans, noting that the actions taken by the Committee today were consistent with the intent and actions of the Board.

There being no further business to come before the Committee, the meeting was adjourned at 10:00 a.m., C.S.T.

Paula L Rieker
Secretary

APPROVED:

Charles A LeMaistre

Chairman

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Business Unit	Headcount	2001_BONUS
MC	7	10,400,000
AA	45	1,262,800
CORP	92 ~~91~~	~~10,195,000~~ 10,345,000
EA	66	5,541,250
EBS	9	2,373,500
EC	1	300,000
EES	61	5,211,000
EGAS	10	1,275,000
ETS	54	4,325,600
EWC	1	100,000
EGM	24	4,506,000
EIM	16	2,005,000
ENW	142	6,508,500
Total	528 ~~527~~	~~54,003,650~~

54,153,650

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MC

Full Name	JOB_TITLE	2001_BONUS
LAVORATO, JOHN	MC	5,000,000
KITCHEN, LOUISE	MC	2,000,000
FALLON, JAMES	MC	1,500,000
HAEDICKE, MARK	MC	600,000
BOWEN JR, RAYMOND	MC	500,000
HUGHES, JAMES	MC	500,000
DIETRICH, JANET	MC	300,000
		10,400,000

AA

Full Name	JOB_TITLE	2001_BONUS
FULLER, ROBERT	TRADING ASSOCIATE	200,000
DRISCOLL, MICHAEL	ANALYST	75,000
MALLORY, PATRICK	ANALYST	75,000
WILLIAMS, WILLIAM J	ANALYST	75,000
NGUYEN, MICHAEL	ASSOCIATE	50,000
STOKLEY, MARLIN	ASSOCIATE	50,000
REITMEYER, JAMES	ASSOCIATE	40,000
RICHEY, ROBERT	ASSOCIATE	40,000
SMITH, MATHEW	TRADING ASSOCIATE	40,000
THOMAS, PAUL D.	ASSOCIATE	40,000
SCHIAVONE, PAUL	TRADING ASSOCIATE	36,700
BENCHLUCH, MOISES	ASSOCIATE	30,000
QUIGLEY, HENRY	ASSOCIATE	30,000
WELDON, V. CHARLES	ASSOCIATE	30,000
AMES, CHARLES	TRADING ANALYST	25,000
BALLATO, RUSSELL	TRADING ANALYST	25,000
GUALY, JAIME	ASSOCIATE	25,000
OH, SEUNG-TAEK	TRADING ASSOCIATE	25,000
ROGERS, BENJAMIN	ASSOCIATE	25,000
CHU-YANG-HEU, MOG	TRADING ANALYST	18,000
LENHART, MATTHEW	ANALYST	18,000
MAKKAI, PETER	ANALYST	18,000
SAIBI, ERIC	ANALYST	18,000
SCOTT, SUSAN	ANALYST	18,000
WOLFE, JASON	ANALYST	18,000
GAY, RANDALL	ASSOCIATE	15,000
PIMENOV, VLADI	TRADING ASSOCIATE	15,000
ROSTANT, JUSTIN	ASSOCIATE	15,000
TERP, BRIAN	ASSOCIATE	15,000
VERSEN, VICTORIA	ASSOCIATE	15,000
YAWAPONGSIRI, VIRAWAN	TRADING ASSOCIATE	15,000
SCHNEIDER, BRYCE	TRADING ASSOCIATE	13,750
COFFING, TIMOTHY ANDREW	ANALYST	12,500

NELSON, KOURTNEY	ANALYST	12,500
PLACHY, DENVER	TRADING ANALYST	12,500
SALISBURY, HOLDEN	ANALYST	12,500
LIESKOVSKY, JOZEF	TRADING ASSOCIATE	10,500
PHILIP, WILLIS	TRADING ASSOCIATE	8,750
KANISS, JASON	ANALYST	8,350
BAYER, ADAM	ANALYST	8,250
GIRON, GUSTAVO	TRADING ASSOCIATE	6,250
FALIK, BRIAN	ANALYST	5,750
JENKINS IV, DANIEL	ANALYST	5,750
LARKWORTHY, CARRIE	TRADING ANALYST	5,750
HERNANDEZ, ANAMARIA	ANALYST	5,000
		1,262,800

CORP

Full Name	JOB_TITLE	2001_BONUS
MAXEY, R. DAVIS	VP TAX ORIGINATION	400,000
BUTTS, ROBERT	MNG DIR & CONTROLLER	375,000
BRADFORD, WILLIAM	VP CREDIT	300,000
FALDYN, RODNEY	VP TRANSACTION ACCOUNTING	300,000
HERMANN, ROBERT	MNG DIR AND GENERAL TAX COUNSEL	300,000
ROGERS, REX	VP & ASSOC GEN COUNSEL	300,000
WALLS JR, ROBERT	MNG DIR & DEPUTY GEN COUNSEL	300,000
EICKENROHT, ROBERT	VP & ASST GEN CNSL	250,000
GORTE, DAVID	VP & CHIEF UNDERWRITER	250,000
GINTY, JAMES	VP TAX COUNSEL	225,000
SCHNAPPER, BARRY	VP FINANCE	225,000
COATS, EDWARD	VP TAX	200,000
DONAHUE JR, JEFFREY	MNG DIR CORPORATE DEVL	200,000
JOYCE, MARY	VP EXECUTIVE COMPENSATION	200,000
MINTZ, JORDAN	VP & GEN CNSL	200,000
PALMER, MARK	VP COMMUNICATIONS	200,000
RICE, GREEK	VP TAX	200,000
RIEKER, PAULA	MD CORPORATE SECRETARY	200,000
SHAPIRO, RICHARD	MNG DIR GOVT AFFAIRS	200,000
TAYLOR, MITCHELL	MNG DIR CORP DEVE	200,000
SCHNEIDER, CHARLES	VP UNDERWRITING	190,000
TRIBOLET, MICHAEL	VP UNDERWRITING	190,000
DESPAIN, TIMOTHY	VP FINANCE	175,000
DUKE, CULLEN	VP TAX COUNSEL	175,000
HOWARD, KEVIN	VP FINANCE	175,000
LINDSEY, MARK	VP & ASST CONTROLLER	150,000
LORD, PHILLIP	VP TRANSACTION ACCTG	150,000
DOUGLAS, STEPHEN	DIR SR TAX PLANNING	140,000
BOYLE, DAN	VP FINANCE	125,000
DELACEY, CHARLES	VP FINANCE	125,000
DETMERING, TIMOTHY	MNG DIR CORPORATE DEVL	125,000
PERKINS, MARY	VP FIN SUPT	125,000

BRACKETT, DEBORAH	DIR SR RISK CREDIT	100,000
KAUFMAN, PAUL	VP GOVT AFFAIRS	100,000
LARSON, BRADFORD	VP UNDERWRITING	100,000
MCKEAN, GEORGE	DIR FIN	100,000
ROHAUER, TANYA	DIR SR RISK CREDIT	100,000
SIUREK, RYAN	DIR SR TRANSACTION ACCTG	100,000
STEFFES, JAMES	VP GOVERNMENT AFFAIRS	100,000
TERRASO, MICHAEL	VP ENV HEALTH & SAFETY	100,000
WALDEN, JOHN	DIR SR TRANSACTION ACCTG	100,000
BROWN, JAMES	DIR SR TRANSACTION ACCTG	90,000
DASOVICH, JEFFREY	DIR SR GOV/REG AFFAIRS	90,000
PARSONS, DAVID	DIR SR IT-DEVELOPMENT	90,000
FREELAND, CLINT	DIR FIN	75,000
HAGELMANN, BJORN	DIR MARKET RISK MGMT	75,000
PORT, DAVID	DIR SR MARKET RISK MGMT	75,000
JOHNSON, JANET	DIRECTOR SR ACCOUNTING	70,000
ANDREWS, NAVEEN	DIR MARKET RISK MGMT	~~60,000~~
BARROW, CYNTHIA	DIR SR BENEFITS	60,000
BROWN, AARON	DIR COMPENSATION	60,000
BUTLER, PAMELA	DIR COMPENSATION	60,000
HARRIS, MARY	DIR RISK CREDIT	60,000
HAYDEN, FRANK	DIR MARKET RISK MGMT	60,000
KINGERSKI, HARRY	DIR SR GOV/REG AFFAIRS	60,000
NICOLAY, CHRISTI	DIR SR GOV/REG AFFAIRS	60,000
NOVOSEL, SARAH	DIR SR GOV/REG AFFAIRS	60,000
SCHULTEA, KATHRYN	DIR HRIS	60,000
SULLIVAN, KRISTE	COUNSEL SR	60,000
BAKER, RON	DIR TRANSACTION ACCTG	55,000
NORDSTROM, MARY	DIR MARKET RISK MGMT	55,000
DEVILLE, FRANK	DIR FNCL	50,000
FARMER, STANLEY	DIR TRANSACTION ACCTG	50,000
HACHEN, JAMES	DIR UNDERWRITING	50,000
KOBES, GLENN	DIRECTOR TAX	50,000
OVERTURF, ELAINE	DIR SR & DEPUTY CORP SECTY	50,000
PENG, GARY	DIR ACCTG	50,000
SACKS, EDWARD	MGR RISK CREDIT	50,000
SCHWARZBACH, STEPHEN	DIR ACCTG	50,000
SHANNON, PATRICIA	DIR ACCTG	50,000
WILCOTT, ROBERT	DIR TAX	50,000
WILLIAMS, DAVID	DIRECTOR SR TAX	50,000
MCGINNIS, STEPHANIE	DIR RISK CREDIT	45,000
MORAN, THOMAS	DIR RISK CREDIT	45,000
REASONER, MONICA	MGR MARKET RISK MGMT	45,000
WHEELER, TERESA	DIR FNCL	40,000
EGHNEIM, GUS	DIR ENV HEALTH & SAFETY	30,000
JOHNSON, RICK	DIR. OFFICE OF LABOR & EMPLOYEE RELATION	30,000
PHILLIPS, MARC	DIR REGULATORY ANALYSIS	30,000
RAHAIM, CHRISTIAN	DIR BENEFITS	30,000
RATH, MIKIE	MGR BNFTS	30,000

TAYLOR, DIANE	MGR PAYROLL/RELOCATION	30,000
GARCIA, PAUL	DIR FIN SUPT	25,000
MOEHLMAN, CATHY	DIR FIN SUPT	25,000
AULDS, SHARON	SPEC COMPENSATION	20,000
GARCIA, SUSAN	SPEC COMP SYSTEMS	20,000
HUSEMAN, SANDRA	ADVISOR BENEFITS	20,000
RATCLIFF, DONNA	COMPENSATION SPECIALIST	20,000
SIMON, SHAWANA	SUPV PAYROLL PROCESSING	20,000
WILLMANN, DONNIE	DIR ENV HEALTH & SAFETY	20,000
ZULETA, EDGAR	MGR ENVIR SAFETY	15,000
		10,195,000

Bob Williams Legal - Stockholder + Derivative Chief Litigator 150,000

$10,345,000

EA

Full Name	JOB_TITLE	2001_BONUS
COLWELL, WESLEY	MNG DIR ACCTG	600,000
SCHULER, W	VP & ASST GEN CNSL	300,000
GONZALEZ, ORLANDO	VP	200,000
HODGES, GEORGANNE	VICE PRESIDENT ACCOUNTING	200,000
MURRAY, JULIA	MNG DIR LEGAL	200,000
TAYLOR, MARK	VP & GEN CNSL	200,000
MILLER, LLOYD	VP ORIG WHOLESALE	175,000
ZIPPER, ANDREW	VP TRADING	175,000
JOSEY, SCOTT	VP ORIG WHOLESALE	150,000
KEOHANE, PETER	VP & ASST GEN CNSL	150,000
PATRICK, MICHAEL	VP TRANS SUPPT	150,000
SAGER, ELIZABETH	VP & ASST GEN CNSL	150,000
SANDERS, RICHARD	VP & ASST GEN CNSL	150,000
SHERMAN, RICHARD	VP TRANS SUPPT	150,000
WIGGS, BRETT	VP BUS DEV ORIG	150,000
ARONOWITZ, ALAN	VP & GEN CNSL	125,000
CASH, MICHELLE	GEN COUNSEL ASST	125,000
MCCULLOUGH, TRAVIS	VP & ASST GEN CNSL	125,000
CILIA, MARY	DIR SR TRANSACTION ACCTG	100,000
DEFFNER, JOSEPH	MANAGING DIRECTOR TREASURY	100,000
MELLENCAMP, LISA	COUNSEL SR	100,000
QUAINTANCE, JR., ALAN	SR. DIR TRANS SUPPT	100,000
ST. CLAIR, CAROL	GEN COUNSEL ASST	100,000
SCOTT, LAURA	VP ACCOUNTING	85,000
CROSS, EDITH	DIR STRUCTURING	75,000
KEEL, ALLAN	VP ORIG WHOLESALE	75,000
MELENDREZ, JESUS	VP PORTFOLIO MGMT	75,000
O'NEIL, MURRAY	DIR SR TRADING SUPT	70,000
O'ROURKE, TIM	DIR HR	60,000
SCHIELD, ELAINE	SR DIRECTOR ACCOUNTING	60,000
COOK, MARY	COUNSEL SR	50,000
FRANK, MARK	DIRECTOR SR ACCOUNTING	50,000
IRVIN, STEVEN	DIR ORIG WHOLESALE	50,000
KILLEN, FAITH	DIR ACCTG	50,000

LABAUME, WANDA	DIR SR ACCOUNTING	50,000
MCMICHAEL JR, ALBERT	VP ORIG WHOLESALE	50,000
MORSE, BRADFORD	MGR TRADING	50,000
VARGAS, ESPERANZA	DIR ACCTG	50,000
WHITING, GREGORY	DIR ACCTG	50,000
SLONE, JEANNE	MGR HR	40,000
PIERCE, JOSEPH	DIR ACCTG	35,000
FITZPATRICK, AMY	MGR HR	30,000
FUNKHOUSER, SHANNA	DIR HR	30,000
IMAI, RIKA	MGR TRADING SUPT	30,000
WALTON, SHEILA	DIR HR	30,000
AUNE, STACEY	MGR ACCTG	28,000
IRVIN, TRACY	MGR ACCTG	28,000
LAMB, MARNIE	MGR ACCTG	28,000
SCHWERTNER, BRIAN	MGR ACCTG	28,000
WARWICK, TODD	MGR ACCTG	28,000
BRODEUR, STEPHANE	ANALYST	25,000
STEPENOVITCH, JOSEPH	SPEC SR TRADING SUPT	25,000
WATT, RYAN	ANALYST	25,000
WILLIAMS, JASON	SPEC SR LOGISTICS	25,000
DOUCET, DAWN	REP SR HR	20,000
OQUINN, KARI	MGR HR	20,000
DRAPER, LON	ANALYST	18,000
BROUSSARD, THARSILLA	SPEC HR	15,000
CROWELL, RACHEL	SPEC SR ACCTG	15,000
HARDY, JOSEPH	SPEC SR ACCTG	15,000
HARDY, STACY	SPEC SR ACCTG	15,000
MAYES, FRANCES	MGR HR	15,000
VANDOR, DAVID	SPEC SR ACCTG	15,000
WOLFE, STEPHEN	SPEC SR ACCTG	15,000
DAY, MISTI LYNN	SPEC ACCTG	12,000
TAYLOR, FABIAN	ANALYST	6,250
		5,541,250

EBS

Full Name	**JOB_TITLE**	**2001_BONUS**
DIMICHELE, RICHARD	MD CORP DEV	600,000
RACICOT JR, PAUL	VP TRADING	400,000
SEELIGSON, STEWART	VP ORIGINATION	350,000
THAPAR, RAJEEV	VP TRADING	250,000
SMIDA, EDWARD	VP ORIGINATION	225,000
FEHL, RICHARD	VP NETWORK ENG & OPS	208,500
BRYSCH, JAMES	DIR ORIGINATION	150,000
MOSS, KEVIN	VP ENG	150,000
ENOCHS, FRED	DIR TRADING	40,000
		2,373,500

EC

Full Name	JOB_TITLE	2001_BONUS
LEFF, DANIEL	CHIEF OPERATING OFFICER	300,000
		300,000

EES

Full Name	JOB_TITLE	2001_BONUS
MULLER, MARK	PRESIDENT & CEO	400,000
BLACHMAN, JEREMY	MD ENERGY PORTFOLIO MGMT	250,000
GAHN, ROBERT	MD ENRON DIRECT USA	250,000
HOLMES, SEAN	VP DEAL MANAGEMENT	250,000
PAGAN, J	VP ASSET MGMT	200,000
SCHWARZ, ANGELA	VICE PRESIDENT ORIGINATION	200,000
SHARP, VICTORIA	MNG DIR & GEN CNSL	200,000
STUBBLEFIELD, GREGORY	VP FINANCIAL OPERATIONS	150,000
WILLIAMS, JIMMIE	VP EES CORP DEV	150,000
WOULFE, GREGORY	DIR TRADING	150,000
ADAMS, GREGORY	VICE PRESIDENT ORIGINATION	100,000
BERTASI, RONALD	VICE PRESIDENT MASS MARKET	100,000
DOBLER, MARK	VP ENERGY OPNS	100,000
FRAZIER, LAMAR	DIRECTOR REGIONAL MARKET SVC	100,000
GOLDEN, JEFFREY	VP CORPORATE DEVELOPMENT	100,000
HUGHES, EVAN	DIRECTOR SR SERVICE MANAGEMENT	100,000
MERRIL, DEBORAH	DIR COMMODITY STRUCT	100,000
MUENCH, GAYLE	VP PORTFOLIO ORIGINATION	100,000
SHARP, GREGORY	VP DIRECT ENERGY SALES	100,000
SUTTER, CRAIG	VICE PRESIDENT ORGINATION	100,000
WOOD, JAMES	DIR SR PROD DEVEL/MKT DEVEL	100,000
MAYNARD, ANNE	VP & ASST GEN CNSL	80,000
SMITH, MICHAEL	VP & ASST GEN CNSL	80,000
GORNY, VLADIMIR	DIRECTOR CONSUMPTION RISK	75,000
PIEPER, KALEN	VP HR	75,000
APKE, BETH	DIRECTOR SR TAX	60,000
KRAUTZ, MICHAEL	SR DIRECTOR TRANSACTION SUPPORT	60,000
LEE, PATRICIA	DIR TAX SR	60,000
RUFFER, MARY	DIR SR ACCTG	60,000
ADAMS, THOMAS	DIRECTOR OF ASSESTS & LABOR	50,000
BARRETT, MISTY	DIR ASSURANCE SERVICES	50,000
BENNETT, THOMAS	DIRECTOR TECH OPNS	50,000
BLANKS JR., WAYNE	SPECIALIST SR SERVICE PRICING	50,000
BOUDREAUX, KEVIN	SPEC SR SERVICE MANAGEMENT	50,000
CHERRY, RHENN	VP DEAL MANAGEMENT	50,000
FISCHER, JEFF	MGR TAX	50,000
FISHER, JONI	MANAGER ACCOUNTS RECEIVABLE	50,000
FOX, WHITNEY	SPEC SR SERVICE MANAGEMENT	50,000
HUDDLESON, DIANN	DIRECTOR SPECIAL PROJECTS	50,000
KORTES, BARBARA	DIR SR SERVICE MANAGEMENT	50,000
MORROW, CYNTHIA	DIR SR ASSET OPS	50,000
NASSAB, PETER	VP INDUSTRIAL SERVICES	50,000

NELSON, KIMBERLEY	DIR FINANCE	50,000
NIELAND, JEFFERY	DIR SERVICE MANAGEMENT	50,000
PECK JR, OMAR	DIR SR CLIENT SERVICES	50,000
RILEY, CHRISTOPHER	DIR COMMODITY STRUCT	50,000
SMITH JR., BEN	DIR SERVICE MANAGEMENT	50,000
SOVA, GARY	INDUSTRY SEGMENT GENERAL MANAGER	50,000
STRAATMANN, CHRISTINE	DIR ASSETS/LABOR	50,000
WEISSELBERG, ALEX	DIR FIELD EXECUTION MGMT	50,000
WISHERT, CYNTHIA	DIR SR SERVICE MANAGEMENT	50,000
WOODWARD, JASON	DIRECTOR SERVICE PRICING	50,000
YOUNG, GREGG	DIRECTOR BUSINESS CENTER	50,000
RAY, SARA	MGR PLNG & RPTG	30,000
MASSEY, RACHEL	MGR FINCL ACCTG & ANALYSIS	28,000
NGUYEN, NINA	MGR TECH ACCTG & RESEARCH	28,000
MORYL, HEIDI	SPEC SR PLNG & RPTG	20,000
BROWN, DANIEL	MGR HR	15,000
CAPESTANY, MARI	MGR CORPORATE DEV	~~15,000~~
NEFF, JAMES	MGR CORPORATE DEV	15,000
VANN, SUZANNE	MGR CORP DEV	10,000
		5,211,000

EGAS

Full Name	JOB_TITLE	2001_BONUS
MAHAN, ROSA	VP ASSET BUS DEV	225,000
WEIDLER, PETER	VP ASSET BUS DEV	225,000
KINDER, DARRELL	VP ORIG WHOLESALE	200,000
SOMMERS, JEFFREY	VP & CONTROLLER	200,000
LUNDSTROM, BRUCE	VP & GEN COUNSEL	150,000
GILCHRIST, IAN	SENIOR DIRECTOR COMMERCIAL SUPPORT	75,000
HOWES, CAROL	DIR SR FIN & ACCTG	70,000
BOE, LAWRENCE	DIR ACCTG	50,000
RANGEL, RAFAEL	DIR SR ACCT & CNTRLS	50,000
CALLAHAN, TIMOTHY	DIR HR INTL	30,000
		1,275,000

ETS

Full Name	JOB_TITLE	2001_BONUS
HAYSLETT, RODERICK	MANAGING DIRECTOR ETS FINANCE & ACCTG	400,000
FOSSUM, DREW	VP & GEN COUNSEL	210,000
HAYES, ROBERT	MNG DIR MARKETING	210,000
NEUBAUER, DAVID	VP BUS DEV AND MKTG	210,000
CORMAN, SHELLEY	VP GAS LOGISTICS & COMMUNICATIONS	200,000
HOTTE, STEVE	VP & CHIEF INFORMATION OFFICER	200,000
LOWRY, CHARLES	MANAGING DIRECTOR ETS OPERATIONS	200,000
BOATMAN, JACK	VP MKTG FGT GPG	131,000
HARRIS, STEVEN	VP TRANSWESTERN COMM GROUP	131,000
MILLER, KENT	VICE PRESIDENT STORAGE MANAGEMENT	131,000
MILLER, MARY KAY	VP RATES & CERTIFICATES	131,000

SAUNDERS, JAMES	VP FINANCE & ADMINISTRATION	131,000
SOLDANO, LOUIS	VP & GEN COUNSEL	110,000
KILMER III, ROBERT	VP RATES & CERTIFICATES	100,000
NELSON, MICHEL	VP PIPLINE INTEGRITY PROG MGMT	100,000
SMITH, GARY	VP HUMAN RESOURCES	100,000
CRAIG, RICHARD	VP OPNS	81,000
MARTIN, JERRY	VP ENGINEERING & CONSTRUCTION	81,000
PRIBBLE, DANNY	VP OPNS	81,000
SHAFER, JOHN	VP ENV HEALTH & SAFETY	81,000
NEVILLE, SUSAN	DIR STORAGE SERVICES	75,000
BRASSFIELD, MORRIS	DIR SR OPNS SUPPORT SVCS	70,000
PORTER, J. GREGORY	GEN COUNSEL ASST	65,000
CHANDLER, ROBERT	DIR FNCL ACCTG & RPTG	50,000
COBB JR, JOHN	DIR ACCTG	50,000
GEACCONE, TRACY	DIRECTOR CONSOLIDATIONS ETS	50,000
RICE, RANDY	DIRECTOR SR OPNS	50,000
WATSON, KIMBERLY	DIR DEAL ORIGINATION	50,000
WILLIAMS, JO	DIRECTOR PRICING & STRUCTURING	50,000
KIRK, STEVEN	DIR RATES & TARIFFS	45,000
LOKEY, WALTER	DIR RATES & TARIFFS	45,000
VAUGHN, ANN	DIR HR	45,000
VEATCH, STEPHEN	DIR CERT & REPORTS	45,000
JANUARY, STEVEN	DIR SR GAS CONTROL	40,000
ODNEAL, DAVID	DIR REGIONAL	38,000
BLAIR, GRACE	DIR CUST SVCS	36,000
BRYANT, MICHAEL	DIRECTOR GAS CONTROL	34,000
FUHRER, PAUL	DIRECTOR PROJECT	34,000
GAINES, DAVID	DIR REGIONAL	34,000
GILBERT, THOMAS	DIR REGIONAL	34,000
LEBEAU, DAVID	DIR REGIONAL	34,000
MERTZ, THOMAS	DIR REGIONAL	34,000
TEAL, JAMES	DIR REGIONAL	34,000
WEATHERFORD, WILLIAM	DIR REGIONAL	34,000
MCGEE, JOHNNY	DIR ROW	30,000
LEWIS, GREGORY	MANAGER IT	28,000
DIETZ, RICHARD	DIR CONTRACT SUPPORT SVCS & CNTRLS	25,000
HOLMES, BRADLEY	DIR BUSINESS APPLICATIONS	25,000
KISSNER, TIM	MGR COST OF SVCS	24,600
NACEY, SHEILA	DIR CUST SVCS	23,000
CLARK, WILLIAM	DIR REGIONAL	20,000
MCGILLIVRAY, RODRICK	DIR REGIONAL	20,000
STEPHENS, LOYD	DIR REGIONAL	20,000
EDWARDS, RALPH	DIR HEALTH & SAFETY	15,000
		4,325,600

EWC

Full Name	**JOB_TITLE**	**2001_BONUS**
GUNTHER, DAVID	VP	100,000

		100,000

EGM

Full Name	JOB_TITLE	2001_BONUS
HICKERSON, GARY	MNG DIR TRADING	700,000
NOWLAN JR, JOHN	VP TRADING	500,000
STALEY, STUART	VICE PRESIDENT, COMMERCIAL	500,000
MCCLELLAN, GEORGE	MNG DIR TRADING	400,000
GONZALES, ERIC	VP ORIG WHOLESALE	350,000
MCGOWAN, KEVIN	VP TRADING	300,000
TAWNEY, MARK	VP TRADING	300,000
AURY, PIERRE	DIRECTOR COMMERCIAL	150,000
DE LA OSSA, JR, MARIO	MGR TRADING	150,000
LEWIS, JAMES	VP FINANCE	150,000
MAHONEY, CHRISTOPHER	VICE PRESIDENT, COMMERCIAL	150,000
MASSEY II, JOHN	MGR TRADING	150,000
SEKSE, PER	VP ORIG WHOLESALE	150,000
RAMACHANDRAN, SANDEEP	MGR TRADING	100,000
THIRSK, JEREMY	VICE PRESIDENT - COMMERCIAL	100,000
MYERS, THOMAS	DIR SR ACCTG	90,000
KROGMEIER, RYAN C.	DIR ACCTG	50,000
MONCRIEFF, SCOTT	DIRECTOR COMMERCIAL	50,000
SMITH, JEFFREY	DIR ACCTG	50,000
GREIG, IAIN	DIRECTOR COMMERCIAL SUPPORT	30,000
BELTRI, ANGELES	MGR ACCTG	28,000
HARALSON, NANCY	MGR ACCTG	28,000
MAYO, ANDREW	SENIOR SPECIALIST	15,000
MEAD, PHILIP	SENIOR SPECIALIST	15,000
		4,506,000

EIM

Full Name	JOB_TITLE	2001_BONUS
MALCOLM, RODNEY	VP ORIG WHOLESALE	275,000
BROWN, WILLIAM	VP & REGIONAL CFO	225,000
CRANE JR, ROBERT	VP TRADING	225,000
HERMANS, GREGOIRE	VP ORIG WHOLESALE	225,000
HOLZER, ERIC	VP ORIG WHOLESALE	225,000
CASTLEMAN, JERRY	VP & CHIEF ACCTG OFFICER	180,000
WRIGHT, GLENN	DIR TRADING	100,000
CONNER, ANDREW	MGR TRADING	75,000
COULTER, JODI	MGR FIN	75,000
EPSTEIN, JAY	MGR TRADING	75,000
MCCORMICK, GEORGE	DIR ORIG WHOLESALE	75,000
CONNOR, ERIC	DIR SR TRANS SUPT	50,000
CROOM, WILLIAM	DIR ORIG WHOLESALE	50,000
HAMILTON, DANIEL	DIR LOGISTICS	50,000
HIDDLESTON, CRAIG	DIR ORIG WHOLESALE	50,000
UECKERT, ALLEN	DIR ACCTG	50,000

		2,005,000

ENW

Full Name	JOB_TITLE	2001_BONUS
PIPER, GREGORY	PRESIDENT & CEO	400,000
BECK, SALLY	CHIEF OPERATING OFFICER	350,000
WEBB, JAY	VP IT	300,000
DAYAO, ANTHONY	VP IT	200,000
JONES, ROBERT	VP HR	200,000
PERLMAN, BETH	VP IT	200,000
RUB, JEANETTE	VP IT	200,000
HALL, ROBERT	VP TRANS SUPT	125,000
APOLLO, BETH	VP TRANS SUPT	100,000
GUADARRAMA, MICHAEL	DIRECTOR SR IT	100,000
JENSON, JAROD	DIRECTOR IT	100,000
MONTAGNE, KEVIN	DIRECTOR SR IT	100,000
PEARCE, BARRY	VP COMM TRADING SUPT	100,000
MCAULIFFE, ROBERT	DIRECTOR SR. IT	90,000
GOSSETT, JEFFREY	DIR RISK MGMT GAS	85,000
PUTHIGAI, SAVITA	DIR E-COMMERCE	85,000
SHULTS, ROBERT	DIR E-COMMERCE	85,000
HEDSTROM, PEGGY	VP TRANS SUPT	80,000
HALL, D.	DIR SR PORTFOLIO MGMT	75,000
HILLIER, BOB	DIRECTOR SR IT	75,000
HEROD, BRENDA	DIR SR RISK MGMT	70,000
JOHNSON, JEFFREY	DIRECTOR SR. IT	70,000
MILLS, SCOTT	DIR SR TRANS SUPT	70,000
REEVES, LESLIE	DIR SR TRANS SUPT	70,000
SCHMIDT, MARK	DIR SR IT-DEVELOPMENT	70,000
STOCK, STEPHEN	DIRECTOR SR IT	70,000
SWEENEY, KEVIN	DIR SR RISK MGMT	70,000
WHITE, STACEY	DIR RISK MGMT POWER	70,000
BEHNEY, CHRISTOPHER	DIRECTOR SR IT	60,000
DOPSON, LAMETRICE	DIR SR IT	60,000
EARNEST, SCOTT	DIR SR PORTFOLIO MGMT	60,000
GUBSER, MARLIN	DIR SR IT	60,000
NAT, STEVE	DIRECTOR SR IT	60,000
BELMONT, MICHAEL	MANAGER IT	55,000
ALLEN, THRESA	DIR LOGISTICS	50,000
BOWLING, WILLIAM	DIRECTOR IT	50,000
DZIADEK, KEITH	DIRECTOR SR. IT	50,000
FINK, MICHAEL	DIRECTOR SR IT	50,000
ROPER, KERWIN	SR. DIRECTOR ACCOUNTING	50,000
STEPHENS, CYNTHIA	MANAGER INVOICING & REPORTING	50,000
STUBBS, SHELLY	DIR RISK MGMT	50,000
SUPERTY, ROBERT	DIR LOGISTICS	50,000
WEI, ZHIYONG	DIRECTOR SR IT	50,000
WILSON, SHONA	DIR TRANS SUPT	50,000

BRUCE, MICHELLE	DIR RISK MGMT	45,000
CHENG, JOHN	CONSULTANT TECH IT	40,000
COUCH, KEITH	DIRECTOR IT	40,000
DAVIES, DAVID	DIR HR	40,000
GALVAN, MICHAEL	DIR ACCTG	40,000
DE BOISBLANC, JENNIFER	MGR TRANS SUPT	35,000
KEISER, KAM	MGR RISK MGMT GAS	35,000
LOVE, PHILLIP	MGR RISK MGMT GAS	35,000
BARBER, MICHAEL	CONSULTANT TECH IT	30,000
BATRAK, HENNADIY	SPECIALIST SR. IT	30,000
ENGEL, THOMAS	MGR E-COMMERCE SUPT	30,000
HART, VIVIAN	DIRECTOR IT	30,000
PISSANETZKY, PABLO	MANAGER IT	30,000
RAO, RAMESH	DIRECTOR SR IT	30,000
THERIOT, KIM	DIR DEAL COMPLIANCE	30,000
TRIESCHMAN, PAUL	DIR SR HR	30,000
BAXTER, ROBERT	MGR SETTLEMENTS	28,000
FARMER, JERRY	MGR LOGISTICS	28,000
GREIF, DONNA	MGR LOGISTICS	28,000
HANNUM, RICHARD	MGR INVOICING	28,000
HARE, BILL	MGR GLOBAL MGMT	28,000
KINSEY, LISA	MGR LOGISTICS	28,000
LAMADRID, VICTOR	MGR LOGISTICS	28,000
LAVINE, JO ANN	MGR CUST RPTG	28,000
LESKOWITZ, MARK	MGR ACCTG	28,000
MOSCOSO, MICHAEL	MGR TRANS SUPT	28,000
EVANS, CASEY	SPEC SR RISK MGMT TRANS SUPT	25,000
GILLIS, BRIAN	MANAGER RISK MGMT	25,000
HERNANDEZ, GUSTAVO	SPECIALIST SENIOR INVOICING & REPORTING	25,000
JOHNSON, CHRISTINA	SPEC SR BASELINE ENGRG	25,000
MCLAUGHLIN, JR., ERROL	SPEC SR RISK MGMT GAS	25,000
MILLER, TONY	SPECIALIST SENIOR INVOICING & REPORTING	25,000
MURPHY, MELISSA	SPEC SR DEAL COMPL	25,000
RAY, EDWARD	CONSULTANT TECH IT	25,000
SCHOMER, CHRISTOPHER	MANAGER IT	25,000
SMITH, REGAN	MANAGER IT	25,000
SULLIVAN, PATRICIA	MGR LOGISTICS	25,000
VINSON, DONALD	SPEC SR RISK MGMT TRANS SUPT	25,000
WYNNE, RITA	MGR VOLUME MGMT	25,000
BASU, NILAY	MANAGER IT	20,000
BODE, GARY	MANAGER IT	20,000
BREWER, CHARLES	MANAGER IT	20,000
CALDERON II, EDUARDO	SPECIALIST SR IT	20,000
FIGUEROA, REGINA	MGR HR	20,000
FORTNEY, GEORGE	CONSULTANT TECH IT	20,000
GULLION, STEVEN	MANAGER IT	20,000
HARRELL, DAN	SPECIALIST SR. IT	20,000
KRISHNASWAMY, JAYANT	MANAGER IT	20,000
LEES, LISA	MGR TRANS SUPT	20,000

LIM, FRANCIS	CONSULTANT TECH IT	20,000
MARCINKOWSKI, DANIELLE	MANAGER IT	20,000
MCNAIR, DARREN	CONSULTANT TECH IT	20,000
POSTON, DAVID	MANAGER IT	20,000
POWELL, JOHN	MANAGER IT	20,000
SHARMA, LARRISSA	DIRECTOR IT	20,000
TANG, MABLE	MANAGER IT	20,000
WARD, BOB	MANAGER IT	20,000
WEATHERSPOON, PATRICIA	DIR SR COMM TRADING SUPT	20,000
WONG, NGIAM	MANAGER IT	20,000
LEUSCHEN, SUE	DIR SR RISK MGMT	19,000
DAHLKE, ANDREA	SPEC SR RISK MGMT TRANS SUPT	18,000
GRACE, REBECCA	SPEC SR LOGISTICS	18,000
POSTLETHWAITE, JOHN	SPEC RISK MGMT TRANS SUPT	18,000
STEVENS, MECHELLE	SPEC SR SETTLEMENTS	18,000
WALLUMROD, ELLEN	SPEC SR DEAL COMPL	18,000
WINFREE, O'NEAL	SPEC SR RISK MGMT GAS	18,000
ADAMIK, DARREN	MANAGER IT	16,000
BALLMER, CHARLES	CONSULTANT TECH IT	16,000
COLES, FRANK	CONSULTANT TECH IT	16,000
HANSON, KRISTEN	MGR TRANS SUPT	16,000
KINKEAD, MARK	SPECIALIST SR. IT	16,000
ABEL, CHRISTOPHER	MGR TRANS SUPT	15,000
HALL, JOSEPH	SPECIALIST SR. IT	15,000
MEREDITH, KEVIN	SPECIALIST SR TRANSACTION SUPPORT	15,000
PENA, JOHN	MANAGER IT	15,000
SHISHIDO, SCOTT	SPECIALIST SR. IT	15,000
SWEITZER, TARA	SPEC SR TRANS SUPT	15,000
WERNER, JON	SPECIALIST SR. IT	15,000
BOSSE, KEVIN	SPEC SETTLEMENTS	12,000
CHANG, FANG-TZU	SPEC RISK MGMT TRANS SUPT	12,000
GOWEN, THERESA	SPEC INVOICING & REPORTING	12,000
GUILLEN, FRANCESC	SPECIALIST IT	12,000
LOIBL, KORI	SPEC RISK MGMT GAS	12,000
PARKER, MEGAN	SPEC SETTLEMENTS	12,000
WILLIAMS, KAREN	SPEC DEAL COMPLIANCE	12,000
CHARBONNET, CLEMENT	CONSULTANT TECH IT	10,000
HA, CUONG	TECH CONSULTANT IT	10,000
JAMES, MATTHEW	SPEC SR IT	10,000
LARKIN, BRIAN	MANAGER IT	10,000
ZACCOUR, DAVID	SPECIALIST SR IT	10,000
COLEMAN, TANDRA	MGR GLOBAL MGMT	9,500
SEVERSON, RUSS	MGR RISK MGMT TRANS SUPT	7,000
CHI, CHIEN-HAO	SPECIALIST IT	5,000
DOLAN, MICHAEL	SPECIALIST SR IT	5,000
LOU, ZHUOMING	SPECIALIST SR. IT	5,000
WANG, QIULAI	SPEC SR IT	5,000
WHITE, KENNETH	SPECIALIST IT	3,500
KHURI, BASEM	SPEC SR IT HS	2,500

		6,508,500

VIII. MATERIALS RELATING TO NONQUALIFIED DEFERRED COMPENSATION

Enron Expat Service, Inc. Deferral Plan
9/30/01 Balances

1ST SUBMISSION - 9/30/01 BALANCES

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account Acct Bal 9/30/01 (Pmt In $)	PSA Account (delivered in Enron Common stock) [1] Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution [3]
Paidout	10/30/2001	10/25/2001	1	BLACK	DONALD	$492,402.77			
Paidout	10/30/2001	10/26/2001	2	FREVERT	MARK	$3,281,157.26			
Paidout	10/30/2001	10/29/2001	3	GADD	ERIC	$148,781.34			
Paidout	10/30/2001	10/29/2001	4	GONZALES	ERIC	$468,342.01			
Paidout	10/30/2001	10/30/2001	5	NEAL	SCOTT	$549,340.10			
Paidout	10/30/2001	10/30/2001	6	SEELIGSON	STEWART	$9,950.53			
			6			$4,949,974.01			

1994 Deferral Plan
9/30/01 Balances

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account Acct Bal 9/30/01 (Pmt In $)	PSA Account (delivered in Enron Common stock) [1] Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution [3]
Paidout	10/30/2001	10/26/2001	1	BLACK	DONALD	$607,968.14	742.65	$2,978.02	
Paidout	10/30/2001	10/26/2001	2	WALIA	AMIT	$140,528.14			
Paidout	10/30/2001	10/29/2001	3	OLSON	CINDY K	$77,715.90			
Paidout	10/30/2001	10/29/2001	4	GONZALES	ERIC	$271,391.69			
Paidout	10/30/2001	10/26/2001	5	ARORA	HARPREET	$132,142.94			
Paidout	10/30/2001	10/29/2001	6	RUB	JEANETTE	$38,548.75	2,481.89	$9,952.39	
Paidout	10/30/2001	10/29/2001	7	FREVERT	MARK A	$3,145,832.81			
Paidout	10/30/2001	10/25/2001	8	HAEDICKE	MARK E	$2,139,561.92	7,467.98	$29,946.58	$17,964.80
FDA Only	10/30/2001	10/30/2001	9	TAYLOR	MARK E	$164,568.20			
Paidout	10/30/2001	10/30/2001	10	MULLER	MARK S	$842,924.48			
Paidout	10/30/2001	10/26/2001	11	JOYCE	MARY K	$192,570.48			
Paidout	10/30/2001	10/29/2001	12	SWERZBIN	MICHAEL J	$2,049,325.93			
Paidout	10/30/2001	10/29/2001	13	CASH	MICHELLE H	$16,977.97			
Paidout	10/30/2001	10/30/2001	14	RACICOT JR	PAUL H	$147,350.45	1,706.44	$6,842.81	
Paidout	10/30/2001	10/26/2001	15	RIEKER	PAULA H	$214,678.36			
Paidout	10/30/2001	10/26/2001	16	ALLEN	PHILLIP K	$2,852,434.12	5,945.80	$23,842.64	$17,283.10
Paidout	10/30/2001	10/30/2001	17	MAXEY	R. DAVIS	$693,826.71			
Paidout	10/30/2001	10/29/2001	18	THAPAR	RAJEEV	$23,045.49			
Paidout	10/30/2001	10/29/2001	19	BUY	RICHARD B	$649,583.52			
Paidout	10/30/2001	10/26/2001	20	JONES	ROBERT W	$185,494.37			
Paidout	10/30/2001	10/25/2001	21	NEAL	SCOTT M	$236,815.04	7,440.38	$29,835.93	
Paidout	10/30/2001	10/29/2001	22	KNUDSEN	SHEILA A	$401,817.42	417.92	$1,675.88	
Paidout	10/30/2001	10/30/2001	23	HORTON	STANLEY	$3,131,860.34			
Paidout	10/30/2001	10/30/2001	24	SEELIGSON	STEWART	$124,168.45	2,088.51	$8,374.94	
Paidout	10/30/2001	10/26/2001	25	MARTIN	THOMAS A	$1,157,988.71	9,437.89	$37,845.92	
Paidout	10/30/2001	10/29/2001	26	DETMERING	TIMOTHY J	$857,558.51	7,377.49	$29,583.73	$17,748.26
Paidout	10/30/2001	10/26/2001	27	BELDEN	TIMOTHY N	$2,144,012.87			
Paidout	10/30/2001	10/29/2001	28	COLWELL	WESLEY	$27,610.46			

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Attachment 7

Paidout	10/30/2001	10/29/2001	29 PALMER	MARK A	$86,134.33	1,253.29	$5,033.18	
	Subtotal		29		$22,754,436.49			

2nd Submission

1994 DEFERRAL PLAN

Status	Appr Date	Receipt	No Last Name	First Name	FDA Account Acct Bal 10/31/01 (Pmt in $)	PSA Account (delivered in Enron Common stock) [1] Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution [3]
Paidout	11/14/2001	11/1/2001	1 SCHWIEGER	JAMES	$498,334.30			
Paidout	11/14/2001	11/2/2001	2 SHAPIRO	RICHARD	$0.00	3,163.89	$12,687.19	$8,116.24
Paidout	11/14/2001	11/5/2001	3 BAY	FRANKLIN	$258,133.37	965.04	$3,869.82	$2,321.79
Paidout	11/14/2001	11/5/2001	4 PIPER	GREGORY	$1,104,320.23	8,845.70	$35,471.27	$25,716.13
Paidout	11/14/2001	11/5/2001	5 RUSS	MARK	$635,028.84			
Paidout	11/14/2001	11/7/2001	6 LEMMONS, JR	WILLIAM	$233,968.80			
Paidout	11/14/2001	11/7/2001	7 REXRODE	STUART	$57,071.93			
Paidout	11/14/2001	11/8/2001	8 HAYES	ROBERT	$7,960.84			
Paidout	11/14/2001	11/8/2001	9 SHARP	VICTORIA	$187,468.95			
Paidout	11/14/2001	11/8/2001	10 PETERSEN	KURT RANDALL	$97,915.05			
Paidout	11/14/2001	11/8/2001	11 MCGOWAN	MICHAEL	$177,360.67			
Paidout	11/14/2001	11/8/2001	12 SOMMERS	JEFFREY	$171,075.44			
Paidout	11/14/2001	11/8/2001	13 BROWN	WILLIAM W.	$189,236.11	1,705.99	$6,841.00	
FDA Only	11/14/2001	11/8/2001	14 MILLER	MARY KAY	$188,376.22			
Paidout	11/14/2001	11/8/2001	15 GIBBS	DANA	$504,610.40			
Paidout	11/14/2001	11/8/2001	16 NOWLAN	JOHN	$22,392.84			
Paidout	11/14/2001	11/8/2001	17 HUMPHREY	GENE	$2,854,688.48	45,644.54	$183,034.62	$109,817.90
Paidout	11/14/2001	11/8/2001	18 LEACH	DOUGLAS	$142,895.32			
Paidout	11/14/2001	11/8/2001	19 SCHROEDER	MARK	$149,386.82			
Paidout	11/14/2001	11/8/2001	20 SHANBHOGUE	VASANT	$246,961.80			
Paidout	11/14/2001	11/8/2001	21 GAHN	ROBERT SCOTT	$73,121.74			
Paidout	11/14/2001	11/9/2001	22 CHILDERS	WILLIAM C.	$680,263.95	10,387.14	$41,652.42	
Paidout	11/14/2001	11/9/2001	23 PRENTICE	JAMES S	$564,347.60			
Paidout	11/14/2001	11/9/2001	24 LINDHOLM	TOD A	$204,075.19			
Paidout	11/14/2001	11/9/2001	25 HILL	ROBERT A	$262,170.58			
FDA/Part PSA	11/14/2001	11/9/2001	26 PARQUET	DAVID	$319,589.74	120.44	$482.97	
No Payment [5]			PARQUET	DAVID		pre-98 deferrals		
	Subtotal		26		$9,830,755.19			

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Enron Expat Service, Inc. Deferral Plan

FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Acct Bal 10/31/01	Gross	Taxable Value	After-Tax Value of

Status	Appr Date	Receipt	No	Last Name	First Name	(Pmt in $)	Share Distribution	($4.01/share) [2]	Distribution [3]
Paidout	11/14/2001	11/6/2001	1	WIGGS	BRETT	$174,080.32			
Paidout	11/14/2001	11/8/2001	2	SCHROEDER	MARK	$318,945.04			
Paidout	11/14/2001	11/9/2001	3	ALE	JOHN	$245,051.59			
	Subtotal		3			$738,076.95			

2nd Submission

9/30/01 Balances

						FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 9/30/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution [3]
Paidout	11/14/2001	10/26/2001	1	NOLES	JAMES	$770,760.40	$1,253.29	$5,025.70	$3,641.08
Paidout	11/14/2001	10/29/2001	2	BAXTER	CLIFF	$1,295,737.50			
Paidout	11/14/2001	10/30/2001	3	BAZELIDES	PHIL	$684,693.92			
Paidout	11/14/2001	10/30/2001	4	BAZELIDES	DIANE	$750,992.71			
	Subtotal		4			$3,502,184.52			

10/31/2001 BALANCES

						FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution [3]
Paidout	11/14/2001	11/1/2001	5	MEYER	ROCKFORD	1,848,226.60			
Paidout	11/14/2001	11/1/2001	6	DUNN	DOUGLAS	153,797.60			
Withdrew Req	11/14/2001	11/1/2001	7	WHITE	JULIA	48,207.12			
Withdrew Req	11/14/2001	11/1/2001	8	SCHAFER	JOHN DAVID	604,783.27			
	Pending	11/6/2001	9	RICE	KENNETH	4,792,695.27			
Paidout	11/14/2001	11/7/2001	10	LIEWER	PAUL	106,638.82			
	Subtotal		6			2,761,653.41			

3RD SUBMISSION - 10/31/01 BALANCES
(ACTIVE)

Expat Plan
10/31/2001 BALANCES

						FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution [3]
Paidout	11/21/2001	11/16/2001	1	GONZALEZ	ORLANDO	$255,910.91	$3,738.83	14,992.72	
Paidout	11/21/2001	11/20/2001	2	PORTER	SCOTT	$137,394.89	$5,291.74	21,219.87	
Paidout	11/21/2001	11/20/2001	3	WADDELL	RICKY	$241,901.04	$4,022.22	16,129.09	
Paidout	11/21/2001	11/21/2001	4	HARRIS	CLAIBOURNE	$170,356.19			
	Subtotal		4			$805,563.02			

1994 Deferral Plan
10/31/2001 BALANCES

						FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution [3]

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EC 002634763

Paidout	11/21/2001	11/7/2001	1	MUENCH	GAYLE	$191,239.21		
Paidout	11/21/2001	11/9/2001	2	MARTIN	AMANDA	$85,430.02		
Paidout	11/21/2001	11/9/2001	3	RAGLAND	MARIAN	$26,432.00		
Paidout	11/21/2001	11/14/2001	4	MESSINA	JEFFREY	$156,608.87		
Paidout	11/21/2001	11/14/2001	5	CORMAN	SHELLEY	$139,426.61		
Paidout	11/21/2001	11/16/2001	6	HOLMES	CHRISTIAN	$71,638.24		
No Payout	11/21/2001	11/16/2001	7	HARTSOE	JOSEPH	$0.00		
FDA Only	11/21/2001	11/19/2001	8	MENCHACA	PEGGY	$313,542.79		
Paidout	11/21/2001	11/20/2001	9	PORTER	SCOTT	$16,795.76	$6,083.05	$24,393.05
Paidout	11/21/2001	11/20/2001	10	SUTTER	CRAIG	$73,461.03	$768.54	$3,081.85
Paidout	11/21/2001	11/20/2001	11	WADDELL	RICKY	$18,322.24		
Paidout	11/21/2001	11/20/2001	12	SHIELDS	DAVID	$654,509.68		
Not PO/check bounced	11/21/2001	11/21/2001	13	WALLS, JR	ROBERT H.	$118,571.68		
Paidout	11/21/2001	11/21/2001	14	TAYLOR	MITCH	$227,449.22		
Paidout	11/21/2001	11/21/2001	15	SULLIVAN-SHAKL	COLLEEN	$181,992.53		
	Subtotal		15			$2,275,419.86		

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1994 Deferral Plan
10/31/2001 BALANCES

						FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution [3]
No Payment		11/20/2001	1	HANNON	KEVIN	$6,068,201.92			
No Payment		11/20/2001	2	MORAN	MICHAEL	$975,524.09			
No Payment		11/20/2001	3	WYATT	MARY	$394,485.01			
Subtotal			3			$7,438,211.02			

4TH SUBMISSION - 10/31/01 BALANCES

Expat Plan
10/31/2001 BALANCES

						FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution [3]
Paidout	11/28/2001	11/22/2001	1	MAY	LEWIS	$57,937.10			
Paidout	11/28/2001	11/20/2001	2	WASAFF	GEORGE	$145,244.12			
Paidout	11/28/2001	11/27/2001	3	CASTLEMAN	JERRY	$13,853.94			
Paidout	11/28/2001	11/28/2001	4	STALEY	STUART	$208,093.30			
FDA Only	11/28/2001	11/28/2001	5	SANDT	JAMES	$28,015.09			
Subtotal			5			$453,143.55			

EC 002634764

1994 Deferral Plan

10/31/2001 BALANCES

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account Acct Bal 10/31/01 (Pmt in $)	PSA Account (delivered in Enron Common stock)[1] Gross Share Distribution	Taxable Value ($4.01/share)[2]	After-Tax Value of Distribution[3]
Paidout	11/28/2001	11/21/2001	1	MAYS	WAYNE	$158,891.05			
Paidout	11/28/2001	11/22/2001	2	MAY	LEWIS	$50,631.84			
Paidout	11/28/2001	11/26/2001	3	FOSSUM	DREW	$156,285.47			
FDA Only	11/28/2001	11/26/2001	4	WASAFF	GEORGE	$686,054.89			
Paidout	11/28/2001	11/26/2001	5	PALMER	MAUREEN	$292,523.40			
Paidout	11/28/2001	11/26/2001	6	PRIBBLE	DANNY	$87,286.45			
Paidout	11/28/2001	11/26/2001	7	LUNDSTROM	BRUCE	$220,223.61			
Paidout	11/28/2001	11/26/2001	8	BROWN	MICHAEL LYNN	$256,123.25			
FDA Only	11/28/2001	11/26/2001	9	SOLDANO	LEWIS	$105,085.77			
Paidout	11/28/2001	11/26/2001	10	ENERSON	JOHN	$67,459.85			
FDA Only	11/28/2001	11/26/2001	11	LYDECKER	RICHARD	$91,035.50			
Paidout	11/28/2001	11/26/2001	12	VOTE	C. ROBERT	$112,912.59			
FDA Only	11/28/2001	11/26/2001	13	CRAIG	RICHARD	$130,886.20			
FDA Only	11/28/2001	11/27/2001	14	PETZOLD	BRADLEY	$841,759.06			
FDA Only	11/28/2001	11/27/2001	15	HURT, III	ROBERT	$0.00			
FDA Only	11/28/2001	11/27/2001	16	LOWRY	CHARLES	$531,925.62			
Paidout	11/28/2001	11/27/2001	17	MURRAY	JULIA	$60,401.79			
Paidout	11/28/2001	11/27/2001	18	RICE	GREEK	$181,646.92			
Paidout	11/28/2001	11/27/2001	19	CASTLEMAN	JERRY	$14,469.90			
Paidout	11/28/2001	11/27/2001	20	SHERRICK	JEFFREY	$435,601.66			
Paidout	11/28/2001	11/27/2001	21	ARONOWITZ	ALAN	$32,147.14			
Paidout	11/28/2001	11/27/2001	22	BARRETT	CAROLYN	$115,949.71			
FDA Only	11/28/2001	11/28/2001	23	MAYEUX	GAY	$52,686.05			
Paidout	11/28/2001	11/28/2001	24	WHITE	LEESA	$57,811.35			
Paidout	11/28/2001	11/28/2001	25	HERMANN	ROBERT	$60,218.70			
Paidout	11/28/2001	11/28/2001	26	GINTY	JAMES	$26,617.10			
Paidout	11/28/2001	11/28/2001	27	SANDT	JAMES	$20,624.39			
Paidout	11/28/2001	11/28/2001	28	DUKE	CULLEN	$37,462.83			
	Subtotal		28			$4,884,722.07			

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4TH SUBMISSION - 10/31/01 BALANCES

1994 Deferral Plan
10/31/2001 BALANCES

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account Acct Bal 10/31/01 (Pmt in $)	PSA Account (delivered in Enron Common stock)[1] Gross Share Distribution	Taxable Value ($4.01/share)[2]	After-Tax Value of Distribution[3]
No Payment		11/21/2001	1	WOLFE	GREGORY	$462,089.91			
No Payment		11/21/2001	2	THORN	TERENCE	$681,137.56			
No Payment		11/22/2001	3	SCHAFER	JOHN DAVID	$604,783.27			
No Payment		11/22/2001	4	WHITE	JULIA	$48,207.12			

EC 002634765

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account Acct Bal 10/31/01 (Pmt in $)
No Payment		11/26/2001	5	BOWMAN	CHARLES B.	$172,671.45
No Payment		11/26/2001	6	LONG	MARY ANN	$27,434.27
No Payment		11/27/2001	7	BERGSIEKER	RICHARD	$463,567.03
No Payment		11/27/2001	8	POTEMPA	LOUIS	$1,479,866.14
No Payment		11/27/2001	9	OVERDYKE	JERE C	$303,463.94
No Payment		11/27/2001	10	DORLAND	CHARLES K	$4,871.76
No Payment		11/27/2001	11	SUNDE	MARTIN	$115,484.06
No Payment		11/27/2001	12	DAHLKE	MICHAEL D	$224,692.41
No Payment		11/28/2001	13	WENZEL	MARTIN	$42,373.84
No Payment		11/28/2001	14	BUTLER	WILLIAM	$847,247.21
No Payment		11/28/2001	15	DUPUY	JANICE	$254,893.47
No Payment		11/28/2001	16	PEARLMAN	STEPHEN	$85,652.30
No Payment		11/28/2001	17	LANDRY	PAMELA	$23,555.95
No Payment		11/28/2001	18	HUNEKE	KURT	$661,928.01
No Payment		11/28/2001	19	HICKEY	PATRICK	$45,494.27
No Payment		11/28/2001	20	GUDE	ALBERTO	$172,090.61
	Subtotal	20				$6,721,504.59

Expat Plan
10/31/2001 BALANCES

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account Acct Bal 10/31/01 (Pmt in $)	PSA Account (delivered in Enron Common stock) [1] Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
No Payment		11/27/2001	1	BERGSIEKER	RICHARD	$261,466.38			
No Payment		11/28/2001	2	EWELL	MARGARET	$336,528.14			
No Payment		11/28/2001	3	PEARLMAN	STEPHEN	$143,678.93			
No Payment		11/28/2001	4	BARTH	DAVID	$273,319.10			
No Payment		11/28/2001	5	BUTLER	WILLIAM O	$240,739.60			
	Subtotal	5				$1,255,732.14			

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5TH SUBMISSION - 10/31/01 BALANCES

1994 Deferral Plan
10/31/2001 BALANCES

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account Acct Bal 10/31/01 (Pmt in $)	PSA Account (delivered in Enron Common stock) [1] Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
Paidout	11/29/2001	11/28/2001	1	DAVIS	BRITT	$239,535.51			
FDA Only	11/29/2001	11/28/2001	2	BIERBACH	BRIAN	$115,991.03			
Paidout	11/29/2001	11/28/2001	3	PETERS	JERRY	$54,340.85			
FDA Only	11/29/2001	11/28/2001	4	CRANE	ROBERT	$98,124.75			
Paidout	11/29/2001	11/28/2001	5	NEPPL	RAYMOND	$91,858.82			
FDA Only	11/29/2001	11/28/2001	6	REDMOND	BRIAN	$351,775.13			
Subtotal			6			$951,626.10			

EC 002634766

6TH SUBMISSION - 10/31/01 BALANCES

1994 Deferral Plan
10/31/2001 BALANCES

FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Acct Bal 10/31/01	Gross	Taxable Value	After-Tax Value of

Status	Appr Date	Receipt	No	Last Name	First Name	(Pmt in $)	Share Distribution	($4.01/share) [2]	Distribution[3]
Not Wired	11/29/2001	11/29/2001	1	LYNCH	DREW	$76,422.11			
Not Wired	11/29/2001	11/29/2001	2	BUTCHER	SHARON	$36,266.87			
Not Wired	11/29/2001	11/29/2001	3	CORDES	WILLIAM	$1,354,897.06			
Not Wired	11/29/2001	11/29/2001	4	MARINO	DOROTHEA	$105,582.08			
Not Wired	11/29/2001	11/29/2001	5	BECKER	MELISSA	$67,920.40			
Not Wired	11/29/2001	11/29/2001	6	THOMAS	JACOB	$155,593.63			
Not Wired	11/29/2001	11/29/2001	7	HARDY, JR	JOHN	$5,764.92			
Not Wired	11/29/2001	11/29/2001	8	KIMBERLY	KELLY	$39,162.56			
Not Wired	11/29/2001	11/29/2001	9	RILEY	THOMAS	$31,498.60			
Not Wired	11/29/2001	11/29/2001	10	CLARK	KELLY	$173,520.57			
Not Wired	11/29/2001	11/29/2001	11	NEBERGALL	BRAD	$42,661.87			
	Subtotal		11			$2,089,290.66			

Expat Plan
10/31/2001 BALANCES

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account Acct Bal 10/31/01 (Pmt in $)	PSA Account (delivered in Enron Common stock) [1] Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
Not Wired	11/29/2001	11/29/2001	1	LYNCH	DREW	$68,379.19			
Not Wired	11/29/2001	11/29/2001	2	GOLD	JOSEPH	$3,527.96			
Not Wired	11/29/2001	11/29/2001	3	GARNER	BRUCE	$211,119.73			
	Subtotal		3			$283,026.88			

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1994 Deferral Plan
10/31/2001 BALANCES

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account Acct Bal 10/31/01 (Pmt in $)	PSA Account (delivered in Enron Common stock) [1] Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
No Payment		11/29/2001	1	BENTLEY	DONALD C	$24,417.72			
No Payment		11/29/2001	2	HARRIS	MATTHEW	$17,067.42			
No Payment		11/29/2001	3	DEROIN	LARRY	$267,246.58			
No Payment		11/29/2001	4	ELLIOTT	STEVE	$98,171.45			
No Payment		11/29/2001	5	MAINELLI	ANDREA	$20,458.81			
No Payment		11/29/2001	6	BUCHER	JEFFREY	$122,391.41			
No Payment		11/29/2001	7	ROME	WILLIAM	$91,068.93			
No Payment		11/29/2001	8	JAIN	PRAVIN	$43,072.46			
No Payment		11/29/2001	9	URQUHART	JOHN A	$385,097.01			
No Payment		11/29/2001	10	CROWDER	JAMES	$73,196.34			
	Subtotal	10				$1,142,188.13			

EC 002634767

Expat Plan
10/31/2001 BALANCES

FDA Account	PSA Account (delivered in Enron Common stock) [1]

Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
No Payment		11/29/2001	1	MAINELLI	ANDREA	$8,520.49			
No Payment		11/29/2001	2	JAIN	PRAVIN	$239,283.56			
No Payment		11/29/2001	3	ELLIOTT	STEVE	$296,759.32			
	Subtotal	3				$544,563.37			

7TH SUBMISSION - 10/31/01 BALANCES

1994 Deferral Plan
10/31/2001 BALANCES

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account	PSA Account (delivered in Enron Common stock) [1]		
						Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
	(ACTIVE)								
No Payment		11/30/2001	1	LYONS	DANIEL	$7,160.26			
No Payment		11/30/2001	2	PLACE	JANET	$267,787.80			
No Payment		11/30/2001	3	KELLY, III	FRED	$97,383.97			
No Payment		11/30/2001	4	CHEEK	CHARLES	$429,917.40			
No Payment		11/30/2001	5	RUANE	MARK	$148,477.50			
No Payment		11/30/2001	6	APASU	YAO	$92,794.50			
No Payment		11/30/2001	7	GRAY	BARBARA	$161,827.20			
No Payment		11/30/2001	8	CAUSEY	RICHARD	$143,966.26			
No Payment		11/30/2001	9	CULVER	DEBORAH	$40,900.08			
	Subtotal		9			$1,390,214.96			

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1994 Deferral Plan
10/31/2001 BALANCES

Status	Appr Date	Receipt	No	Last Name	First Name	FDA Account	PSA Account (delivered in Enron Common stock) [1]		
						Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
	(INACTIVE)								
No Payment		11/30/2001	1	REYNOLDS	LAWRENCE	$346,488.54			
No Payment		11/30/2001	2	JONES	LINCOLN	$277,247.94			
No Payment		11/30/2001	3	STRAM	BRUCE	$84,584.11			
No Payment		11/30/2001	4	SHELTON	THOMAS	$274,999.37			
No Payment		11/30/2001	5	JIEDE	RONALD	$4,069.31			
No Payment		11/30/2001	6	LEGALLO	ANDRE	$140,078.70			
No Payment		11/30/2001	7	KOHNSTAMM	KEVIN	$155,673.90			
No Payment		11/30/2001	8	HIRKO	JOSEPH	$110,147.40			
No Payment		11/30/2001	9	LARSON	DWIGHT	$415,240.20			
No Payment		11/30/2001	10	ROOD	GEORGE	$153,127.80			
	Subtotal	10	10			$1,961,657.27			

1994 Deferral Plan
10/31/2001 BALANCES

FDA Account	PSA Account (delivered in Enron Common stock) [1]

EC 002634768

Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
No Payment	(ACTIVE)	12/4/2001	1	JOHNSON	DAVID L	$31,749.20			

1994 Deferral Plan
10/31/2001 BALANCES

						FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
No Payment		12/4/2001	1	GULYASSY	WILLIAM	$229,901.27			
No Payment		12/3/2001	2	LAMMERS	RICHARD	$39,650.45			
No Payment		12/10/2001	3	GATHMANN	WILLIAM	$197,032.61			

1994 Deferral Plan
Expat Plan

						FDA Account	PSA Account (delivered in Enron Common stock) [1]		
Status	Appr Date	Receipt	No	Last Name	First Name	Acct Bal 10/31/01 (Pmt in $)	Gross Share Distribution	Taxable Value ($4.01/share) [2]	After-Tax Value of Distribution[3]
	(INACTIVE)								
No Payment		12/3/2001	1	LAMMERS	RICHARD	$38,183.52			

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[1] With respect to deferral elections for calendar years 1998 and forward, and pursuant to Plan provisions, all distributions from the PSA account were delivered in Enron Corp. common stock.

[2] Value of share distribution based on Enron Corp.'s closing stock price the day preceding notification to the transfer agent. This date was November 26, 2001 with an Enron Corp. closing stock price of $4.01.

[3] This net value of shares was reported on Exhibit 3.b.2 (i.e., "Deferral Payment") of the bankruptcy filing. As a result, the payment was understated on Exhibit 3.b.2 to the bankruptcy filing.

[4] As a result of a data entry error, Mr. Childers PSA account balance and share distribution was overstated. Actual shares on 10/31/01 should be 3,218 shares. Waiting on decision from legal department as to whether or not we can net the over payment against any outstanding monetary claims that Mr. Childers has against the Company, should such claims ever be paid.

[5] With respect to deferral elections for calendar years 1997 and prior, and pursuant to Plan provisions, the value of shares in the PSA account will be delivered in cash unless a waiver was signed to receive shares. Mr. Parquet had pre--98 deferrals that would have been paid out in cash, however, this cash payment was not rendered.

EC 002634769

IX. MATERIALS RELATING TO SALE OF OPTIONS TAX SHELTER

Sale of Executive Options Technique – Advantages and Disadvantages
(Privileged Information – Do Not Disseminate)

Associated Advantages of Using the Sale of Executive Options Technique

Executive

1. The executive gets the opportunity to diversify his/her portfolio without having an immediate tax payment due from exercising the options.

2. The executive keeps approximately 80% of the benefits from deferring associated taxes for 15 years.

3. Income from the options is "locked-in" at the sale price.

4. The technique does not have to be reported to the IRS as a tax shelter.

5. The downside risk is limited as Arthur Andersen's opinion letter should eliminate tax penalties imposed by the IRS for disallowing the technique.

Enron

1. Enron may generate goodwill from its top executive staff for introducing such a large potential benefit to its executives.

2. The technique helps serve as an NOL tax refresher for Enron.

Associated Disadvantages of Using the Sale of Executive Options Technique

Executive

1. The executive must pay Arthur Andersen the entire fee by the time the technique is implemented while the benefits will accrue over 15 years.

2. The executive must capitalize the Limited Partnership with non-personal assets in value approximately equal to 10% of the sale price of the options.

3. If the value of the Limited Partnership portfolio drops by a significant amount, then the Limited Partnership could have trouble repaying the "promise to pay" back to the executive. However, this debt must be repaid. In the case of executive death, the debt must be repaid to his/her estate.

4. If tax rates change significantly over the next 15 years, the value of the benefit could be significantly lessened.

?

Enron

1. Could potentially, significantly reduce executive ownership in Enron.

2. Enron must wait until the executive claims income in order to receive the compensation tax deduction for the option. If all goes as planned, Enron will postpone its tax benefit for 15 years.

3. If the executive leaves Enron within the next 15 years, Enron will require some sort of procedure to receive its tax deduction when principal is repaid to the executive from the Limited Partnership.

4. Enron will require guidance from Arthur Andersen as the executive's tax advisor to operationalize manually overriding the payroll system to legally keep income off of the executive's W-2 statement.

5. How will Enron's role in letting Arthur Andersen show the technique to executives be perceived by tax and legal authorities? Enron would prefer not to have involvement.

EC 000770978

Discuss

Sale of Executive Options Technique
(~~Privileged~~ Information – Do Not Disseminate)

Steps Involved in the Transaction

I. The Executive forms a Limited Partnership (LP) with family ownership approximately as follows:

Executive	79% Limited Partner (also General Partner)	
Executive Spouse	18% Limited Partner (also General Partner)	
Children	3% Limited Partners	

Maintain beneficial ownership (indirect

Executive makes a capital contribution to the LP roughly equal to 10% of the value of the options that will be sold to the LP.

Capitalization should be comprised of non-personal assets.

(sale -- for value; occ, insider maintains/ control/ beneficial ownership (he has sold to himself, in effect.)

II. Executive sells options to the LP for an amount equal to the appraised value of the options. Discuss w/ Mary -- cannot be unvested

Generally, nonqualified options will be used (vested or ~~unvested~~).

LP gives to the executive, an unfunded, unsecured, 15 year, balloon promise to pay with a marketable interest rate which is payable yearly. The principal is to be repaid in 15 years.

All income to be recognized concerning the options will now be fixed at the option sale price.

Income recognition is deferred until principal is repaid (15 year principal repayment defers the taxable recognition of income for 15 years). An amortizing debt would recognize income incrementally as the principal is returned to the lender.

Employee income recognition and Enron compensation expense recognition, for tax purposes, must occur at the same time. This means that Enron will not be able to receive a tax deduction for the options (or portions of them) unless the principal on the note (or portions of it) is repaid.

III. While the partnership may exercise the options within the time frame permitted under the relevant option plan, most partnerships exercise the options and sell the underlying shares immediately. — note.

Effect of Transaction on Executive

- Can ~~not~~ rely on S-8
- Must report sale by P/S as sale by insider (or family P/S).

Cash

Initial outflow of 10% of the transferred asset value to fund the LP.

The executive must expend the greater of $150,000 or 20% of the NPV of the deferred benefit as compensation to Arthur Andersen.

The executive will receive interest payments annually from the LP. For tax purposes, the amount is reduced by the amount of the pass through interest expense by the LP.

Income

The executive will defer the income from the sale of the options until principal is received.

EC 000770979

It is recommended that the LP exercise the options immediately after the sale transaction. If the options are exercised immediately after the sale, then the net effect of an IRS disallowed deduction would be to accelerate taxes due from a 15 year deferral period to present. AA's "more likely than not" opinion is intended to shield the executive from penalties for understating income should the transaction be challenged.

Enron must override the payroll system at exercise. Since all income will be deferred, override is necessary to ensure that no income will be attributable to the executive from exercise.

Income is also recognized by the executive for interest received on the note receivable. This is partialy offset by the interest expense passed through by the LP.

SEC Reporting

No additional SEC reporting is required.

Discuss - When P/S exercises option, Ken Lay files a Form 4.

Effect of Transaction on LP

Cash

The LP will have an initial capitalization of approximately 10% of the transaction value.

The LP will take possession of the stock options and simultaneously exercise the options.

Will be reported on Ken Lay's Form 4. (i.e. he maintains beneficial ownership -- not a "gift" to family member.

Income

Interest payments will be an interest expense to the LP while the investment income will be income.

Both interest expense and investment income will be passed through to the partners of the LP.

16a-13 Transaction - Without Change in Pecuniary interest Exempt from Sec 16

SEC Reporting

Upon sale, Form 4 (Family Controlled Entity) is filed by Enron while S-8 should continue to suffice.

? Filed by Ken Lay (not Enron, not Family Controlled Entity)

Effect of Transaction on Enron

Cash

Upon exercise, Enron will recieve the strike price times the number of options exercised.

Since Enron is allowed a compensation expense deduction as the executive recognizes income, a compensation expense (and corresponding the tax deduction) will be taken when principal is returned. This has an effect of reducing cash flow (vis-à-vis a normal exercise) in the year of exercise if Enron is in a positive NOL situation.

is loss of deduction for 15 year valued in excess of $60,000?

If the sale of options transaction is disallowed by the Service, Enron will be allowed an accelerated compensation expense deduction for the income related to the exercise of the options.

Income

As mentioned above, a slight decrease in the tax deduction will effect a small decrease in net income.

EC 000770980

Tax

The transaction has the net effect of increasing tax expense in the year of exercise and decreasing the expense when principal is returned.

If the deferral transaction does not work, all income from exercise will be accelerated to the date of exercise allowing Enron a corresponding immediate deduction.

Accounting

For Financial Accounting purposes, the net effect of the transaction is a small indirect reduction in net income through a lower tax deduction in the year of exercise.

must be immaterial

Discuss w/ Causey ~~[illegible]~~ ENE is not a party to this, so no Proxy disclose

The deferred tax asset will be maintained on Enron's books without an NPV adjustment.

SEC Reporting

Upon sale, Form 4 (Family Controlled Entity) is filed by Enron while S-8 should continue to suffice.

Ken Lay

Other

This transaction could be put in place by an executive without approval by Enron, however proper approval may be warranted as Enron's involvement may require overriding the payroll systems concerning W-2 income recognition.

But — ENE is not a party (Proxy issue)

There is a small chance that an equity analyst could figure out the transaction.

Enron Plan Allowance for the Transaction

Arthur Andersen requires that plan documents permit "transfers" for the transaction to be permitted. The 1991 Plan currently has that language with the 1994 plan to contain that language beginning August 2000.

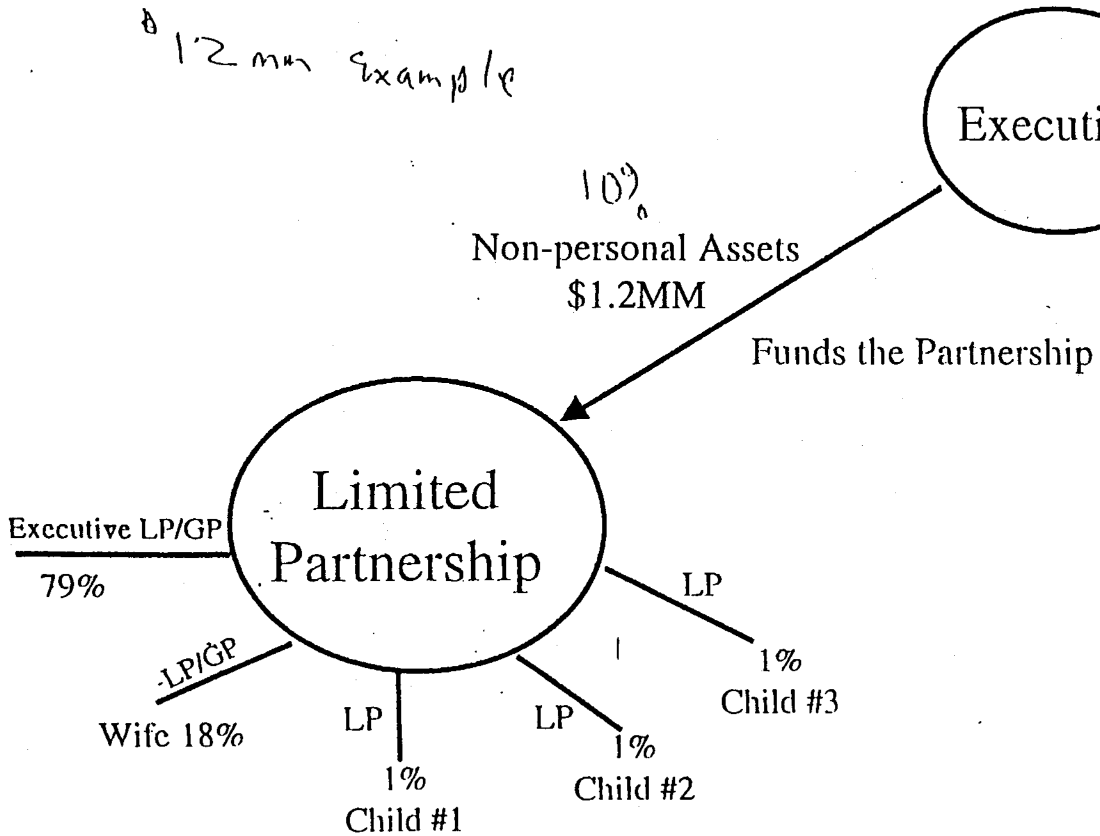
Does Plan provide for "sales". I thought what was contemplated was "gifts" (transfers to family members) Have Pat Mackin look at this.)

Should be limited # of executives that get grants for from 8/'94 Plan

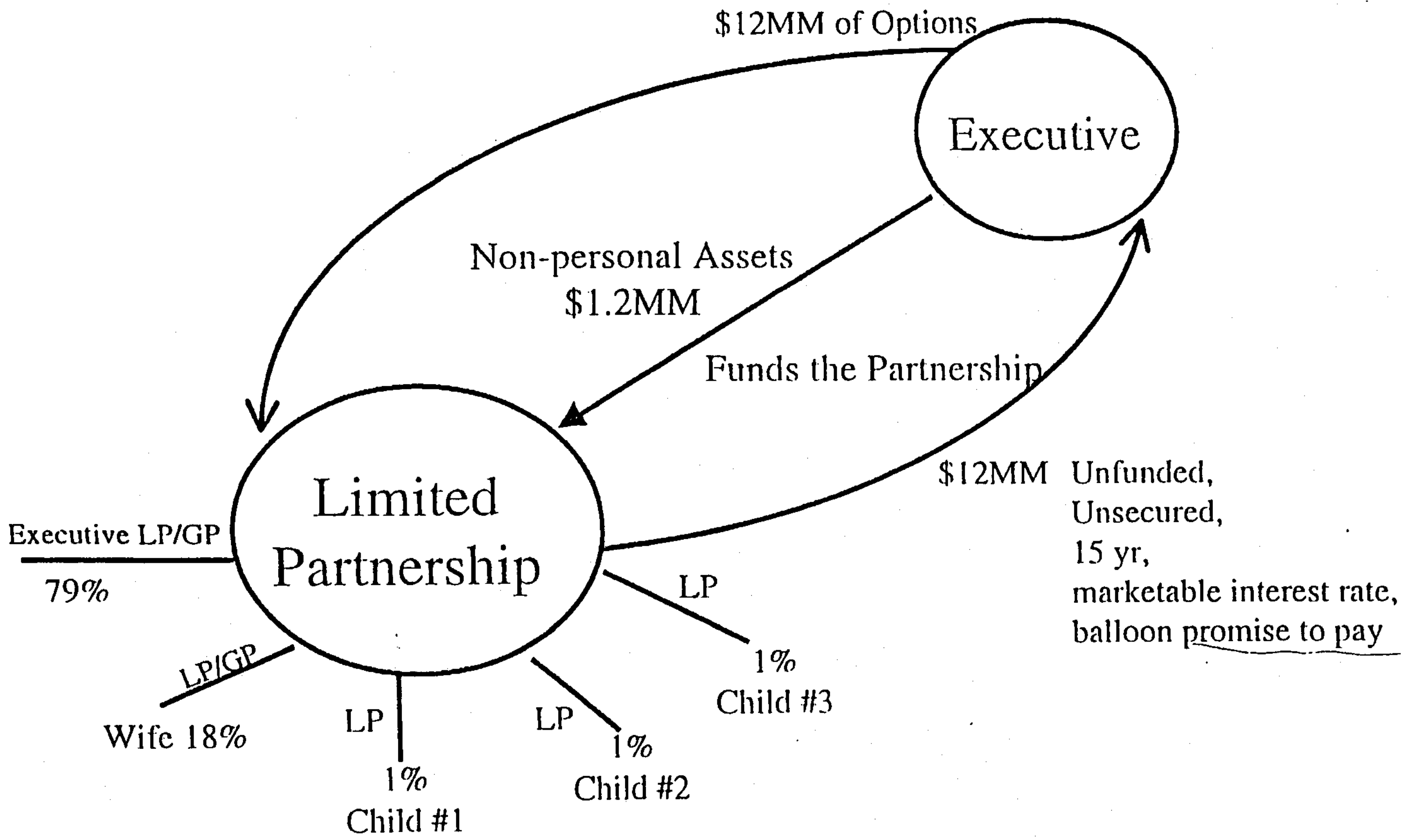
EC 000770981

CALL MARY JOYCE

$12 mm example

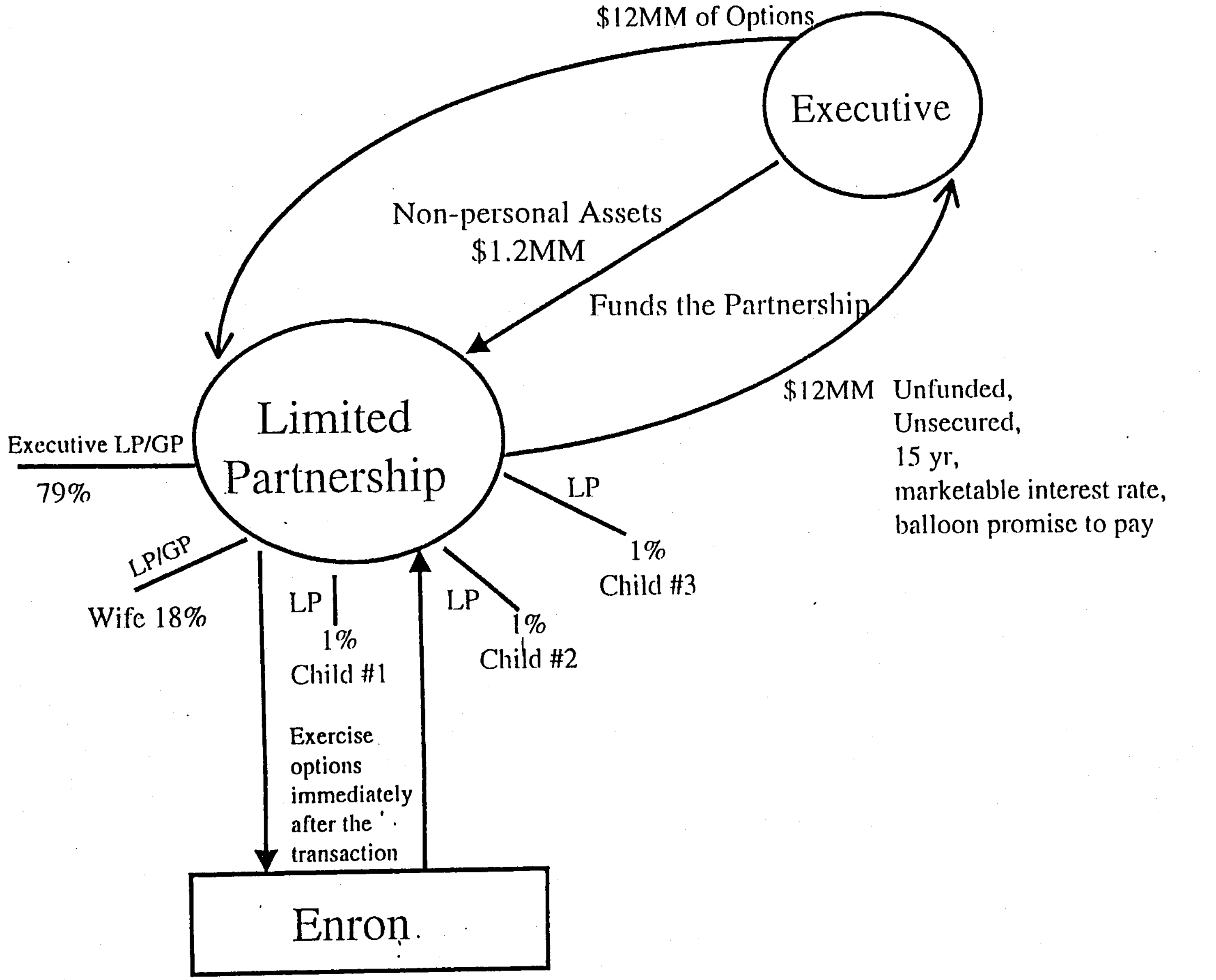


Executive "controls" Ltd. P/S (i.e. continues to be the 'beneficial owner for Section 16 purposes). Stays on Form 4 (i.e., not a "gift" to family members).



D-315

EC 00070976


$12MM of Options
Executive
Non-personal Assets
$1.2MM
Funds the Partnership
$12MM
Unfunded,
Unsecured,
15 yr,
marketable interest rate,
balloon promise to pay
Limited
Partnership
Executive LP/GP
79%
LP/GP
Wife 18%
LP
1%
Child #1
LP
1%
Child #2
LP
1%
Child #3
Exercise
options
immediately
after the
transaction
Enron

D-316

_______________, 1999

PRIVILEGED AND CONFIDENTIAL

Mr.
Address
City, State Zip

Dear Client:

You have requested us to review certain transactions as described herein in connection with the sale of certain of your ABC, Inc., nonqualified stock options to Client Partnership, a Delaware limited partnership, and to provide our opinion to you regarding certain federal income tax issues as stated herein relating to such transactions. We have done so and are communicating our conclusions and our opinions herein.

In analyzing the authorities relevant to the potential tax issues outlined in opinions 1 through 7 below, we have applied the standards of "substantial authority" and "more likely than not," as used in section 6662(d)(2) of the Internal Revenue Code of 1986 (hereinafter the "Internal Revenue Code" or "Code" or "I.R.C.") and Treasury Regulation (hereinafter "Treas. Reg.") § 1.6662-4(d). Based upon our analysis, subject to the various qualifications set forth herein, we have concluded that there is substantial authority for the indicated tax treatment of the issues and opinions discussed herein, and we also believe the indicated treatment of such issues is more likely than not proper.

The opinions expressed herein are based on the facts and assumptions you have provided to us as discussed below under the heading "Facts and Assumptions," and you have represented to us that we have been provided all material facts relating to the transactions described therein and that you concur with the assumptions stated therein. Any misstatement of a material fact or omission of any fact that may be material or any amendment or change in any of the facts referred to may require a modification of all or a part of our opinions. We have no responsibility to update this opinion for events, transactions, or circumstances occurring after the date of issuance of this opinion.

The opinions expressed herein are based upon our interpretation of the Internal Revenue Code and income tax regulations promulgated thereunder as interpreted by court decisions and by rulings and procedures issued by the Internal Revenue Service (the "Service") as of the date of this letter. When, in this letter, we express an opinion on your position, we mean that if the Service were to assert a contrary position, your position, if properly presented to a court, is more likely than not to ultimately prevail. The opinions expressed herein are not binding on the Service, and there can be no assurance that the Service will not take a position contrary to the opinions expressed herein.

The opinions expressed herein reflect our assessment of the probable outcome of litigation and other adversarial proceedings based on the merits of the issues. However, it is important to note that litigation and other adversarial proceedings are frequently decided on the basis of such matters as negotiation and pragmatism. Furthermore, in recent years, courts of law have exhibited a willingness to interpret prior authorities, as well as to develop new theories, to reach a conclusion that will maximize tax revenues. We have not considered the effect of such negotiation, pragmatism or judicial bias in our assessment of the outcome of such potential litigation or other adversarial proceedings.

These opinions reflect what we regard to be the material income tax effects as described therein; nevertheless, they are opinions only and, therefore, should not be taken as an assurance of the ultimate tax treatment.

In our review of the authorities stated herein, we have accorded weight to each authority in accordance with the provisions of Treas. Reg. § 1.6662-4(d)(3)(ii) and (iii). Accordingly, we have given more weight to more recent revenue rulings, private letter rulings, general counsel memorandum, or actions on decisions than to older ones. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. We have given more weight to authority decided under the particular Code section in question than to authority decided under analogous Code sections. In addition, we have accorded weight to the relevant authorities in accordance with the methodology outlined in Treas. Reg. § 1.6662-4(d)(3). We have relied upon the following sources in our analysis: the Code; case law; legislative regulations; final regulations; temporary regulations; proposed regulations; revenue rulings; private letter rulings; technical advice memoranda; and congressional intent as reflected in committee reports.

The opinions expressed herein would have to be reevaluated if, after their issuance, there are any new judicial developments or changes in the Internal Revenue Code, the regulations and published rulings issued thereunder or the current administrative rulings. We have not considered any nonincome tax or state or local income tax consequences and, therefore, do not express any opinion regarding the treatment that would be given the transactions discussed below by the applicable authorities on any nonincome tax or any state or local tax issues. We also express no opinion on nonfederal income tax issues such as personal property transactions, securities law matters, etc.

These opinions are solely for your benefit and are not intended to be relied upon by anyone other than you. We assume no responsibility for tax consequences to the other parties to the transactions. Instead, the other parties should consult and rely upon the advice of their own counsel, accountant or other advisor. Except to the extent expressly permitted hereby, and without the prior written consent of Arthur Andersen LLP, this letter may not be quoted in whole or in part or otherwise referred to in any documents or delivered to any other person or entity, other than a disclosure to a taxing authority in the event of a penalty assertion by such authority.

FACTS AND ASSUMPTIONS

The factual circumstances and the assumptions upon which we base the opinions expressed herein are described below.

You were granted certain nonstatutory stock options ("options") under the terms of an Option to Purchase Shares ("Option Agreement") dated April 1, 1996. These options were granted to you in connection with your performance of services to ABC Industries, Inc ("ABC"). Because these options had no ascertainable fair market value at date of grant, they were not included in your gross income at the time of grant pursuant to I.R.C. § 83. Originally, the option agreement granted to you the right, privilege and option to purchase 49,830 shares of the voting common stock of ABC and 448,470 shares of the nonvoting common stock of ABC at an exercise price of $2.05 per share. The options were exercisable in whole or in part at any time after April 1, 1996, but no later than March 31, 2001. Subsequent adjustments were made to the Option Agreement due to stock splits, a June 1997 initial public offering and amendments to the Option Agreement as authorized by ABC's Board of Directors. Most recently, on March 25, 1999, the Option Agreement was amended, making them transferable to "members of the immediate family of [you] (or entities controlled by [you] and/or such family members), for or without consideration, to the extent vested." On April 9, 1999, the options represented the right, privilege and option to purchase 199,320 shares of common stock of ABC at $5.125 each, no later than March 31, 2001. From the time of grant until the time of the sale, all of the options granted on April 1, 1996, were vested in you, and none had been exercised or transferred.

On April 9, 1999, you and your family established Client Partnership ("Client P/S"), a Delaware limited partnership, with $200,000 cash contributed 80% ($160,000) by you, 18% ($36,000) by your wife, Client Wife, and 1% ($2,000) by each of your two sons, Client Child #1 and Client Child #2. Your 80% initial partnership interest consists of a 1% general partnership interest and a 79% limited partnership interest. Client Wife's 18% initial partnership interest consists of a 1% general partnership interest and a 17% limited partnership interest. The 1% initial partnership interest held by each of your sons is a 1% limited partnership interest.

For estate planning and other reasons, you sold the ABC options described above to Client P/S under a Stock Option Purchase Agreement ("Purchase Agreement") dated April 13, 1999, in exchange for an unfunded and unsecured promissory obligation to pay the purchase price in a lump sum on April 13, 2014. The contract price is for the fair market value of the stock options at the date of sale. The Purchase Agreement stated a total purchase price for the options of $2,248,578.75, which was subject to an adjustment clause whereby the stated purchase price would be replaced by the value subsequently determined by an independent appraisal conducted by Arthur Andersen. The subsequent appraisal of these options by Arthur Andersen was performed using the Black-Scholes model for valuing stock options in accordance with Rev. Proc. 98-34, I.R.B. 1998-18, which provides rules for valuing stock options for transfer tax purposes. The independent appraisal determined the value of each option to be $10.11, for a total value of $2,014,756. Thus, the adjusted purchase price of the options is $2,014,756. The Purchase Agreement also provided for the accrual of interest on the outstanding unpaid principal amount at the rate of 8% per year until paid in full. All accrued but unpaid interest is required to be paid on each anniversary of the Purchase Agreement until the principal amount and all accrued but unpaid interest is paid in full. According to the Purchase Agreement, the stated interest rate was also subject to adjustment based on the results of an independent appraisal to by performed by Arthur Andersen. While the appraisal has yet to be finalized as of the date of the issuance of this letter, it has been represented that the interest rate will be such that the promissory obligation had a fair market value equal to the purchased options ($2,014,756) at the time the Purchase Agreement was executed. Under the terms of the Purchase Agreement, you may not transfer, assign or pledge your receivable. As described above, the terms of the Purchase Agreement were designed to be comparable to similar commercial transactions.

To meet its repayment obligations under the Purchase Agreement, Client P/S will segregate and earmark assets to be used for this purpose. However, because the promissory obligation is unsecured, these funds are subject to the claims of general creditors in the event of bankruptcy. As noted above, Client P/S had assets of $200,000 cash prior to this sale, or approximately 10% of the fair market value of the purchased options. Pursuant to the Partnership Agreement, Client P/S may not make distributions to its partners (other than tax distributions) without your prior consent.

Thus, as of the date of the issuance of this letter, Client P/S L.P. is the owner of the options. As owner, Client P/S has absolute discretion in determining whether to exercise or hold the options. As consideration for your sale of these options, you received a promissory obligation, structured as a balloon obligation, under which you will receive annual interest payments with the balance due April 13, 2014.

ISSUES

1. Will Client P/S be respected as a valid partnership for federal income tax purposes?
2. Will your sale of options to Client P/S be respected as a valid sale between two separate taxable entities?
3. Will the Assignment of Income Doctrine apply to your sale of options to Client P/S?
4. Does the sale of the options to Client P/S qualify as an "arm's length transaction" for purposes of I.R.C. § 83?
5. For purposes of I.R.C. § 83, if nonqualified stock options are disposed of in an "arm's length transaction," are there any tax consequences to you upon the subsequent exercise of the options by Client P/S?
6. Does the receipt of an unfunded unsecured contractual promise to pay in exchange for the options constitute the receipt of "property," such that ordinary income must be recognized under I.R.C. § 83?
7. What are the tax consequences to ABC upon your arm's length sale of options to Client P/S?

SUMMARY OF OPINIONS

Based on the analysis set forth below and the assumptions and representations referred to herein, it is our opinion that (a) the following positions are "more likely than not" proper and (b) you would "more likely than not" prevail if these positions are challenged by the IRS. These positions are as follows:

1. Client P/S will more likely than not be recognized as a valid partnership for federal income tax purposes.
2. Your sale of ABC options to Client P/S will more likely than not be respected as a valid sale between two separate and distinct taxable entities.
3. The Assignment of Income Doctrine more likely than not does not apply to your sale of options to Client P/S.
4. A disposition of nonqualified options at fair market value under commercially reasonable terms more likely than not satisfies the arm's length standard of I.R.C. § 83.
5. Once nonqualified options are disposed of at arm's length under I.R.C. § 83, thereby triggering the realization of ordinary income, any subsequent exercise of the options by Client P/S more likely than not does not invoke the re-application of I.R.C. § 83.
6. Your receipt of Client P/S's unfunded and unsecured promise to pay the appraised value for the options plus interest more likely than not will not constitute "the receipt of property" for purposes of I.R.C. § 83. As a result, recognition of compensatory ordinary income should more likely than not be delayed until you receive principal payments under this promissory obligation.
7. It is more likely than not proper that the timing and amount of ABC's deduction for compensation paid correspond to the timing and amount of compensation included in your gross income.

TECHNICAL ANALYSIS

1. Client P/S will more likely than not be recognized as a valid partnership for federal income tax purposes.

Generally, the most important factor in determining the existence of a partnership for tax purposes is the intent of the parties. In the leading case of Commissioner v. Culbertson, 337 U.S. 733, 742 (1949), the Supreme Court stated that a partnership exists for tax purposes when "considering all the facts - the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent - the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." See also Carriage Square, Inc. 69 T.C. 119 (1977); Hubert M. Luna, 42 T.C. 1067 (1964); Clem Moore, 46 T.C.M. 473 (1983).

You, your wife, and your sons have clearly evidenced an intention to join together in the present conduct of an enterprise by forming Client P/S pursuant to Delaware state law. Client P/S will hold title to all investment assets and will conduct its operations in the name of Client Partnership Control of Client P/S, its assets and the income generated by the partnership will be in the hands of the general partners. Client P/S has true and substantial economic substance, having been capitalized with initial contributions totaling $200,000, and thus should not be considered a "mere shell." Additionally, Client P/S's income and losses will be shared jointly among the partners pursuant to the terms of the Partnership Agreement.

Client P/S's classification as a partnership for federal tax purposes is not affected by the fact that the partnership is engaged primarily in investment activities, rather than an active trade or business. The "check-the-box" regulations provide that an entity can qualify as a partnership if the entity carries on a "trade, business, *financial operation*, or venture." Treas. Reg. § 301.7701-1(a)(2) (emphasis added). The final partnership anti-abuse regulation provides additional evidence that an organization formed solely for investment purposes can be a partnership for federal tax purposes. This regulation provides that Subchapter K is intended to permit taxpayers "to conduct joint business (*including investment*) activities." Treas. Reg. § 1.701-2(a) (emphasis added). In addition, Example 5 of the anti-abuse regulation treats a partnership as a bona fide partnership, even though the partnership is engaged solely in investment activities. See Treas. Reg. § 1.701-2(d) (Example 5). Finally, I.R.C. § 761(a) provides that an unincorporated entity that is availed of for investment purposes only (and not for the active conduct of a business) can elect not to be treated as a partnership for federal tax purposes.

Implicit in the ability of such an entity to elect out of partnership classification is the concept that an entity formed solely for investment purposes can qualify as a partnership for federal tax purposes. Based on these authorities, Client P/S will more likely than not be classified as a partnership for federal tax purposes.

2. Your sale of ABC options to Client P/S will more likely than not be respected as a valid sale between two separate and distinct taxable entities.

In exchange for capital contributions, you, your wife and your children received partnership units of Client P/S. As of the date of this letter, the ownership of Client P/S is as follows:

Client	80%	L.P./G.P.
Client Wife	18%	L.P./G.P.
Client Child #1	1%	L.P
Client Child #2	1%	L.P.

From the time you were granted your ABC options until the date you sold them to Client P/S, you owned the options in your individual capacity. Because the sale of the options was to an entity in which you own 80%, the Service could potentially argue that the sale should not be respected under legal doctrines such as the "sham transaction doctrine" or "substance over form."

In Frank Lyon v. U.S., 435 U.S. 561 (1978), the Supreme Court commented on the substance over form principle explaining,

> The Court has looked to the objective economic realities of a transaction, rather than to the particular form the parties employed. The Court has never regarded "the simple expedient drawing up of papers," as controlling for tax purposes when the objective economic realities are to the contrary. In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal rigid documents are not rigidly binding. Nor is the parties' desire to achieve a particular tax result necessarily relevant.

Id.

In Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992), two entities, a partnership and a corporation, were owned by the same individuals possessing the same ownership percentages in both entities. The stated purpose of the partnership was the acquisition of property for investment. The corporation had been formed for the purpose of developing and selling land. The partnership purchased approximately 270 acres of land, and later sold the property to the corporation in exchange for a promissory note. The corporation later sold the property to third parties. The issue centered around whether the proceeds from the partnership's sale of the property to the corporation represented capital gain or ordinary income. The Service argued that in light of the activities between the two entities, the partnership was really in the business of selling land and should report the gain from the sale to the corporation as ordinary. Id. at 528. In addressing the issue, the court examined the substance rather than the form of the transaction. The court explained that the corporation was not a sham because there were valid business purposes for the partners to form the corporation, most significantly insulation from unlimited liability. Id. at 533-34. Additionally, the court stated that the transaction appeared to be arm's length and all business and legal formalities had been observed. Finally, the court noted that the partnership purchased the property as an investment, thereby assuming the risk that the land would depreciate. In light of these factors and agency principles, the court held the partnership was entitled to capital gain treatment. Implicit in this holding was a determination that the partnership and the corporation were two separate and distinct entities, and a sale between the two should be respected.

Several provisions of the Code recognize that sales between related parties may be valid transactions. For example, under Subchapter K of the Code, Treas. Reg. § 1.707-1(a) addresses transactions between partners and partnerships, such as a sale of property to a partnership. Additionally, Treas. Reg. § 1.721.1(a) clearly provides that "rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it." However, the regulation notes that in all transactions, "the substance of the transaction will govern, rather than its form." Subchapter K contains several provisions that specifically address potentially abusive transactions between related parties. For example, a loss from a sale or exchange of property between a partnership and a partner who owns a more than 50% interest in the capital or profits of the partnership is not recognized for tax purposes under I.R.C. § 707(b)(1)(A). Similarly, the installment sale provisions under I.R.C. § 453 recognize that related parties may enter into valid sale transactions and may recognize any resulting gain under the installment method of accounting. Rather than invalidating related party sales, these provisions provide specific rules limiting the use of the installment method in potentially abusive scenarios. For example, by providing rules governing second dispositions by related persons, I.R.C. § 453(e) implicitly allows related party sales.

In challenging the validity of the sale, the Service could possibly assert that the sale was in reality a contribution of capital to Client P/S. Contributions of capital are governed by I.R.C. § 721, while sales from a partner to a partnership are governed by I.R.C. § 707. In Davis v. Commissioner, 29 T.C.M. 749 (1970), the taxpayer transferred land to a joint venture in which the court determined he was a partner. The partnership agreement provided that he would be paid for the property with the first available funds, and payment would not depend on the success or failure of the project. The court focused on the form of the transaction, specifically that the other 50% partner would have been required to provide the purchase price if the venture was unable to pay. The court held that the transaction was a sale governed by I.R.C. § 707. See also Oliver v. Comm'r., 13 T.C.M. 67 (1954) (rejecting taxpayer's characterization as sale); Otay v. Comm'r., 70 T.C. 312 (1978) (discussing factors supporting sale).

Similar issues have arisen in the context of contributions to corporations under I.R.C. § 351. In Sun Properties v. U.S., 220 F.2d 171 (5th Cir. 1955), the taxpayer sold a piece of property to a corporation of which he was the sole shareholder. The district court held that sale was not arm's length and recharacterized the transaction as a contribution to capital. The Fifth Circuit reversed, holding that the transaction was a sale despite the non-arm's length nature and the lack of business purpose for the sale. The court stated that a transaction should not be disregarded simply because it was not arm's length, and found no evidence that it was a capital contribution. See also Brown v. Comm'r., 27 T.C. 27 (1956), Hardwick v. Comm'r., 33 B.T.A. 249 (1935).

As discussed elsewhere in this opinion, your sale to Client P/S more likely than not was an arm's length transaction. Similarly, you and Client P/S have observed all formalities of a sale. Moreover, Client P/S has other assets to support the purchase of the options. Under the facts and circumstances surrounding your sale, the Service will more likely than not respect your sale of options to Client P/S as a valid sale between two separate taxable entities.

3. The Assignment of Income Doctrine more likely than not does not apply to your sale of options to Client P/S.

The assignment of income doctrine is generally applied when a taxpayer has attempted to transfer property to another, but either wholly or partially failed to do so. The doctrine has a basis in both case and statutory law. Under the traditional rule first set forth by the Supreme Court in Lucas v. Earl, 281 U.S. 111 (1930), income must be taxed to the person who earns it, and income may not be avoided by assignment to another. The Lucas Court explained,

> the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Lucas v. Earl, 281 U.S. 111, 115 (1930).

In Lucas v. Earl, the taxpayer attorney contracted with his wife for the two of them to take ownership as joint tenants in all property that they had at the time of contracting, as well as all after-acquired property. Id. at 114. The issue involved whether the taxpayer could be taxed on the whole of the attorney fees he had earned even though half of such property was immediately distributable to his spouse. As the above quoted language of Justice Holmes indicates, the Court held that the entire amount was taxable as ordinary income to the taxpayer. Unfortunately, the Court did not elaborate on the factors it utilized to draw its conclusion.

As the doctrine developed, other courts had the opportunity to explore the application of the doctrine. For example, in Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962), the court commented on the factors that should be considered in applying the doctrine. The case involved a sole proprietor subcontractor who assigned all his business assets, including his right to receive additional compensation for services rendered that was in disputed litigation at the time of transfer. The taxpayer was the majority shareholder of the corporation to which the claim to compensation was liquidated. The court discussed the following four factors in examining whether the doctrine was applicable:

1. At the time of the transfer, was the claim uncertain, doubtful and contingent,
2. Was the transfer an arm's length transaction,
3. Did the transfer have a business purpose, and
4. Was the transfer full, complete, final and definite.

Jones v. Comm'r., 306 F.2d 292 (5th Cir. 1962).

The Jones Court admitted the difficulty of arriving at a concrete set of determining factors, and the somewhat inconsistent approach courts have taken in applying the doctrine. The court stated that "'drawing the line is a recurrent difficulty in these fields of law when differences in degree produce ultimate differences in kind.' Nevertheless, there are distinct and identifiable principles which have been developed in tax jurisprudence which serve to guide the courts." Jones v. Comm'r., 306 F.2d 292 (5th Cir. 1962) (quoting Harrison v. Schaffner, 312 U.S. 579 (1941)).

The Jones Court continued by explaining the importance of a full and complete transfer. The court discussed two cases which ultimately had differing results, but which both focused primarily on the control the transferor retained over the transferred asset or income right. Id. In Blair v. Commissioner, 300 U.S. 5 (1937), the beneficiary of a trust assigned specific amounts of annual trust income to his children. In rejecting the application of the doctrine, the court noted that the taxpayer retained no control over the share of income that he had assigned. Id. Under this analysis, the transfer was viewed to have been full and complete, with the income derived from the transferred interest taxed to the transferee. In contrast, the Jones court cited in Harrison v. Schaffner, 312 U.S. 579 (1941), in which the court required income recognition under the assignment of income doctrine where the taxpayer transferred a one-year interest in the income stream of a trust to her daughter. Because the taxpayer had not relinquished the property in any real sense, she was required to recognize ordinary income. Id.

Although the Jones Court also cited the arm's length nature of a transaction as a relevant consideration, the court did not greatly elaborate on what satisfies this requirement, merely stating,

> Where there is an arm's length assignment of income rights for a *valuable consideration*, it is clear that the assignor realizes only the amount of the consideration received, Rhodes v. Commissioner, 43 B.T.A. 780 (1941) affirmed 131 F.2d 50 (6^{th} Cir. 1942), and the assignee is taxable for receipts in excess of this amount. See Blair v. Commissioner, 300 U.S. 5 (1937).

Jones v. Comm'r., 306 F.2d 292 (5^{th} Cir. 1962), citing Harrison v. Schaffner, 312 U.S. 579 (1941) (emphasis added). The significance of the above quoted language is that it indicates the doctrine will not apply in situations where the transfer is arm's length and for full and adequate consideration.

The Jones court also examined the business purpose of the transfer. The court relied on Burnet v. Leininger, 285 U.S. 136 (1932), in which a law firm partner assigned the future income from his partnership to his wife. The Jones Court stated that the taxpayer in Burnet was like taxpayers in many other cases in which there had actually been a gift of the asset because no business purpose could be found for the transfer. However, Mr. Jones was deemed to have met the business purpose test because he himself desired to sell to help alleviate his insolvency. Jones v. Comm'r., 306 F.2d 292 (5^{th} Cir. 1962).

Although the authorities discussed above place a great deal of importance on the control the transferor retained over the transferred assets, these authorities dealt with gratuitous assignments. Courts have clearly made a distinction between the doctrine's application to gratuitous transfers and to arm's length transfers for full and adequate consideration. For example, in Estate of Stranahan v. Commissioner, 472 F.2d 867 (6^{th} Cir. 1973), the taxpayer sold a right to future dividends to his son. The taxpayer reported the proceeds from the sale to his son as ordinary income. The business purpose for this sale was to accelerate the ordinary income recognition in order to take advantage of interest expenses incurred during the tax year. The Service asserted the son's receipt of the dividends was taxable to the taxpayer under assignment of income principles. The Sixth Circuit rejected this argument, holding that where good and sufficient consideration is received for the bona fide transfer of income rights, the transferors are taxable on that consideration and not on the transferees' receipt of the transferred income. Id. at 869. See also Pounds v. U.S., 372 F.2d 342, 348 (2d. Cir. 1967) (holding once assignment of rights in real estate commissions passed from the hands of the assignor, they lost their character as compensation and became instead an investment by the taxpayer/assignee); PLR 9533008 (similar). Similarly, in Cotlow v. Commissioner., 228 F.2d 186 (2d Cir. 1955), the Second Circuit distinguished gratuitous transfers from arm's length transfers for valuable consideration. According to the Cotlow Court, "where there is an arm's length assignment of income rights for valuable consideration, it is clear that the assignor realizes only the amount of the consideration received ... and the assignee is taxable for receipts in excess of this amount." Id.

Your sale of ABC options to Client P/S was for their independently appraised fair market value. As discussed elsewhere in this opinion, the sale to Client P/S was more likely than not at arm's length. Although you retained partial control over the transferred assets by serving as a general partner of Client P/S, this control was substantially limited by your wife's position as an additional general partner of Client P/S. After your sale of the options to Client P/S for their appraised fair market value, you no longer have unilateral control over the assets. You have transferred your entire equitable interest in the options to Client P/S. Thus, Client P/S possesses all rights associated with the options, including the right to exercise or hold them indefinitely. The risk that the value of the Options will decrease or increase is completely borne by Client P/S. Additionally, you will ultimately recognize and report the proceeds from the sale as compensatory ordinary income. Under these circumstances, the assignment of income doctrine more likely than not will have no application to your transaction.

4. A disposition of nonqualified options at fair market value under commercially reasonable terms more likely than not satisfies the arm's length standard of I.R.C. § 83.

I.R.C. § 83 is the exclusive I.R.C. section governing the taxation of property, including stock options, transferred to an employee or independent contractor in connection with the performance of services. The section provides that the person who performed such services shall include in his gross income in the first taxable year in which his rights are transferable or not subject to substantial risk of forfeiture, the excess of the fair market value of such property at that time over the amount paid for such property. I.R.C. § 83(a). If the property is sold or otherwise disposed of in an arm's length transaction before the rights in the property become transferable or not subject to substantial risk of forfeiture, income is recognized at that point in an amount equal to the consideration received from the sale. Id.

Treasury Regulation § 1.83-7(a) provides further guidance on the application of I.R.C. § 83 with respect to nonqualified stock options granted to service providers. In general, for purposes of I.R.C. § 83, the value of an option is not readily ascertainable unless the option is actively traded on an established market. Treas. Reg. § 1.83-7(b). If the option does not have a readily ascertainable fair market value at the time of the grant, I.R.C. §§ 83(a) and 83(b) will apply with respect to the options when the options are exercised or otherwise disposed of, even though they may have a readily ascertainable value prior to their exercise or disposition. If the options are exercised, the employee or independent contractor recognizes ordinary income in accordance with I.R.C. § 83(a). However, if the options are sold or otherwise disposed of before exercise in an arm's length transaction, the regulations provide that "sections 83(a) and 83(b) apply to the transfer of money or other property received [from their disposition] in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to the exercise of the option." Id. Thus, if the options are disposed of in an arm's length transaction, that disposition triggers the application of I.R.C. § 83 with respect to the consideration received in exchange for the options. If the sale or disposition is not at arm's length, I.R.C. § 83 will continue to apply with respect to the options. In such a situation, exercise of the options by the transferee will trigger compensation income to the transferor under I.R.C. § 83. Treas. Reg. § 1.83-7(a). See, e.g. PLR 199927002, PLR 9713012.

From the above discussion, it is clear that the tax consequences of your sale to Client P/S hinge on whether the transaction was arm's length. Neither the regulations nor the legislative history of I.R.C. § 83 provide any guidance on what constitutes an arm's length transaction.[1] Although the courts have not addressed the specific issue, existing authority appears to recognize that an arm's length transaction is possible between related parties for purposes of I.R.C. § 83. Moreover, no authority can be located which holds or implies that transactions between related parties per se violate I.R.C. § 83's arm's length standard. In describing the amount of compensation required to be recognized under I.R.C. § 83, the Code and regulations repeatedly use the phrase "fair market value." A fair market value transfer appears to be an implicit concept imbedded in the common understanding of what constitutes an arm's length transaction. See Bagley v. Comm'r, 85 T.C. 663, 673 n.17 (1985) (explaining, in dicta, that I.R.C. §83's "arm's length requirement is intended to assure that the statutory scheme is not circumvented by means of a disposition for less than fair market value"). Yet Treas. Reg. § 1.83-7, in dealing with the taxation of options, uses the term "arm's length transaction." Despite the plausible interpretation of the arm's length requirement in Bagley, standard statutory construction may lead to the conclusion that the arm's length standard requires more than a mere fair market value disposition.

a. Related parties and the "arm's length" standard

The statutory and regulatory ambiguity leaves open the issue of whether a transaction between related parties may satisfy the arm's length standard. Although the regulations under I.R.C. § 83 do not directly address the issue, no authority can be found precluding related party transactions from satisfying the arm's length standard. Moreover, the terminology used in the regulations suggests the drafters of I.R.C. § 83 did not intend to prohibit such a transaction. For example, in discussing the effect of a transfer of non-vested property subject to I.R.C. § 83, Treas. Reg. § 1.83(b) uses the more general term "third party," rather than another phrase, such as an "unrelated third party." By analogy, I.R.C. § 267, which covers losses, expenses and interest, specifically states that losses between "related taxpayers" are disallowed. However, I.R.C. § 83-1(a) does not state that the sale of non-vested property must be to an unrelated party, rather it simply requires a sale to a "third party." There is no requirement in the statute or the related committee reports for any additional standard beyond "arm's length." If the drafters intended the relationship between the transferor and transferee to be controlling, the regulations would have likely reflected this intention.

While the court has never directly ruled on this issue in the context of I.R.C. § 83, existing authority strongly implies that a transaction between related parties may satisfy the arm's length standard. For example, in Pagel v. Commissioner, 91 T.C. 200 (1988), aff'd, 90-2 U.S.T.C. ¶ 50,347 (8th Cir. 1990), a corporation received compensatory warrants to purchase stock in exchange for underwriting services rendered to the issuer. The corporation later sold the warrants to its sole shareholder for $314,900, characterizing the gain as a capital gain. The IRS contended that the income recognized on the sale should be ordinary income under I.R.C. § 83 and Treas. Reg. § 1.83-7(a) since the warrant was compensation from underwriting services provided by taxpayer. The Tax Court and the Eighth Circuit Court of Appeals upheld the IRS's position, finding the corporation's arm's length disposition triggered ordinary income under Treas. Reg. § 1.83-7(a). In finding that Treas. Reg. § 1.83-7(a) was applicable, the court accepted the party's stipulation that the transaction was arm's length and stated,

> [a]lthough the transaction was between petitioner and its sole shareholder, neither petitioner nor respondent has suggested that the sales price of $314,900 was other than the fair market value of the warrant or that the sale of the warrant was other than an arm's length transaction. We therefore find that petitioner's sale of the warrant... was an arm's length transaction executed at the fair market value of the warrant.

Id. at 210.

In Pagel, the court acknowledged the fact that the compensatory warrants were sold to a related party, but did not find that this precluded an arm's length transaction. The court had the opportunity to challenge the parties' stipulation that the transaction was arm's length but did not. The court's acceptance of the parties' stipulation supports the position that it is possible to have an arm's length transaction for purposes of I.R.C. § 83 between related parties. The court's opinion was similarly unaffected by the fact that a related party, the shareholder, ended up holding the warrants after the disposition. The court could have ruled as a matter of law that a sale between related parties was per se not an arm's length transaction, or could have taken issue with the value as fair market value. Neither issue was raised or discussed by either party in the case. Instead, the court focused on whether the related party shareholder paid fair market value for the warrant. Implicit in the approach used in Pagel is an analysis focusing on whether the seller received value equivalent to what would have been received had the buyer been an independent party.

The Service similarly indicated that a transfer between related parties does not preclude arm's length treatment in Private Letter Ruling 9421013. This ruling involved a taxpayer's receipt of compensatory stock options from a corporate employer. The taxpayer later sought to transfer the options to her son, and requested a ruling as to the son's basis in the underlying stock upon the future exercise of the options. The Service ruled that "provided that the [son] acquires the Options in a transaction not at arm's length," his stock basis would be increased by the amount the parent includes in her gross income at exercise date. The clear implication from this ruling is that a transfer between parent and child could be arm's length.

The Tax Court has also indicated that transactions between related parties do not preclude arm's length treatment in contexts other than I.R.C. § 83. For example, in Zachry v. Commissioner, 49 T.C. 73 (1967), the corporate taxpayer sold preferred stock to a related company for cash, and recognized no gain or loss under I.R.C. § 1032. The Service asserted that the transaction was a sham and did not qualify as a § 1032 exchange of stock for property. Instead, the Service characterized the transfer as one of several "interrelated steps in a single transaction" subject to I.R.C. § 351. Id. at 81. The Tax Court rejected the Service's argument, finding the transaction was a "normal arm's length purchase." Id. The court further stated "[i]t is true that there was a sale between related parties, but that in itself does not destroy its validity." Id.

In each of these authorities the court or the Service had the opportunity to challenge the transactions on grounds that the related party status precluded an arm's length transaction, yet they failed to do so. In light of these authorities, the fact that a transaction involves a sale to a related-party more likely than not does not prevent the disposition from being arm's length.

b. Commercially reasonable

In light of the lack of authoritative guidance specifically addressing what the phrase "arm's length" means in the context of I.R.C. § 83, I.R.C. § 482 may provide some guidance. I.R.C. § 482 grants the Service authority to allocate income and deductions among commonly controlled organizations as necessary to prevent the evasion of taxes or to clearly reflect income. Although the types of transactions governed by I.R.C. § 482 can be readily distinguished from those governed by I.R.C. § 83, the regulations under I.R.C. § 482 provides insight into the meaning of the arm's length standard. Treasury Regulation § 1.482-1(b)(1) provides the general rule:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at *arm's length* with an uncontrolled taxpayer. A controlled transaction meets the *arm's length* standard if the results of the transaction are consistent with the results that would have

> been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

Treas. Reg. § 1.482-1(b)(1) (emphasis added).

Thus, if this general rule of I.R.C. § 482 can be applied in the context of I.R.C. § 83,[2] the sale of options to a related party should be viewed as arm's length if the "results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." Treas. Reg. § 1.482-1(b)(1). Applying this language, it appears that if unrelated parties would enter into a particular transaction, and if related parties also enter into the same transaction on the same or comparable terms, the related party transaction will be respected as being at arm's length.

The regulations continue by pointing out that "because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances." Id. Thus, it appears that absent an identical transaction, the application of I.R.C. § 482 would require a comparison of the your transaction with comparable transactions. In general, this is done by comparing factors that could influence prices or profits in arm's length dealings. Treas. Reg. § 1.482-1(d)(1). Under these regulations, the comparability factors include:

- Functional analysis
- Contractual terms
- Risks
- Economic conditions
- Property or services.

Thus, under I.R.C. § 482, the Service may apply these factors to reasonably allocate income and deductions between two commonly controlled entities as if the transaction between related entities were conducted at arm's length. Because it is often rare or impracticable to identify identical transactions, similar factors are commonly applied by qualified appraisers in ascertaining the fair market value of businesses, real estate, notes, etc. Thus, absent using an identical transaction to determine the arm's length nature of a transaction, it would appear that I.R.C. § 482 supports the proposition that such a determination could be made with reference to a qualified appraisal. Essentially, an analysis under the comparability factors of I.R.C. § 482 employs a standard of commercial reasonableness. Although I.R.C. § 83 specifically references neither I.R.C. § 482 nor the phrase "commercially reasonable," without further guidance from the Service or the courts, there appears to be no other reasonable interpretation of what this phrase represents.

Under a commercially reasonable analysis, one method to verify the arm's length nature of the transaction is to determine whether the terms of the obligation are similar to terms that would be offered by commercial lenders to unrelated borrowers. This would include a comparison of such terms as interest rates charged, collateral requirements, payment schedules and the term of the loan. If the terms of a loan between related parties are consistent with terms available to the borrower from commercial lending institutions, the transaction should arguably be characterized as arm's length. Thus, as expounded upon above, any relationship between the borrower and the lender more likely than not should be irrelevant.

In the context of valuing promissory notes for estate tax purposes, the Service and courts have examined a number of factors. I.R.C. § 2031 provides that both secured and unsecured obligations and receivables have an estate tax value equal to the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes a lower value or proves that the notes are worthless. Treas. Reg. § 20.2031-4. Generally, the factors examined by courts in valuing promissory obligations include payment terms, collateral, interest rate, financial security of the obligor and whether the obligation is recourse or nonrecourse. These should provide some guidance as to what may constitute commercially reasonable terms. For example, in Estate of Berkman v. Commissioner, 38 T.C.M. 183 (1979), the taxpayer died holding several promissory notes representing loans made to his daughter and son-in-law. The term of each note was 20 years, with interest at 6% per annum, payable monthly. No payment was due on the principal until the maturity of the note, at which time the full balance of the principal was due. Interest had been paid monthly on each note from date of execution. Additionally, none of the notes were secured. During the seven-year period during which the loans were made, the taxpayers could have obtained a loan from a commercial lending institution. The prime interest rate for bank loans during this period ranged from 6.25% to 9.75%. The taxpayer's executor valued the five notes at 50% of face value plus interest accrued at date of death for estate tax purposes. The Service issued a notice of deficiency, asserting that the notes had a fair market value equal to their face amount. In finding for the taxpayer, the court cited Treas. Reg. § 20.2031-4 and noted the interest rate on all five notes was below the prime rate of interest. The court stated "[t]aking into account this low rate of interest, together with the lack of security and the considerable length of time until maturity, we conclude that these notes are includable in the decedent's gross estate at their fair market value and not their face amount." Id.

In the context of gift tax, the court has held that if a note carries the I.R.C. § 7872 Applicable Federal Rate (AFR), the transaction will be considered arm's length, and no gift tax will be imposed on the transaction. In Frazee v. Commissioner, 98 T.C. 554 (1992), the taxpayers sold a piece of improved real estate to their children in exchange for a promissory note bearing a below market interest rate. The court noted the sweeping scope of I.R.C. § 7872, stating "[i]n contrast to sections 483 and 1274, the language and legislative history of section 7872 make it clear that it is to apply for gift tax purposes. See sec. 7872(d)(2). The coverage of section 7872 ... provide[s] comprehensive treatment of below-market loans for income and gift tax purposes." 98 T.C. at 589. In determining whether the rate used created taxable gifts, the Tax Court explained that "[u]nder section 7872, a below the market loan is recharacterized as an arm's length transaction in which the lender is treated as transferring to the borrower on the date the loan is made the excess of the issue price of the loan over the present value of all the principal and interests payments due under the loan." Id. at 588. The Tax Court further stated that "[b]y enacting section 7872, Congress indicated that virtually all gift transactions involving the transfer of money or property would be valued using the current applicable federal rate. Sec. 7872(f)(2)(B). In doing so, Congress displaced the traditional fair market methodology of valuation of below market loans by substituting a discounting methodology." Id. at 589. By adopting a discounting methodology, Congress effectively eliminated the need to evaluate the collateral, net worth, cash flow or other characteristics of the issuer of a note in order to determine the note's fair market value. Thus, for gift tax purposes, if the loan had been at the Applicable Federal Rate, I.R.C. § 7872 would deem the note to be worth its face amount, regardless of other information concerning the note's issuer or the note's terms. Although the fact that a note carries the I.R.C. § 7872 interest rate does not establish that the note is arm's length, Frazee clearly indicates the importance the courts and the Service place on interest rates. In your transaction, regardless of whether the arm's length standard has been met, there is no taxable gift to Client P/S because the interest rate at least equals the I.R.C. § 7872 rate. This interest rate should be another factor to strengthen the arm's length nature of the transaction. It could easily be inferred that the Congressional intent behind I.R.C. § 7872 was to deem every loan bearing a rate of interest at least equal to the Applicable Federal Rate as worth its face bly equivalent to an arm's length loan for all income tax purposes, including I.R.C. § 83.

c. Conclusion

As discussed above, neither the courts nor the Service have indicated that transfers between related parties prevent them from being arm's length. Thus, the relationship of the third party should be technically irrelevant; however, as a practical matter, the Service scrutinizes more closely related party transactions. The authorities discussed above, as well as the use of the phrase "arm's length" elsewhere in the Code, imply that the issue of whether a transaction is arm's length depends primarily on whether the terms of the transaction are commercially reasonable.

In your sale of ABC options to Client P/S, the terms of the transaction appear to be commercially reasonable. First, a qualified independent appraiser has determined or will determine that the market value of the promissory obligation is equal to its face value. Second, the terms of the obligation call for market interest payments (such interest rate being at least equal to the Applicable Federal Rate) to be made at least annually. Third, the obligation contains an acceleration clause allowing Client P/S to accelerate payments on the obligation at any time prior to expiration of the stated term. Fourth, although the obligation will not be secured, the lender should be adequately protected in the event of default because the sales agreement precludes Client P/S from making distributions other than to meet its partners' tax obligations. This provision mirrors comparable security arrangements often required by commercial lending institutions, and thus, helps to ensure that Client P/S retains assets adequate to meet its obligation. Partnership property is essentially reserved to repay the promissory obligation, albeit subject to claims of general creditors in bankruptcy. Fifth, Client P/S has other assets that provide you (as the seller) some protection from downside risk in the case the partnership's assets drop in value. The $200,000 of cash (or approximately 10% of the value of the options sold to Client P/S) with which you and your family initially funded the partnership provide this protection. Finally, Client P/S's exposure to other contingent liabilities is likely to be minimal due to the fact that it is primarily engaged in investing and will have few, if any, creditors other than you (as the obligee). There are many real estate and other financial loans which have less stringent terms and conditions with much greater risk. Therefore, in light of these factors and the fact that the obligation has a fair market value equal to its face value, the promissory obligation appears to be commercially reasonable. Therefore, your disposition of the options to Client P/S will more likely than not satisfy the arm's length standard of I.R.C. § 83 and the regulations thereunder.

5. <u>Once nonqualified options are disposed of at arm's length under I.R.C. § 83, thereby triggering the realization of ordinary income, any subsequent exercise of the options by Client P/S more likely than not does not invoke the re-application of I.R.C. § 83.</u>

Although stock options may not have a readily ascertainable fair market value at the time of grant, the terms of the options may still allow for transferability. If the employee granted such options disposes of the options before exercise, the tax consequences to the employee depend on whether the disposition was arm's length or non-arm's length. The rules governing these types of dispositions of stock options mirror the general rules of I.R.C. § 83(a) regarding dispositions of restricted property before the compensation element has been triggered.

I.R.C. § 83(a) provides a general rule deferring the taxation of property transferred in connection with the performance of services until the property becomes transferable or is no longer subject to a substantial risk of forfeiture. The theory behind I.R.C. § 83 is that the fair market value of property received in connection with the performance of services is taxed as compensation as soon as the employee's rights with respect to the property are sufficiently clear and the property is readily valued. With respect to stock options, this generally occurs once the options are exercised or are sold in an arm's length transaction. Under I.R.C. § 83, if property which is transferable and not subject to substantial risk of forfeiture is granted in connection with the performance of services, I.R.C. § 83 will apply at the time of the grant. For example, if an executive is granted shares of stock in connection with the performance of services which are not subject to substantial risk of forfeiture, are fully transferable, and have a readily ascertainable fair market value, I.R.C. § 83(a) would apply to tax the stock as compensation at the time of the grant. I.R.C. § 83(a)(2). If the executive continued to hold the stock after I.R.C. §

83 has triggered taxation, the stock would be treated as a capital asset. If the executive later sold the stock, I.R.C. § 83 would have no further application. Id. I.R.C. § 83(a) clearly reflects that Congress did not intend that the statute operate to tax property more than once by stating "the preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to substantial risk of forfeiture." Id.

The regulations under I.R.C. § 83 are drafted to emphasize the fact that the section will not apply more than once. For example, Treas. Reg. § 1.83-1(b), which specifically addresses the taxation of substantially non-vested property received pursuant to the performance of services, provides that if substantially non-vested property is sold subsequent to its receipt in an arm's length transaction, while still substantially non-vested, the person who performs such services shall realize compensation in an amount equal to the excess of the amount realized from such sale or other disposition over the amount paid for the property. Subparagraph (1) of this regulation continues by stating that I.R.C. § 83(a) shall thereafter cease to apply with respect to such transferred property. Treas. Reg. § 1.83-1(b)(1). The impact of the regulation is that once I.R.C. § 83 applies to the transfer of property and income has been realized under I.R.C. § 83 with respect to the full value of the property, subsequent gain associated with that property from the exercise of the options by the transferee is no longer subject to I.R.C. § 83(a). While not explicitly stated in the regulations, this reasoning should apply equally to vested stock options.

Treasury Regulation § 1.83-7(a), which explains the operation of I.R.C. § 83 in the context of nonqualified stock options, states that if an option is sold or otherwise disposed of in an arm's length transaction, I.R.C. § 83(a) and (b) will apply to the transfer. Although Treas. Reg. § 1.83-7(a) does not specifically state that I.R.C. § 83 will no longer apply to stock options following an arm's length disposition, the regulation suggests such treatment by referencing I.R.C. § 83(a) and (b). This reference to I.R.C. § 83(a) is significant because, as noted above, I.R.C. § 83 clearly indicates that the section will no longer apply following an arm's length disposition. If this were not the case, Treas. Reg. § 1.83-7(a) would operate to tax the options at the time of the arm's length disposition and again upon their subsequent exercise. This result would be contrary to Congress's intent expressed in the statutory language of I.R.C. § 83.

In your arm's length sale of options to Client P/S, income realization under I.R.C. § 83 more likely than not occurs at the time the options are sold. Because compensation will be realized at the point of this arm's length sale, I.R.C. § 83 more likely than not no longer applies to the options in the hands of the transferee, Client P/S. Therefore, when Client P/S ultimately exercises the options, the exercise of the options more likely than not will not trigger further taxation under I.R.C. § 83.

6. Client P/S's unfunded and unsecured promise to pay the appraised value for the options plus interest more likely than not will not constitute "property" for purposes of I.R.C. § 83. As a result, it is more likely than not proper that compensatory ordinary income should not

be recognized until principal payments are received under this promissory obligation.

a. "Property" under I.R.C. § 83

Treasury Regulation § 1.83-7(a) governs the taxation of nonqualified stock options. The regulation provides that if the option is sold or otherwise disposed of in an arm's length transaction, I.R.C. §§ 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as I.R.C. §§ 83(a) and 83(b) would have applied to the exercise of the option. To the extent the seller of the options receives cash or property from the sale of the options, such proceeds would be taxed as compensatory ordinary income under the principles of I.R.C. § 83. The theory behind Treas. Reg. § 1.83-7(a) is that once the options have been disposed and the special deferral treatment of stock options is no longer applicable, the proceeds from the sale should be taxed under the general rules of I.R.C. § 83.

The term "property" takes on a specific meaning for purposes of I.R.C. § 83. Treasury Regulation § 1.83-3(e) defines property for purposes of I.R.C. § 83 as "real and personal property *other than* either money or an unfunded and unsecured promise to pay money or property in the future." (emphasis added). Property also includes "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." This definition of property creates a distinction between the treatment of a bare contract right to receive future payment, and a secured right to payment represented by evidence of indebtedness.

Prior to the enactment of I.R.C. § 83, authorities addressing the issue of when to tax property transferred in connection with the performance of services applied the well-established principles of actual and constructive receipt. The potential application of the constructive receipt doctrine to your transaction will be discussed later in this opinion. The results reached under this approach were similar to those reached under I.R.C. § 83 in that they distinguish between bare contractual rights to receive payments and rights secured by evidence of indebtedness. Because I.R.C. § 83's definition of property continues to reflect this distinction and there is little authority interpreting the meaning of "unfunded and unsecured" in the context of I.R.C. § 83, these pre - I.R.C. § 83 authorities appear relevant in determining what is meant by this phrase.

In Rev. Rul. 71-419, 1971-2 C.B. 220, the Service applied these principles to a company's deferred compensation plan. Under the plan, at the end of each year the corporation's board of directors could elect to defer the receipt of all or part of their annual director fees for the following year. The deferred amounts were credited to a separate corporate memorandum account and earned interest until distributions began. If the director stepped down from his position and became an employee, officer, or affiliate with any competing business, the entire balance of his deferred fees would be paid to him. Upon death of the director, the balance of his deferred fees would be paid to his estate. The Service noted that the deferred funds held pursuant to the plan were unsecured and unfunded. Because the corporation was "under a merely contractual obligation to make the payments when due," the director was not required to include the deferred amounts in his gross income until they were paid or otherwise made available to him.

In Rev. Rul. 60-31, 1960-1 C.B. 174,[3] the Service discussed the general rule for determining the taxable year of inclusion. Although issued prior to the enactment of I.R.C. § 83, the Service has cited this ruling in numerous Private Letter Rulings dealing with I.R.C. § 83's application to deferred compensation arrangements. See PLR 9612027, PLR 9218037, PLR 9149024. Situation (1) of this ruling involved a deferred compensation arrangement between a taxpayer and corporation. The employment contract established an annual salary and additional compensation of 10x dollars each year. The additional compensation was deferred and credited each year to a reserve bookkeeping account on the corporate books. The terms of the agreement specified that the corporation was under a contractual obligation to make the deferred payments in accordance with the plan. In the event of the taxpayer's death, the deferred amounts would be paid to the taxpayer's family in annual installments beginning in the calendar year after the taxpayer's death. Applying the doctrine of constructive receipt of income, the Service found that the additional compensation under the employment contract was not includable in taxpayer's gross income until the installment payments were received.

I.R.C. § 83 does not define or offer any further guidance on what constitutes an "unfunded and unsecured promise to pay. " The regulation's definition of property implies that for a contractual obligation to be treated as I.R.C. § 83 property, the obligation must be either funded or secured. In Childs v. Commissioner, 103 T.C. 634 (1994), the Tax Court considered whether amounts receivable under an annuity contract were "property" within the meaning of I.R.C. § 83 by first examining whether they were funded and then whether they were secured. The plaintiffs in Childs were three attorneys who were entitled to receive attorney's fees as part of a structured settlement. The structured settlement was to be paid by an annuity purchased by the defendant's insurance company. The insurance company retained ownership of the annuities, and had the power to change the beneficiaries. Additionally, the annuities specifically provided that the attorneys' rights were those of general creditors. After examining the provisions and funding of the structured settlement arrangement, the court determined that the payments were not "property" within the definition of I.R.C. § 83. Id. at 653. Although funding may occur where no further action is required of the obligor for the trust or insurance proceeds to be distributable to the beneficiary, funding has not occurred if the trust or annuity policy is subject to the rights of general creditors of the obligor. Id. at 651. The Childs court agreed with the taxpayer's position that the settlement payments were unsecured because the beneficiaries of the annuity policies were not granted a security interest in the property that would be used to pay the obligations. The Childs court noted "[i]t is well settled that a simple guarantee does not make a promise secured, since by definition a guarantee is merely itself a promise to pay." Id. at

652. Because the amounts receivable under the settlement were neither funded nor secured, the court determined I.R.C. § 83 was inapplicable.

This distinction was also evident in Revenue Procedure 92-64, issued by the Service in 1992, which provided a model rabbi trust to serve as a safe harbor in drafting deferred compensation arrangements. If a trust is drafted to mirror the model trust, the employee benefiting from the payments to the trust will not be in constructive receipt of income or incur an economic benefit solely on account of the adoption or maintenance of the trust. One key provision of the model trust provides that the trust assets are "subject to the claims of Company's creditors in the event of Company's Insolvency... until paid to Plan participants and their beneficiaries." Generally, amounts received under a deferred compensation plan modeled according to these provisions will not constitute property for purposes of I.R.C. § 83.

The Service has consistently applied the I.R.C. § 83 definition of property in numerous Private Letter Rulings. The majority of these rulings have addressed the issue in the context of deferred compensation plans. For example, in Private Letter Ruling 8642045, a Company adopted a stock option plan which provided for a grant of non-qualified stock options and stock appreciation rights ("SAR's") to employees. The options and SAR's granted under the plan were not transferable by the employee other than by will or the laws of descent and distribution. If a participant exercised his stock option, the SAR entitled him to receive the number of shares of stock having an aggregate fair market value on the date of exercise equal to the amount by which the fair market value of a share exceeds the option price per share, times the number of shares subject to the option. Applying the I.R.C. § 83 definition of property, the Service determined the SAR was an unfunded and unsecured promise to pay money or property in the future. Therefore, it was not property for purposes of I.R.C. § 83.

In Private Letter Ruling 8727028, the Service determined amounts placed in irrevocable trust accounts to fund deferred compensation for the benefit of key employees was not I.R.C. § 83 property. Although the funds were segregated in an irrevocable trust, the funds were still subject to the claims of creditors in the event of bankruptcy. The Service concluded that this risk constituted a substantial risk of forfeiture, and the assets were not I.R.C. § 83 property.

In Private Letter Ruling 9540033, the Service examined a deferred compensation plan established by an insurance company. Under the plan, selected insurance agents were able to accumulate benefits for later distribution, generally retirement. Each agent made an annual election to defer all or a portion of his compensation. The obligation of the insurance company to make future benefit payments was unfunded and unsecured. The rights of the plan participants to receive future payments were those of unsecured, general creditors. After citing the Treas. Reg. § 1.83-3(e) definition of property and discussing the economic benefit doctrine, the Service ruled that neither the crediting of salary deferrals under the plan nor the crediting of earnings under the plan constituted property to participating employees under I.R.C. § 83 or the regulations.

These authorities clearly establish that an obligation is "unfunded and unsecured" if the funds intended to be used to satisfy the obligation are subject to the claims of creditors in bankruptcy proceedings. In consideration for your sale of the options, you received a contractual right to receive future payment. The Partnership has segregated and earmarked assets that will be used to meet its repayment obligation to you. Although these assets are earmarked and segregated, they still remain subject to the claims of the Partnership's creditors in the event of bankruptcy. The segregation of funds will merely provide you with a greater level of assurance of repayment than a naked promise to pay would provide. Because your contractual rights to future payment from the sale of the options constitute an "unfunded and unsecured promise to pay money in the future," this right more likely than not does not rise to the status of property for purposes of I.R.C. § 83.

Since the promissory obligation is not considered property for purposes of I.R.C. § 83, the question becomes how should it be taxed under I.R.C. § 83. Many of the previously cited authorities make it clear, regardless of the arm's length nature of a transaction, that the mere receipt of an unfunded and unsecured promise to pay does not rise to the level of property requiring immediate taxation. See, e.g. PLR 9540033, PLR 8642045. Instead, ordinary income is recognized as payments are made on the promissory obligation. While the authorities cited above involve a promissory obligation of an employer rather than a third party, there is no special rule limiting this provision to employers. In fact, the theoretical support for not requiring immediate taxation upon the receipt of an unfunded and unsecured promise to pay applies equally should the promissor be a third party or an employer. Therefore, the receipt of an unfunded, unsecured promise to pay made by a non-employer more likely than not does not have a different treatment than if it was made by an employer. Since you will not receive any money or property at the time your options are sold, the transaction more likely than not will not result in immediate taxation. Instead, you will more likely than not recognize compensation in accordance with I.R.C. § 83(a) upon the future receipt of property or cash as principal payments are made under the terms of the promissory obligation.

b. Income recognition under doctrine of constructive receipt

Although, as discussed above, your recognition of income from the sale will more likely than not be delayed until property is received under the promissory obligation in accordance with I.R.C. § 83, the Service could potentially argue for immediate recognition under the doctrine of constructive receipt. Under Treas. Reg. § 1.451-2(a), cash basis taxpayers must include amounts constructively received in gross income. Treas. Reg. § 1.451-2(a). If the Service prevailed in asserting this theory, you would be required to currently recognize the amounts due under the promissory obligation in gross income.

In Private Letter Ruling 9639016 the IRS stated that the courts have determined that the following conditions are necessary to tax an amount under the doctrine of constructive receipt: (1) the amount must be due; (2) the amount must be appropriated on the books of the obligor; (3) the obligor must be willing to pay; (4) the obligor must be solvent and able to pay; and (5) the obligee must have knowledge of the foregoing facts. In essence, the obligee's demand for payment must be the only thing that would be necessary for payment; the taxpayer *must* be entitled to present possession. See Robinson v. Comm'r., 44 T.C. 20 (1965); Basila v. Comm'r., 36 T.C. 111 (1961) acq., 1962-1 C.B. 3; Oates v. Comm'r., 18 T.C. 570 (1952), aff'd, 207 F.2d 711 (7th Cir. 1953); Veit v. Comm'r., 8 T.C. 809 (1947), acq., 1947-2 C.B. 4.

In your case, the Purchase Agreement clearly states that the amount due under the contract is not due until 2014, so the first criterion is not met. Also, the third criterion is missing since there is no evidence that Client P/S is willing to accelerate payment. Additionally, Treas. Reg. § 1.451-2(a) requires that, in order for there to be constructive receipt, income must be "otherwise available to the taxpayer so that he can draw upon it at any time..." In your case, you have no call on any assets owned by Client P/S. The contractual obligation for payment does not mature until year 2014. Until then, as the holder of the obligation, you have no ability to force or demand payment. Under the terms of the contract, Client P/S could decide to prepay the contract, but that is not your decision - it's the Partnership's. Additionally, you cannot assign your contract rights to a third party. As previously discussed in this opinion, amounts that are unfunded and unsecured are generally not treated as constructively received. See, e.g., PLR 954003, PLR 8728028, PLR 8642045. Client P/S's obligation to you is clearly unfunded and unsecured. Thus, under the above cited authorities, you do not appear to be in constructive receipt of the money due under the obligations.

In arguing the doctrine of constructive receipt, the Service could focus on your role as general partner. As general partners of Client P/S, you and your wife Client Wife control the management decisions of the partnership. The Service could potentially assert that in light of your control and ownership relating to Client P/S, you are in constructive receipt of "property." Treasury Regulation § 1.451-2(a) provides that income is not constructively received if the "taxpayer's *control* of its receipt is subject to substantial limitations or restrictions." (emphasis added). Analysis of the relevant authority in this area indicates that your ownership does not rise to a sufficient level to result in constructive receipt.

This general rule has been held to apply in deferred compensation cases between an employee and a controlled entity. In Basila v. Commissioner., 36 T.C. 111 (1961), petitioner was president, general manager and principal shareholder of a company. His employment contract with the company provided for a bonus to be determined at the end of each fiscal year, October 31, and to be paid to him on January 4 of the following year. The IRS argued that petitioner constructively received the bonus in October. Petitioner contended that the contract under which he was to receive the bonus provided that it was not due and payable until January; that the amount was not set aside for his unrestricted use; and that, albeit he had the power to write checks on company funds, he did not have the right to do so in October because of the contract. The court agreed, pointing out the fact that a company president, even if a majority shareholder, did not have the power to dispose of company assets inconsistent with company contracts. Id.

Basila is distinguishable from Haack v. Commissioner, 41 T.C.M. 708, TC Memo 1981-13, which also addressed the issue of constructive receipt and deferred payments of bonuses in a controlled entity setting. In Haack, the Tax Court held that no substantial restriction existed upon petitioner's right to receive bonuses on the dates of authorization. The only restriction identified by petitioner was a "long-standing custom" to pay the bonuses in the following year. This custom, however, was started only 3 years prior to the tax years in issue and the court did not think it could reasonably be characterized as a substantial restriction preventing petitioner from demanding his bonus in the earlier year. In fact, the taxpayer served as the corporation's majority shareholder, president, treasurer and director, and thus decided when and for how long to defer payment. Unlike the facts in Basila, where the contractual obligations were determined before the income was earned, in Haack, there was no contractual arrangement entered into before earning the bonus that required the company to defer payment until the subsequent year. As a result, the court held that the deferral was solely within the control of the employee/president and was therefore constructively received. Id.

In your case, you and your wife, Client Wife, as general partners control Client P/S. That was also the case on the transaction date. You and your wife negotiated a sales contract that does not require payment until the year 2014 and does not provide funding or security for that contract in the meantime. Under the terms of the Partnership Agreement, any act taken by a general partner requires action of general partners holding more than 50% of the aggregate capital account balances held by all general partners. Thus, you do not have the unilateral ability to control the business operations of Client P/S. Furthermore, the terms of the Stock Option Purchase Agreement do not authorize Client P/S to accelerate payment of the balloon obligation. Under the circumstances, you do not have unfettered discretion - even today - to take control of the assets of Client P/S or to accelerate the contract payments, nor is it in the best interests of the Partnership to do so. Thus, the Service would more likely than not fail in asserting that you have constructively received amounts under the promissory obligation.

7. It is more likely than not proper that the timing and amount of ABC's deduction for compensation paid correspond to the timing and amount of compensation included in your gross income.

I.R.C. § 83(h) governs an employer's deduction for the compensatory income generated by the application of I.R.C. § 83(a). The amount of deduction to which the employer is entitled is equal to the amount included as compensation in the gross income of the employee under I.R.C. §

83(a). Treasury Regulation § 1.83-6(a) limits this amount by incorporating the requirements of I.R.C. §§ 162 and 212. The regulation only allows a deduction in the employer's taxable year in which or with which ends the employee's taxable year in which the income was included. Thus, it would appear that this regulation overrides the general rules for both accrual and cash method taxpayers. Under former Treas. Reg. § 1.83-6, an employer was required to withhold upon the amount of compensation generated by I.R.C. § 83(a) in order to claim a deduction. This requirement was deleted from the regulation by a 1995 amendment. See T.D. 8599, 1995-2 CB 12. The amended regulation allows a deduction equal to the amount included in the employee's gross income. If the employer timely complies with the reporting requirements of I.R.C. §§ 6041 and 6041A, the regulations state that the compensation amounts will be deemed included in employee's gross income. Thus, the employer will be entitled to a deduction provided it complies with the applicable Form W-2 or Form 1099 reporting requirements under I.R.C. § 6041 or § 6041A.

Thus, the timing and amount of ABC's deduction for compensation paid is tied to the timing and amount of compensation included in your gross income. Because you more likely than not are not required to include the compensation in your gross income until principal payments are actually received under the promise to pay, the deduction by ABC more likely than not is delayed until that time.

RESTRICTIONS APPLICABLE TO THIS OPINION LETTER

We are rendering this Opinion Letter with respect to all issues solely for your benefit under I.R.C. § 7525. Accordingly: (i) we consider this Opinion Letter to be a confidential communication which may not be furnished, reproduced, distributed or disclosed to anyone other than, in the event of a penalty assertion, a taxing authority, without our prior written consent, (ii) this Opinion Letter is rendered solely for your information and for assistance to you in connection with the above described transaction, and may not be relied upon by any person other than you, or for any other purpose without our prior written consent, (iii) this Opinion Letter is rendered as of the date hereof, and we undertake no, and hereby disclaim any, obligation to advise you of any changes or any new developments which might affect any matters or opinions set forth herein, and (iv) this Opinion Letter is limited to the matters stated herein and no opinions may be inferred or implied beyond the matters expressly stated herein.

Very truly yours,

ARTHUR ANDERSEN LLP

By

Although the Code and the regulations are silent as to what constitutes an arm's length transaction, several Private Letter Rulings have held that a *gift* of a stock options to a related party is not an arm's length transaction. See PLR 10002702 , PLR 9713012.

1 Reg. §1.482-1(a)(3) specifically limits a taxpayer's ability to affirmatively apply §482. This restriction does not appear to limit the use of the §482 regulations as a guide in applying the concept of arm's length transaction under §83.

2 Rev. Rul. 60-31 was modified by Rev. Rul. 64-279, 1964-2 C.B. 100 and Rev. Rul. 70-435, 1970-2 C.B. 100. However, these modifications do not effect the above cited portion of Rev. Rul. 60-31.

X. MATERIALS RELATING TO EXECUTIVE LOANS

ENRON CORP - ACCOUNT RECONCILIATION
OFFICERS' LOANS
As of December, 1997

01/14/98

	Lay Personal	Kinder Common Stock	Kinder Personal	Gray Personal	Mark Personal	Skilling	Principal 1240-997-0100
Original Rate		9.50 %	8.04 %				
March 1, 1992 - December 31, 1992		7.50%	6.35%				
January 1, 1993 - Present	AFR Mid-Term Annual	AFR Mid-Term Annual	AFR Mid-Term Annual	AFR S-T Semi-Annual	AFR M-T Semi-Annual	AFR M-T Semi-Annual	
Balance Forward - 12/31/96	0.00	1,553,086.24	1,500,000.00	250,000.00	0.00	0.00	3,303,086.24
New Loan - 2/10/97	733,919.00	0.00	0.00	0.00	0.00	0.00	733,919.00
Loans forgiven - write off	0.00	(1,553,086.24)	(1,500,000.00)	0.00	0.00	0.00	(3,053,086.24)
New Loan - 3/5/97	800,000.00	0.00	0.00	0.00	0.00	0.00	800,000.00
New Loan - 4/23/97	1,009,197.00	0.00	0.00	0.00	0.00	0.00	1,009,197.00
New Loan - 4/29/98	360,000.00	0.00	0.00	0.00	0.00	0.00	360,000.00
New Loan - 5/6/97	0.00	0.00	0.00	0.00	900,000.00	0.00	900,000.00
Payment on principal - 6/11/97	(1,000,000.00)	0.00	0.00	0.00	0.00	0.00	(1,000,000.00)
Payment on principal - 7/11/97	(1,000,000.00)	0.00	0.00	0.00	0.00	0.00	(1,000,000.00)
Payment on principal - 8/01/97	(753,116.00)	0.00	0.00	0.00	0.00	0.00	(753,116.00)
New Loan - 9/9/97	1,200,000.00	0.00	0.00	0.00	0.00	0.00	1,200,000.00
New Loan - 10/23/97	0.00	0.00	0.00	0.00	0.00	4,000,000.00	4,000,000.00
New Loan - 12/31/97	140,000.00	0.00	0.00	0.00	0.00	0.00	140,000.00
Ending Balance	1,490,000.00	0.00	0.00	250,000.00	900,000.00	4,000,000.00	6,640,000.00

	Accr Interest	Accr Interest	Accr Interest	Accr Interest	Accr Interest	Accr Interest	Accr Interest 1710-999-0003
Balance Forward - 12/31/96	31,652.33	418,474.37	314,640.67	15,416.41	0.00	0.00	780,183.78
January Payment (1)	(31,652.33)	0.00	0.00	(14,150.36)	0.00	0.00	(45,802.69)
January Accrual	0.00	10,214.30	9,401.33	1,251.09	0.00	0.00	20,866.72
January adjustment	0.00	0.00	0.00	(34.42)	0.00	0.00	(34.42)
February Accrual	2,437.42	2,412.33	2,220.32	1,104.47	0.00	0.00	8,174.54
Write-off balance	0.00	(431,101.00)	(326,262.32)	0.00	0.00	0.00	(757,363.32)
March Accrual	7,801.00	0.00	0.00	1,227.07	0.00	0.00	9,028.07
April Accrual	9,745.87	0.00	0.00	1,204.01	0.00	0.00	10,949.88
May Accrual	16,889.77	0.00	0.00	1,310.30	0.00	0.00	18,200.07
June Accrual	12,499.60	0.00	0.00	1,268.03	0.00	0.00	13,767.63
July Accrual	6,922.67	0.00	0.00	1,276.16	0.00	0.00	8,198.83
August Accrual	814.07	0.00	0.00	1,235.61	19,076.80	0.00	21,126.48
September Accrual	5,274.16	0.00	0.00	1,183.36	4,541.92	0.00	10,999.44
October Accrual	7,269.29	0.00	0.00	1,229.21	4,769.75	6,154.52	19,422.77
November Accrual	6,768.49	0.00	0.00	1,158.58	4,445.76	19,758.90	32,131.72
December Accrual	6,925.48	0.00	0.00	1,195.06	4,532.79	20,145.75	32,799.08
Ending Balance	83,347.82	0.00	0.00	15,874.58	37,367.01	46,059.17	182,648.58

(1) Pd. 12/30, booked 01/97.

	Lay Personal Int Income	Kinder Common Stock Int Income	Kinder Personal Int Income	Gray Personal Int Income	Mark Personal Int Income		Interest Income 4190-950-99
January Income Accrual	0.00	(10,214.30)	(9,401.33)	(1,251.09)	0.00	0.00	(20,866.72)
January adjustment	0.00	0.00	0.00	34.42	0.00	0.00	34.42
February Income Accrual	(2,437.42)	(2,412.33)	(2,220.32)	(1,104.47)	0.00	0.00	(8,174.54)
March Income Accrual	(7,801.00)	0.00	0.00	(1,227.07)	0.00	0.00	(9,028.07)
April Income Accrual	(9,745.87)	0.00	0.00	(1,204.01)	0.00	0.00	(10,949.88)
May Income Accrual	(16,889.77)	0.00	0.00	(1,310.30)	0.00	0.00	(18,200.07)
June Income Accrual	(12,499.60)	0.00	0.00	(1,268.03)	0.00	0.00	(13,767.63)
July Income Accrual	(6,922.67)	0.00	0.00	(1,276.16)	0.00	0.00	(8,198.83)
August Income Accrual	(814.07)	0.00	0.00	(1,235.61)	(19,076.80)	0.00	(21,126.48)
September Income Accrual	(5,274.16)	0.00	0.00	(1,183.36)	(4,541.92)	0.00	(10,999.44)
October Income Accrual	(7,269.29)	0.00	0.00	(1,229.21)	(4,769.75)	(6,154.52)	(19,422.77)
November Income Accrual	(6,768.49)	0.00	0.00	(1,158.58)	(4,445.75)	(19,758.90)	(32,131.72)
December Income Accrual	(6,925.48)	0.00	0.00	(1,195.06)	(4,532.79)	(20,145.75)	(32,799.08)
Ending Balance	(83,347.82)	(12,626.63)	(11,621.65)	(14,608.53)	(37,367.01)	(46,059.17)	(205,630.81)

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ENRON CORP - ACCOUNT RECONCILIATION
OFFICERS' LOANS
As of December, 1998

01/26/99

Int. rate January 1, 1993 - Present	Lay Personal AFR Mid-Term Annual	Gray Personal AFR S-T Semi-Annual	Mark Personal (1) AFR M-T Semi-Annual	Mark Personal (2) (R/S Taxes) AFR S-T Semi-Annual	Skilling AFR M-T Semi-Annual	Principal 1240-997-0100
Balance Forward - 12/31/97	1,490,000.00	250,000.00	900,000.00	0.00	4,000,000.00	6,640,000.00
New Loan - 1/09/98	550,000.00	0.00	0.00	0.00	0.00	550,000.00
New Loan - 1/30/98	350,000.00	0.00	0.00	0.00	0.00	350,000.00
New Loan - 2/20/98	125,000.00	0.00	0.00	0.00	0.00	125,000.00
Payment on principal - 2/25/98	(2,515,000.00)	0.00	0.00	0.00	0.00	(2,515,000.00)
New Loan - 5/4/98	0.00	0.00	0.00	2,500,000.00	0.00	2,500,000.00
New Loan - 6/18/98	650,000.00	0.00	0.00	0.00	0.00	650,000.00
New Loan - 7/2/98	250,000.00	0.00	0.00	0.00	0.00	250,000.00
New Loan - 7/9/98	75,000.00	0.00	0.00	0.00	0.00	75,000.00
New Loan - 7/14/98	100,000.00	0.00	0.00	0.00	0.00	100,000.00
New Loan - 7/20/98	200,000.00	0.00	0.00	0.00	0.00	200,000.00
Payment on principal(Gray) - 8/24/98	0.00	(250,000.00)	0.00	0.00	0.00	(250,000.00)
New Loan - 9/4/98	500,000.00	0.00	0.00	0.00	0.00	500,000.00
Ending Balance	1,775,000.00	0.00	900,000.00	2,500,000.00	4,000,000.00	9,175,000.00

	Accr Interest	Accr Interest	Accr Interest	Accr Interest	Accr Interest	Accr Interest 1710-999-0003
Balance Forward - 12/31/97	83,347.82	15,874.58	37,367.01	0.00	46,059.17	182,648.58
January Payment (12/31/97) (1)	(83,324.72)	0.00	0.00	0.00	0.00	(83,324.72)
January Payment (1/9/98)	0.00	(15,874.58)	0.00	0.00	0.00	(15,874.58)
January Accrual	9,673.21	1,215.29	4,649.34	0.00	20,088.45	35,606.29
February Accrual	9,039.30	1,049.04	4,034.02	0.00	17,412.47	31,534.83
March Accrual	0.00	1,129.59	4,386.62	0.00	18,934.45	24,450.66
April Accrual	0.00	1,117.81	4,329.87	0.00	18,689.47	24,137.15
May Accrual	0.00	1,152.95	4,466.23	10,413.70	19,278.09	35,310.97
June Accrual	1,335.79	1,130.14	4,383.80	11,301.37	18,922.25	37,073.35
July Accrual	5,224.82	1,163.56	4,458.27	11,635.62	19,243.72	41,725.99
August Accrual	6,031.63	778.15	4,370.70	11,486.99	18,865.72	41,533.19
Payment on interest(Gray) - 8/24/98	0.00	(8,736.53)	0.00	0.00	0.00	(8,736.53)
September Accrual	8,082.33	0.00	4,214.30	10,993.15	18,190.64	41,480.42
October Accrual	7,718.58	0.00	4,028.37	10,616.44	17,388.08	39,751.47
November Accrual	6,579.64	0.00	3,443.86	9,082.19	14,865.11	33,970.80
December Accrual	6,814.06	0.00	3,447.20	9,087.67	14,879.52	34,228.45
Ending Balance	60,522.46	(0.00)	87,579.59	84,617.13	262,797.14	495,516.32

	Lay Personal Int Income	Gray Personal Int Income	Mark Personal Int Income	Mark Personal Int Income	Skilling Personal Int Income	Interest Income 4190-950-99
January Income Accrual	(9,873.21)	(1,215.29)	(4,649.34)	0.00	(20,088.45)	(35,606.29)
February Income Accrual	(9,039.30)	(1,049.04)	(4,034.02)	0.00	(17,412.47)	(31,534.83)
March Income Accrual	0.00	(1,129.59)	(4,386.62)	0.00	(18,934.45)	(24,450.88)
April Income Accrual	0.00	(1,117.81)	(4,329.87)	0.00	(18,689.47)	(24,137.15)
May Income Accrual	0.00	(1,152.95)	(4,466.23)	(10,413.70)	(19,278.09)	(35,310.97)
June Income Accrual	(1,335.78)	(1,130.14)	(4,383.80)	(11,301.37)	(18,922.25)	(37,073.35)
July Income Accrual	(5,224.82)	(1,183.56)	(4,458.27)	(11,835.82)	(19,243.72)	(41,725.99)
August Income Accrual	(6,031.63)	(778.15)	(4,370.70)	(11,486.99)	(18,865.72)	(41,533.19)
September Income Accrual	(8,082.33)	0.00	(4,214.30)	(10,993.15)	(18,190.64)	(41,480.42)
October Income Accrual	(7,718.58)	0.00	(4,028.37)	(10,616.44)	(17,388.08)	(39,751.47)
November Income Accrual	(6,579.64)	0.00	(3,443.86)	(9,082.19)	(14,865.11)	(33,970.80)
December Income Accrual	(6,814.06)	0.00	(3,447.20)	(9,087.67)	(14,879.52)	(34,228.45)
Ending Balance	(60,499.36)	(8,736.53)	(50,212.58)	(84,617.13)	(216,737.97)	(420,803.57)

(1) Paid 12/31/97, booked 01/99.

EC 002680499

ENRON CORP - ACCOUNT RECONCILIATION
OFFICERS' LOANS
As of December 31, 1999

01/02/00

* Note: Half of Rebecca Mark loan was to be paid back 1/31/99 - at the 2/7/99 comp committee meeting $700 K of that $1.25M was forgiven.
Interest related to the $700K forgiveness should be paid back along with all interest related to the $2.5 loan on 1/31/2000 according to contract and Pam Butler.
Interest should be accrued beginning 2/1/99 only on the $1,250,000 remaining principal.
Corp will probably bill EI for half of that $700K forgiveness - Mark checking.
** $900K plus interest was forgiven 5/98 - billing EI for half of that plus interest - Mark checking to see if Water Co. will take remaining
(leave balance here for now, may have to write off on corp's books before year-end if water co. will not take)
*** On May 12, 1999 Mr. Lay swapped in 54,000 shares @ 74.6875 (4,033,125.00 + 38.33 check = 4,033,163.33) for repayment on his loan.
**** On May 3, 1999 Mr. Skilling swapped in 26,425 shares @ 75.6875 (2,000,042.19) for partial payment on his loan.
***** On November 11,1999 Mr Lay swapped in 98,487 shares @ 40.8125 (4,019,500.69) plus a check for $ 20.41 - total 4,019,521.10

	Lay Personal	Mark Personal (1) **	Mark Personal (2) (R/S Taxes) *	Skilling	Principal 20019100	
Int. rate January 1, 1993 - Present	AFR Mid-Term Annual	AFR M-T Semi-Annual	AFR S-T Semi-Annual	AFR S-T Semi-Annual		5/31/99 G/L balance
Balance Forward - 12/31/98	1,775,000.00	900,000.00	2,500,000.00	4,000,000.00	9,175,000.00	9,175,000.00
1/99 Loan billed to EI -(forgiven 5/98)	0.00	(450,000.00)	0.00	0.00	(450,000.00)	(450,000.00)
2/99 pymt on loan($1.25mil. Due-$700K forgiven)	0.00	0.00	(550,000.00)	0.00	(550,000.00)	(550,000.00)
Advance - 5/7/99	2,225,000.00	0.00	0.00	0.00	2,225,000.00	2,225,000.00
Shares swapped in for repayment - 5/03/99 ****	0.00	0.00	0.00	(2,000,000.00)	(2,000,000.00)	(2,000,000.00)
Shares swapped in for repayment - 5/12/99 ***	(4,000,000.00)	0.00	0.00	0.00	(4,000,000.00)	(4,000,000.00)
Loan - 9/27/99	2,000,000.00	0.00	0.00	0.00	2,000,000.00	2,000,000.00
Loan - 10/26/99	2,000,000.00	0.00	0.00	0.00	2,000,000.00	2,000,000.00
Shares swapped in for repayment - 11/10/99 ***	(4,000,000.00)	0.00	0.00	0.00	(4,000,000.00)	(4,000,000.00)
Ending Balance	0.00	450,000.00	1,950,000.00	2,000,000.00	4,400,000.00	4,400,000.00

	Accr Interest	Accr Interest	Accr Interest	Accr Interest	Accr Interest 20026000-700000120	
Balance Forward - 12/31/98	60,522.46	87,579.59	84,617.13	262,797.14	495,516.32	495,516.32
Accr Interest billed to EI -forgiven 5/98	0.00	(29,616.55)	0.00	0.00	(29,616.55)	(29,616.55)
Reverse June-Dec interest	0.00	(28,346.50)	0.00	0.00	(28,346.50)	(28,346.50)
Interest Payment - 3/99	(60,522.46)	0.00	0.00	(215,664.43)	(276,186.89)	(276,186.89)
January Accrual	7,233.47	0.00	9,922.10	18,545.49	33,701.06	33,701.06
February Accrual	6,632.02	0.00	4,678.84	15,107.82	26,418.68	26,418.68
March Accrual	7,529.67	0.00	5,236.82	16,907.54	29,674.03	29,674.03
April Accrual	7,703.01	0.00	5,407.94	16,598.79	29,709.74	29,709.74
Shares swapped in for repayment - 5/03/99 ****	0.00	0.00	0.00	(42.19)	(42.19)	(42.19)
Shares swapped in for repayment - 5/12/99 ***	(33,163.33)	0.00	0.00	0.00	(33,163.33)	(33,163.33)
May Accrual	4,065.16	0.00	5,486.19	9,056.43	18,607.78	18,607.78
June Accrual	0.00	0.00	5,396.97	8,379.22	13,776.19	13,776.19
July Accrual	0.00	0.00	6,112.03	9,249.67	15,361.70	15,361.70
August Accrual	0.00	0.00	6,240.09	9,440.93	15,681.02	15,986.34
September Accrual	983.01	0.00	6,027.53	9,119.56	16,130.10	16,425.02
October Accrual	11,875.07	0.00	6,368.15	9,631.98	27,875.20	27,875.20
November Accrual	6,663.02	0.00	6,185.26	9,371.75	22,220.03	22,220.03
Shares swapped in for repayment - 11/10/99 *****	(19,521.10)	0.00	0.00	0.00	(19,521.10)	(19,521.10)
December Accrual	0.00	0.00	6,589.35	9,979.71	16,569.06	16,569.06
Ending Balance	(0.00)	29,616.54	158,268.40	186,479.41	374,364.35	374,964.59

	Lay Personal Int Income	Mark Personal Int Income	Mark Personal Int Income	Skilling Personal Int Income	Interest Income 82000000-500000342	
Reverse June-Dec interest	0.00	28,346.50	0.00	0.00	28,346.50	28,346.50
January Income Accrual	(7,233.47)	0.00	(9,922.10)	(16,545.49)	(33,701.06)	(33,701.06)
February Income Accrual	(6,632.02)	0.00	(4,678.84)	(15,107.82)	(26,418.68)	(26,418.68)
March Income Accrual	(7,529.67)	0.00	(5,236.82)	(16,907.54)	(29,674.03)	(29,674.03)
April Income Accrual	(7,703.01)	0.00	(5,407.94)	(16,598.79)	(29,709.74)	(29,709.74)
May Income Accrual	(4,065.16)	0.00	(5,486.19)	(9,056.43)	(18,607.78)	(18,607.78)
June Income Accrual	0.00	0.00	(5,396.97)	(8,379.22)	(13,776.19)	(13,776.19)
July Income Accrual	0.00	0.00	(6,112.03)	(9,249.67)	(15,361.70)	(15,361.70)
August Income Accrual	0.00	0.00	(6,240.09)	(9,440.93)	(15,681.02)	(15,681.02)
September Income Accrual	(983.01)	0.00	(6,027.53)	(9,119.56)	(16,130.10)	(16,130.10)
October Income Accrual	(11,875.07)	0.00	(6,368.15)	(9,631.98)	(27,875.20)	(27,875.20)
November Income Accrual	(6,663.02)	0.00	(6,185.26)	(9,371.75)	(22,220.03)	(22,220.03)
December Income Accrual	0.00	0.00	(6,589.35)	(9,979.71)	(16,569.06)	(16,569.06)
Ending Balance	(52,684.43)	28,346.50	(73,651.27)	(139,388.89)	(237,378.09)	(237,378.09)

D-349

EC 002680500

ENRON CORP - ACCOUNT RECONCILIATION
OFFICERS' LOANS
As of December 31, 2000

01/08/01

* Note: Half of Rebecca Mark loan was to be paid back 1/31/99 - at the 2/7/99 comp committee meeting $700 K of that $1.25M was forgiven.
Interest related to the $700K forgiveness should be paid back along with all interest related to the $2.5 loan on 1/31/2000 according to contract and Pam Butler.
Interest should be accrued beginning 2/1/99 only on the $1,250,000 remaining principal.
Corp will probably bill EI for half of that $700K forgiveness - Mark checking.
** $900K plus interest was forgiven 5/98 - billing EI for half of that plus interest - Mark checking to see if Water Co. will take remaining
(leave balance here for now, may have to write off on corp's books before year-end if water co. will not take)
*** On May 12, 1999 Mr. Lay swapped in 54,000 shares @ 74.6875 (4,033,125.00+ 38.33 check=4,033,163.33) for repayment on his loan.
**** On May 3, 1999 Mr. Skilling swapped in 26,425 shares @ 75.6875 (2,000,042.19) for partial payment on his loan. The remaining 2mm balance will be forgiven by the board when Mr. Skilling fulfills his contract requirements on 12/31/01. He is responsible for accrued interest.
***** On November 11,1999 Mr Lay swapped in 98,487 shares @ 40.8125 (4,019,500.68) plus a check for $ 20.41 - total 4,019,521.10
(1) On August 24th, 2000, Mr. Lay swapped in 47,815 shares @ $85.50 (4,088,182.50) plus a check for $16.92 - total $4,088,199.42

Int. rate January 1, 1993 - Present	Lay Personal AFR Mid-Term Annual	** Mark Personal (1) AFR M-T Semi-Annua	* Mark Personal (2) (R/S Taxes) AFR S-T Semi-Annual	Skilling AFR S-T Semi-Annual	Principal 7000000006
Balance Forward - 12/31/98	1,775,000.00	900,000.00	2,500,000.00	4,000,000.00	9,175,000.00
1/99 Loan billed to EI -(forgiven 5/98)	0.00	(450,000 00)	0.00	0.00	(450,000.00)
Amort of 2/7/99 700K forgiven		0.00	(210,000.00)		(210,000.00)
2/99 pymt on loan($1.25mil. Due-$700K forgiven)	0.00	0.00	(550,000.00)	0.00	(550,000.00)
Advance - 5/7/99	2,225,000.00	0.00	0.00	0.00	2,225,000.00
Shares swapped in for repayment - 5/03/99 ****	0.00	0.00	0.00	(2,000,000.00)	(2,000,000.00)
Shares swapped in for repayment - 5/12/99 ***	(4,000,000.00)	0.00	0.00	0.00	(4,000,000.00)
Loan - 9/27/99	2,000,000 00	0.00	0.00	0.00	2,000,000.00
Loan - 10/26/99	2,000,000.00	0.00	0.00	0.00	2,000,000.00
Shares swapped in for repayment - 11/10/99 ***	(4,000,000.00)	0.00	0.00	0.00	(4,000,000.00)
Advance - 1/27/2000	2,000,000.00	0.00	0.00	0.00	2,000,000.00
Advance 02/09/00	2,000,000.00	0.00	0.00	0.00	2,000,000.00
Shares swapped in for repayment - 02/15/00 ***	(4,000,000.00)	0.00	0.00	0.00	(4,000,000.00)
02/25 payment on loan	0 00	0.00	(1,250,000.00)	0.00	(1,250,000.00)
Amort of $450K loan forgiven	0 00	(135,000.00)	0.00	0.00	(135,000.00)
Advance - 4/21/2000	3,600,000.00	0.00	0.00	0.00	3,600,000.00
Advance - 5/16/00	400,000.00	0.00	0.00	0.00	400,000.00
Amort of $450K loan forgiven in July 2000	0 00	(180,000.00)	0.00	0.00	(180,000.00)
Amort of $700K loan forgiven in July 2000	0.00	0.00	(280,000.00)	0.00	(280,000.00)
Amort of $450K loan forgiven in August 2000	0 00	(45,000.00)	0.00	0.00	(45,000.00)
Amort of $700K loan forgiven in August 2000	0 00	0 00	(70,000.00)	0.00	(70,000.00)
Shares swapped in for repayment - 08/24/00 (1)	(4,000,000 00)	0.00	0.00	0.00	(4,000,000.00)
Amort of $450K loan forgiven in September 2000	0.00	(45,000 00)	0.00	0.00	(45,000.00)
Amort of $700K loan forgiven in September 2000	0 00	0 00	(70,000 00)	0.00	(70,000.00)
Amort of $450K loan forgiven in October 2000	0 00	(45,000 00)	0.00	0.00	(45,000.00)
Amort of $700K loan forgiven in October 2000	0.00	0.00	(70,000.00)	0.00	(70,000.00)
Advance - 11/700	4,000,000 00	0.00	0.00	0.00	4,000,000.00
Repay of 11/7/00 advance - 11/20/00	(4,000,000.00)	0.00	0.00	0.00	(4,000,000.00)
Advance - 12/21/00	4,000,000.00	0.00	0.00	0.00	4,000,000.00
Repay of 12/21/00 advance - 12/28/00	(4,000,000 00)				(4,000,000.00)
Ending Balance	0.00	0.00	0.00	2,000,000 00	2,000,000.00

	Accr Interest	Accr Interest	Accr Interest	Accr Interest	Accr Interest 20026000-700000120
Balance Forward - 12/31/99	0.00	29,616.54	158,268.40	186,479.41	374,364.35
January Accrual	1,361 10	0.00	6,937.17	10,919.22	19,217.49
February Accrual	7,548.49	0.00	5,893.51	10,614.31	24,056.31
Shares swapped in for repayment - 02/15/00 ***	(8,909.59)	0 00	0.00	0.00	(8,909.59)
02/25 payment on loan	0 00	0.00	(171,099.08)	0.00	(171,099.08)
Amort of interest on $450K Loan forgiven	0.00	(6,581.46)	0.00	0.00	(6,581.46)
March Accrual	0 00	0.00	0.00	11,792.01	11,792.01
April Accrual	6,618.08	0.00	0.00	11,609.31	18,227.39
May Accrual	19,568.22	0.00	0.00	11,922.00	31,490.22
June Accrual	19,587.95	0.00	0.00	11,735.10	31,323.05
July Accrual	25,776 40	0.00	0.00	12,256.27	38,032.67
Amort of Interest on $450K Loan forgiven	0.00	(13,162.92)	0.00	0.00	(13,162.92)
August Accrual	16,648.77	(3,290.73)	0.00	11,829.15	25,187.19
Shares swapped in for repayment - 08/24/00 (1)	(88,199.42)	0.00	0.00	0.00	(88,199.42)
September Accrual	0.00	(3,290.73)	0.00	11,375.68	8,084.95
October Accrual	0.00	(3,290.70)	0.00	11,699.16	8,408.46
November Accrual	8,562.19	0.00	0.00	11,327.76	19,889.95
December Accrual	4,503.01	0.00	0.00	11,327.76	15,830.77
Ending Balance	13,065.20	(0.00)	0.00	324,887.14	337,952.34

	Lay Personal Int Income	Mark Personal Int Income	Mark Personal Int Income	Skilling Personal Int Income	Interest Income 62000000-500000342
January Income Accrual	(1,361.10)	0.00	(6,937.17)	(10,919.22)	(19,217.49)
February Income Accrual	(7,548.49)	0.00	(5,893.51)	(10,614.31)	(24,056.31)
March Income Accrual	0.00	0.00	0.00	(11,792.01)	(11,792.01)
April Income Accrual	(6,618.08)	0.00	0.00	(11,609.31)	(18,227.39)
May Income Accrual	(19,568.22)	0.00	0.00	(11,922.00)	(31,490.22)
June Income Accrual	(19,587.95)	0.00	0.00	(11,735.10)	(31,323.05)
July Income Accrual	(25,776.40)	0.00	0.00	(12,256.27)	(38,032.67)
August Income Accrual	(16,648.77)	3,290.73	0.00	(11,829.15)	(25,187.19)
September Income Accrual	0.00	3,290.73	0.00	(11,375.68)	(8,084.95)
October Income Accrual	0.00	3,290.70	0.00	(11,699.16)	(8,408.46)
November Income Accrual	(8,562.19)	0.00	0.00	(11,327.76)	(19,889.95)
December Income Accrual	(4,503.01)	0.00	0.00	(11,327.76)	(15,830.77)
Ending Balance	(110,174.21)	9,872.16	(12,830.68)	(138,407.73)	(251,540.46)

Mr. Lay Line of Credit
Recent Transactions

Date	Transaction	Daily Activity: Advances	Daily Activity: Paybacks	Line of Credit Balance (*)
01/25/01	Advance	4,000,000.00		4,000,000.00
02/01/01	Payback (with shares)		(4,000,000.00)	-
03/23/01	Advance	1,100,000.00		1,100,000.00
04/01/01	Roll prior month LOC			1,100,000.00
04/05/01	Advance	950,000.00		2,050,000.00
04/19/01	Advance	1,950,000.00		4,000,000.00
04/27/01	Payback (with shares)		(4,000,000.00)	-
05/03/01	Advance	4,000,000.00		4,000,000.00
05/14/01	Payback (with shares)		(4,000,000.00)	-
05/23/01	Advance	4,000,000.00		4,000,000.00
05/25/01	Payback (with shares)		(4,000,000.00)	-
06/11/01	Advance	4,000,000.00		4,000,000.00
06/12/01	Payback (with shares)		(4,000,000.00)	-
06/15/01	Advance	4,000,000.00		4,000,000.00
06/19/01	Payback (with shares)		(4,000,000.00)	-
06/22/01	Advance	4,000,000.00		4,000,000.00
06/22/01	Payback (with shares)		(4,000,000.00)	-
06/26/01	Advance	4,000,000.00		4,000,000.00
06/26/01	Payback (with shares)		(4,000,000.00)	-
06/27/01	Advance	4,000,000.00		4,000,000.00
06/27/01	Payback (with shares)		(4,000,000.00)	-
06/28/01	Advance	4,000,000.00		4,000,000.00
06/28/01	Payback (with shares)		(4,000,000.00)	-
06/29/01	Advance	4,000,000.00		4,000,000.00
07/01/01	Roll prior month LOC			-
07/26/01	Payback (with shares)		(4,000,000.00)	-
07/27/01	Advance	4,000,000.00		4,000,000.00
08/01/01	Roll prior month LOC			
08/20/01	Payback (with shares)		(4,000,000.00)	-
08/21/01	Advance	4,000,000.00		4,000,000.00
08/23/01	Payback (with shares)		(4,000,000.00)	-
08/24/01	Advance	4,000,000.00		4,000,000.00
08/24/01	Payback (with shares)		(4,000,000.00)	-
08/28/01	Advance	4,000,000.00		4,000,000.00
08/30/01	Payback (with shares)		(4,000,000.00)	-
08/31/01	Advance	4,000,000.00		4,000,000.00
09/01/01	Roll prior month LOC			
09/04/01	Payback (with shares)		(4,000,000.00)	-
09/06/01	Advance	4,000,000.00		4,000,000.00
10/01/01	Roll prior month LOC			-
10/23/01	Payback (with shares)		(1,500,000.00)	2,500,000.00
10/24/01	Advance	3,500,000.00		6,000,000.00
10/24/01	Payback (with shares)		(1,700,000.00)	4,300,000.00
10/25/01	Advance	1,500,000.00		5,800,000.00
10/25/01	Payback (with shares)		(550,000.00)	5,250,000.00
10/26/01	Advance	2,000,000.00		7,250,000.00
10/26/01	Payback (with shares)		(2,275,000.00)	4,975,000.00
11/01/01	Roll prior month LOC			4,975,000.00
11/01/01	Advance	1,000,000.00		5,975,000.00
11/09/01	Advance	525,000.00		6,500,000.00
11/27/01	Advance	1,000,000.00		7,500,000.00
		77,525,000.00	(70,025,000.00)	

* Line of credit maximum of $7,500,000

Note: In the event of more than one transaction occurring on the same day, the events are presented in the order in which the actual transactions occurred.

Total LOC in 2001	77,525,000.00
Total Payback in 2001	(70,025,000.00)

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EC 002680502

ENRON LINE OF CREDIT
Frevert 2001
INTEREST CALCULATION SCHEDULE
LOC Limit = $2,000,000.00
INTEREST RATE = MID TERM AFR COMPOUNDED ANNUALLY
INTEREST CALCULATION = COMPUTED BASED ON A 365 DAYS A YEAR & THE ACTUAL DAYS ELAPSED OCCURRING IN THE PERIOD FOR WHICH PAYABLE; SHALL ACCRUE BASED ON THE UNPAID LINE OF CREDIT BALANCE @ THE INT RATE DEFINED ABOVE
INTEREST PAYMENT = TOTAL ACCRUED INTEREST DUE UPON MATURITY.

Date To	Date From	Description	Amount of LOC	Amount of LOC Paid	TOTAL Outstanding LOC	days	Interest Rate	Mid-term Interest Incurred	Amount of Interest Paid*	Accrued Interest Rollforward
			0		0			0.00		
10/25/2001	10/31/2001	interest	2,000,000		2,000,000	6	4.59000%	1,509.04		1,509.04
11/1/2001	11/30/2001	interest			2,000,000	30	4.13000%	6,789.04		8,298.08
12/1/2001	12/31/2001	interest			2,000,000	31	3.97000%	6,743.56		15,041.64
Grand Total					2,000,000			15,041.64	0.00	

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XI. MATERIALS RELATING TO PURCHASE AND RECONVEYANCE OF MR. LAY'S ANNUITY CONTRACTS

Ken Lay Insurance Swap Analysis

Scenario 1

Enron Purchases Policies and Awards back to Ken with Vesting vs Enron Stock Award

	Ken's Policy	Linda's Policy	Policy Total	Enron Stock
CURRENT SITUATION				
- Tax Basis	5,000,000	5,000,000	10,000,000	
- Current Market Value	2,459,475	2,232,092	4,691,567	
- Current Floor Value	5,819,795	5,420,890	11,240,685	
EXCHANGE POLICY FOR CASH				
- Purchase Price / Current Fair Market Value	**5,000,000**	**5,000,000**	**10,000,000**	
************************				
AWARD BY ENRON				
- Value of Award	5,000,000	5,000,000	10,000,000	10,000,000
VESTING				
- Assumed Value in 4.25 years (12/31/05)	7,455,171	6,944,173	14,399,344	14,399,344

Enron Issues	Policy Total	Enron Stock
Enron Tax Deduction on Benefit Payments (162m)	No	No
Dilution to Common Shares Outstanding	No	Yes
ENE Taxes on Build-up while ENE owns policy (like any other investment)	Yes	No

Ken Lay Issues	Policy Total	Enron Stock
Initial Liquidity for Insurance	Yes	No
Cash Flow at Vesting for Tax Liability	No	Yes
Cash Flow begins appr. 2007 or when annuity starts	Yes	No
Full Vesting at Earliest of 12/31/2005, Death, Retirement, Disability	Yes	Yes

Ken Lay Insurance Swap Analysis

Scenario 2

Enron Purchases Policies and Awards back to Ken with Vesting vs Enron Stock Award

	Ken's Policy	Linda's Policy	Policy Total	Enron Stock
CURRENT SITUATION				
- Tax Basis	5,000,000	5,000,000	10,000,000	
- Current Market Value	2,459,475	2,232,092	4,691,567	
- Current Floor Value	5,819,795	5,420,890	11,240,685	
EXCHANGE POLICY FOR CASH				
- Purchase Price / Current Fair Market Value	**2,459,475**	**2,232,092**	**4,691,567**	
************************				
AWARD BY ENRON				
- Value of Award	2,459,475	2,232,092	4,691,567	4,691,567
VESTING				
- Assumed Value in 4.25 years (12/31/05)	7,455,171	6,944,173	14,399,344	14,399,344

Enron Issues	Policy Total	Enron Stock
Enron Tax Deduction on Benefit Payments (162m)	No	No
Dilution to Common Shares Outstanding	No	Yes
ENE Taxes on Build-up while ENE owns policy (like any other investment)	Yes	No

Ken Lay Issues	Policy Total	Enron Stock
Initial Liquidity for Insurance	Yes	No
Cash Flow at Vesting for Tax Liability	No	Yes
Cash Flow begins appr. 2007 or when annuity starts	Yes	No
Full Vesting at Earliest of 12/31/2005, Death, Retirement, Disability	Yes	Yes

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Charles E. Essick
Principal

1 Houston Center
1221 McKinney, Suite 2600
Houston, TX 77010-1006
713 754-5416
Fax: 713 754-5462

Towers Perrin

PRIVATE & CONFIDENTIAL

November 2, 2001

Dr. Charles A. LeMaistre
Chairman, Enron Compensation Committee
Enron Corp.
7 Bristol Green
San Antonio, TX 78209

Dear Dr. LeMaistre:

As you requested, Towers Perrin has prepared this letter based on our previous discussions with Mary Joyce prior to September 14, 2001, providing our observations regarding the Ken Lay insurance swap approved by Enron's Compensation Committee earlier this year.

Background

Towers Perrin understands that Ken Lay purchased annuities with a tax basis of $5 million for his wife Linda and himself (for a total tax basis value of $10 million). At the time when Enron's Board asked Ken to resume his duties as CEO following Jeff Skilling's departure, the Company began exploring ways to provide a reasonable retention incentive for Mr. Lay to encourage him to continue serving as CEO for the next 4.25 years.

Traditionally in the market, this type of retention handcuff is handled by issuing restricted stock to the executive. However, we understand that Mr. Lay has a very large current position in Enron stock and that he expressed an interest in having more liquidity in his personal portfolio. Consequently, as part of an attempt to give Mr. Lay the liquidity he desired and a simultaneous retention incentive, Enron's Compensation Committee agreed to the following:

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- Enron purchased the two annuities from Mr. Lay for $10 million in cash.
- The Board agreed to allow Mr. Lay to earn the annuities back over 4 years for continued service.
- The $10 million present value of the annuities is to be netted out against Mr. Lay's long-term incentive awards over the next 4 years ($2.5 million per year).

Towers Perrin

As we understand this transaction, the initial $10 million cash payout to Mr. Lay for the annuities is equal in value (on net present value basis) to his cost for the annuities and is less than the current NPV floor value of the annuities ($11.2 million). Therefore, while there are cash flow consequences to the transaction (since Mr. Lay receives the cash now), the Company will receive greater value for this swap in the future than the $10 million payout made to Mr. Lay.

The feature of the swap which allows Mr. Lay to earn back the annuities over 4 years is similar to the way a restricted stock award would be structured. Thus, it should serve as an effective retention device, similar to restricted stock. However, since this portion of the insurance swap was done in lieu of restricted stock (which would be the more common vehicle used in the market), Towers Perrin recommends that this value be subtracted from future restricted stock/option awards that would otherwise be granted to Mr. Lay over then next 4 years (at a rate of $2.5 million per year).

Finally, Towers Perrin understands that one alternative to the structure described above was to simply provide a $5 million signing bonus to Mr. Lay and to allow him to also sell his annuity, but not his wife's annuity to the Company. Towers Perrin believes the structure of the original agreement is preferable to this alternative, since it provides a meaningful retention incentive.

★ ★ ★ ★ ★

I hope this letter meets Enron's needs. Please call me with any questions.

Sincerely,

Chuck Ensinko

CEE:mhm

cc: Ms. Mary Joyce
Mr. John Duncan

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XII. SPLIT DOLLAR LIFE INSURANCE ARRANGEMENTS

SPLIT DOLLAR LIFE INSURANCE AGREEMENT

THIS AGREEMENT is made as of the 22 day of April, 1994, between Enron Corp. ("Enron"), a Delaware corporation having its headquarters at 1400 Smith Street, Houston, Texas 77002, and the KLL & LPL Family Partnership, Ltd., a Texas limited partnership.

WHEREAS, Kenneth L. Lay (the "Participant"), Chairman and Chief Executive Officer of Enron, has contributed substantially to the success of Enron, and is employed by Enron pursuant to an employment agreement first entered into between Enron and the Participant as of September 1, 1989 (the "Employment Agreement").

WHEREAS, contemporaneously with the execution of this Agreement, the Participant and Enron entered into and executed the Sixth Amendment To Employment Agreement pursuant which (as amended, the "Employment Agreement") the Participant and Enron agreed to enter into this Agreement to establish a program for split dollar life insurance.

WHEREAS, the owner of life insurance policy number 92474662 (the "Insurance Contract") issued by TransAmerica Occidental (the "Insurance Company") on the joint lives of the Participant and his wife, Linda Phillips Lay (the "Participant's Spouse") shall be the KLL & LPL Family Partnership, Ltd., a Texas limited partnership (the "Owner"); and

WHEREAS, Enron is willing to assist in the payment of premiums under the Insurance Contract as provided in this Agreement; and

WHEREAS, the Owner contemporaneous herewith is assigning an interest in the Insurance Contract to Enron as collateral security for such premium payments (the "Collateral Agreement");

NOW, THEREFORE, in consideration of the mutual covenants and agreements described herein, Enron and the Owner hereby agree as follows:

1. <u>Payment of Premiums</u>.

(a) <u>By Enron</u>: Enron shall pay to the Insurance Company an amount equal to Two Hundred Eighty Thousand Two Hundred Sixty-Five Dollars ($280,265), which shall hereinafter sometimes be referred to as the "Agreed Premium Amount," as its share of the initial premium for the Insurance Contract and shall continue to pay to the Insurance Company the same Agreed Premium Amount as its share of the annual premium for the Insurance Contract during the eight (8) successive years following the initial premium payment (meaning a total of nine (9) payments of the Agreed Premium Amount shall be paid by Enron to the Insurance Company), unless this Agreement terminates earlier as provided below, in which event Enron shall only be obligated to continue to pay to the Insurance Company the Agreed Premium Amount on an annual basis until the date on which this Agreement terminates. Provided that this Agreement shall not have terminated earlier, Enron shall have no further

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obligation to pay any amounts to the Insurance Company after Enron has made the nine (9) payments to the Insurance Company of the Agreed Premium Amount in the manner described herein. A portion of each such payment of the Agreed Premium Amount by Enron to the Insurance Company may be reported as imputed income includable as compensation in the Participant's gross income in accordance with federal, state, or local income tax laws.

(b) By the Owner. The Owner may, but shall not be required, to pay the portion of the annual premium (if any) on the Insurance Contract that is in excess of the Agreed Premium Amount to be paid by Enron.

2. Insurance Contract Beneficiary Designation. The right to designate and change the beneficiary of the Insurance Contract and to elect an optional mode of settlement is reserved to the Owner. Such Owner shall have the right to designate and change the beneficiaries and contingent beneficiaries and to elect an optional mode of settlement subject to the interest of Enron as Assignee under the Collateral Agreement, and Enron will make the Insurance Contract available to the Owner, if required for endorsement or a change of beneficiary.

3. Payment of Insurance Contract Proceeds in Event of Death Prior to Termination of this Agreement by Any Other Event. If the Participant and the Participant's Spouse die while the Insurance Contract and this Agreement are in force, then the proceeds of the Insurance Contract will be payable as follows:

(a) Enron shall be entitled to the amount of the death benefit proceeds equal to the sum of the Agreed Premium Amounts paid by Enron pursuant to this Agreement.

(b) The beneficiary designated by the Owner shall be entitled to the amount of the death benefit proceeds, if any, in excess of the amount payable to Enron.

Enron shall not be responsible for payments by the Insurance Company to the Owner of the Insurance Contract or for the benefits payable under the Insurance Contract to the beneficiaries thereof. Neither Participant nor the Owner (including any person or entity claiming through the Participant or the Owner) shall have any claim against Enron for any benefits to be provided under the Insurance Contract.

4. Payment of Insurance Contract Proceeds In Event of Death After Termination of this Agreement. If the Participant and the Participant's Spouse die while the Insurance Contract is in force and after this Agreement has previously terminated (other than due to deaths of the Participant and the Participant's Spouse), then the proceeds of the Insurance Contract will be payable as follows:

(a) Enron shall not be entitled to receive any amount of the death benefit proceeds of the Insurance Contract.

(b) The beneficiary designated by the Owner shall be entitled to all of the death benefit proceeds of the Insurance Contract.

Enron shall not be responsible for payments by the Insurance Company to the Owner of the Insurance Contract or for benefits payable under the Insurance Contract to the beneficiaries thereof. Neither the Participant nor the Owner (including any person or entity claiming through the Participant or the Owner) shall have any claim against Enron for any benefits to be provided under the Insurance Contract.

5. <u>Company's Exercise of Rights as Assignee</u>. While this Agreement is in force, Enron shall have no incidents of ownership with regard to the Insurance Contract. The power to surrender, terminate or cancel the Insurance Contract and the right to borrow or withdraw against the Insurance Contract, subject to the provisions of Paragraph 6 below, shall remain in Owner. The Insurance Contract shall be held by Enron until the termination of this Agreement.

KLL

6. <u>Limitation on Rights of Owner</u>. The Owner agrees not to withdraw, surrender, borrow against, or pledge as security for a loan any portion of the Insurance Contract cash value while this Agreement is in effect. Should this Agreement be terminated for any reason, prior to the expiration of nine (9) years and thirty (30) days following the issue date of the Insurance Contract, or should the Owner surrender the Insurance Contract to the Insurance Company, prior to the expiration of nine (9) years and thirty (30) days following the issue date of the Insurance Contract, the Owner agrees that the Insurance Company shall reimburse Enron for all Agreed Premium Amounts paid to Enron prior to any portion of the cash surrender value being paid to the Owner. The Owner agrees that, in the situation described in the preceding sentence, should the Owner receive from the Insurance Company any portion of the cash surrender value representing the Agreed Premium Amounts paid by Enron, then the Owner shall be constructive trustee for Enron and shall pay such sums to Enron upon receipt.

7. <u>Termination of Agreement</u>. This Agreement shall terminate upon the occurrence of one of the following:

$2,247

(a) the date of payment to Enron by the Owner (or some other source) of the aggregate of the Agreed Premium Amounts paid by Enron to the Insurance Company pursuant to this Agreement;

(b) the date of surrender of the Insurance Contract;

(c) the date of death of the second to die of the Participant and the Participant's Spouse;

(d) thirty (30) days following the ninth (9th) anniversary of the issue date of the Insurance Contract (meaning the month and day in the year 2003 on which the Insurance Contract was issued) or in January after Participant retires from Enron, whichever is later.

In the event of termination of this Agreement pursuant to (a), (b) or (c) above, the aggregate of the Agreed Premium Amounts paid by Enron pursuant to this Agreement shall become due and payable to Enron. Upon payment of such amount to Enron from the Insurance Contract, the Owner, or whatever other source, Enron shall execute a release of the Collateral Agreement and deliver such release and the Insurance Contract to the Owner. In the event of termination of this Agreement pursuant to (d) above, Enron shall no longer be entitled to receive from the Insurance Contract, the Owner, or any other source any of the Agreed Premium Amounts paid by Enron pursuant to this Agreement, and Enron shall execute a release of the Collateral Agreement and shall deliver such release and the Insurance Contract to the Owner.

8. <u>Amendment and Assignment of Agreement</u>.

(a) This Agreement shall not be modified or amended except in writing signed by Enron and the Owner.

(b) This Agreement is binding upon Enron, the Participant (and the Participant's successors, executors, administrators, and transferees), the Owner (and the Owner's successors and transferees) and any Insurance Contract beneficiary.

9. <u>Taxes</u>. Enron makes no guarantees and assumes no obligation or responsibility with respect to the Participant's or the Owner's federal, state, or local income, estate, inheritance and gift tax obligations, if any, under this Agreement, or the Collateral Agreement, or the Insurance Contract.

10. <u>State Law</u>. This Agreement shall be subject to and construed in accordance with the laws of the State of Texas.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the day and year first above written.

ENRON CORP.

By: John H. Duncan

Name: John H. Duncan

Title: Chairman, Executive Committee of Board of Directors

By: Charles A. LeMaistre MD

Name: Charles A. LeMaistre

Title: Chairman, Compensation Committee of Board of Directors

KLL & LPL Family Partnership, Ltd.

By: Kenneth L. Lay

Name: Kenneth L. Lay, General Partner

4/22/94

JDS 4-22-94

Agreed to and ratified by:

Kenneth L. Lay

Kenneth L. Lay

4/22/94

JDS 4-22-94

EC 000752807

COLLATERAL AGREEMENT

THIS AGREEMENT is made and entered into by the undersigned as owner (the "Owner") of Insurance Contract Number 92474662 ("Insurance Contract") issued by TransAmerica Occidental (the "Insurance Company") on the joint lives of Kenneth L. Lay (the "Participant") and his wife Linda Phillips Lay (the "Participant's Spouse"), which Insurance Contract shall herein be assigned to Enron Corp. ("Enron"), as collateral security for those liabilities which may arise under the terms of the Split Dollar Agreement between the Owner and Enron dated as of 22nd April, 1994 (the "Split Dollar Agreement"), subject to the terms and conditions in the Insurance Contract.

WHEREAS, in consideration of Enron's agreement to make certain premium payments (the "Agreed Premium Amounts") under the Insurance Contract, the Owner agrees to grant Enron a security interest in the Insurance Contract as collateral security for the repayment of the aggregate Agreed Premium Amounts paid under the Split Dollar Agreement by Enron for the Insurance Contract, until the Split Dollar Agreement terminates in accordance with its provisions.

NOW, THEREFORE, the undersigned Owner hereby assigns, transfers and sets over to Enron the following specific rights in the Insurance Contract subject to the following terms and conditions:

1. This Agreement is made, and the Insurance Contract is to be held as collateral security, for all liabilities of the Owner to Enron, either now existing or that may hereafter arise, pursuant to the terms of the Split Dollar Agreement.

2. Enron's interest in the Insurance Contract, while the Split Dollar Agreement is in force, shall be strictly limited to the right to collect from the Insurance Company when the Insurance Contract becomes a claim by death or surrender an amount equal to the aggregate of the Agreed Premium Amounts paid by Enron pursuant to the Split Dollar Agreement.

3. Subject to the terms and conditions of the Split Dollar Agreement, the Owner shall retain all incidents of ownership in the Insurance Contract, including, but not limited to, the sole and exclusive right to:

(a) designate and change the beneficiary of the Insurance Contract; and

(b) exercise settlement options.

4. If, at any time, Enron has possession of the original of the Insurance Contract, Enron shall make the Insurance Contract available to the Owner, at any time and from time to time, to enable the Owner to exercise any right reserved by the Owner.

5. Enron covenants and agrees with the Owner that any amounts, which may be paid to Enron by the Insurance Company pursuant to the terms of the Insurance Contract and this Agreement and which are in excess of the then existing liabilities of the Owner under the Split Dollar

Agreement, shall be paid by Enron to the persons who would have been entitled thereto under the Insurance Contract had this Agreement not been executed.

6. Upon the full payment of all liabilities, which are then due and owing to Enron under the Split Dollar Agreement, Enron shall execute an appropriate instrument of release of this Agreement. However, notwithstanding anything to the contrary contained above, if the Split Dollar Agreement shall terminate in accordance with its provisions on the 30 days following the ninth (9th) anniversary of the issue date of the Insurance Contract, or the January following the retirement of Owner from Enron, whichever is later, then in such situation, Enron shall have no further right to receive any payment under the Split Dollar Agreement, and Enron shall execute an appropriate instrument of release of this Agreement.

7. The Insurance Company shall be fully protected and discharged from further obligation by paying in reliance upon the terms of the Insurance Contract and/or the terms of this Agreement.

IN WITNESS WHEREOF, the Owner and Enron have executed this Agreement effective this 22 day of April, 1994.

KLL & LPL Family Partnership, Ltd.

By: [signature]
Kenneth L. Lay, General Partner
4/22/94

ENRON CORP. JES 4-22-94

By: [signature]
Name: John H. Duncan
Title: Chairman, Executive Committee of Board of Directors

By: [signature]
Name: Charles A. LeMaistre
Title: Chairman, Compensation Committee of Board of Directors

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Exhibit

SPLIT DOLLAR AGREEMENT

THIS SPLIT DOLLAR AGREEMENT (this "Agreement") is made and entered into effective as of December 13, 1996, by and among **ENRON CORP.**, a Delaware corporation, with principal offices and place of business in Houston, Texas (hereinafter referred to as the "Company"), **KENNETH L. LAY**, an individual residing in Houston, Texas (hereinafter referred to as the "Employee"), and **KLL & LPL FAMILY PARTNERSHIP, LTD.**, a Texas limited partnership with principal offices and place of business in Houston, Texas (hereinafter referred to as the "Partnership"),

WITNESSETH THAT:

WHEREAS, the Employee is currently employed by the Company; and

WHEREAS, the Partnership is the owner of a policy of life insurance insuring the life of the Employee in the event of the Employee's death (hereinafter referred to as the "Policy"), which is described in Exhibit A attached hereto and by this reference made a part hereof, and which was issued by Transamerica Occidental Life Insurance Company (hereinafter referred to as the "Insurer"); and

WHEREAS, the Policy was obtained on October 14, 1996, by the Partnership upon conversion of another life insurance policy on the life of the Employee that was owned by the Partnership and in which the Partnership had an economic interest valued at $200,112;

WHEREAS, the Company is willing to pay a portion of the premiums due on the Policy as an additional employment benefit for the Employee, on the terms and conditions hereinafter set forth; and

WHEREAS, the Partnership is the owner of the Policy and, as such, possesses all incidents of ownership in and to the Policy; and

WHEREAS, the Company wishes to have the Policy collaterally assigned to it by the Partnership, in order to secure the repayment of the amounts which it will pay toward the premiums on the Policy and certain other amounts;

NOW, THEREFORE, in consideration of the premises and of the mutual promises contained herein, the parties hereto agree as follows:

1. <u>Acquisition of Policy</u>. The Partnership has acquired the Policy from the Insurer in the total face amount of $11,887,900. The parties hereto have taken all necessary action to cause the Insurer to issue the Policy, and shall take any further action which may be necessary to cause the Policy to conform to the provisions of this Agreement. The parties hereto agree that the Policy shall be subject to the terms and conditions of this Agreement and of the collateral assignment filed with the Insurer relating to the Policy.

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2. <u>Ownership of Policy</u>. The Partnership shall be the sole and absolute owner of the Policy, and may exercise all ownership rights granted to the owner thereof by the terms of the Policy, except as may otherwise be provided herein.

3. <u>Payment of Premiums; Provision of Information</u>.

a. Except to the extent required for the Partnership to satisfy its obligations pursuant to section 5 below, the Partnership shall not be required to make any premium payments with respect to the Policy.

b. On or before the due date of each annual Policy premium, or within the grace period provided therein, the Company shall pay $250,000 to the Insurer, and shall, upon request, promptly furnish the Partnership evidence of timely payment of such premium. Except with the consent of the Partnership, the Company shall not pay less than the amount provided in the preceding sentence, but it may, in its discretion, at any time and from time to time, subject to acceptance of such amount by the Insurer, pay more than such amount or make other premium payments on the Policy. Notwithstanding any provision herein to the contrary, the Company shall have no obligation (1) to make more than five annual premium payments in the amount specified in the preceding provisions of this paragraph or (2) to make any premium payments on or after the date the Employee's employment with the Company terminates for any reason whatsoever.

c. The Company shall annually furnish to the Employee a statement of the amount of income reportable by the Employee for federal and state income tax purposes as a result of the insurance protection provided the Partnership's Policy beneficiary. The Partnership and the Employee shall promptly furnish the Company with (1) copies of any information or notices provided by the Insurer from time to time with respect to the Policy and (2) any other material or information relating to the Policy and reasonably requested by the Company from time to time.

4. <u>Collateral Assignment</u>. To secure the repayment to the Company of the amount of the premiums on the Policy paid by it hereunder and the other amounts due to the Company hereunder, the Partnership has, contemporaneously herewith, assigned the Policy to the Company as collateral under a separate assignment instrument. The collateral assignment of the Policy to the Company shall not be terminated, altered or amended by the Partnership, without the express written consent of the Company. The parties hereto agree to take all action necessary to cause such collateral assignment to conform to the provisions of this Agreement and to be accepted by the Insurer. Without limiting the scope of the preceding provisions of this section, the parties hereto agree that the Company shall have an interest in the cash surrender value of the Policy to secure the amounts due to the Company hereunder, which interest shall in no event be less than the aggregate premium payments made with respect to the Policy by the Company pursuant to section 3(b) above.

5. <u>Limitations on Partnership's Rights in Policy</u>. The Partnership shall not sell, assign, transfer, borrow against or withdraw from the cash surrender value of the Policy, surrender, or cancel the Policy without, in any such case, the express written consent of the Company. Further, the Partnership shall not change the beneficiary designation provision of the Policy, change the elected death benefit option provisions thereof, decrease or increase the face amount of insurance, fail to make premium payments, take any other action, or fail to take any action if, as a result of any such action or inaction, (a) the aggregate death benefits payable under the Policy at any given time

would be less than the portion of the death benefits payable to the Company pursuant to the first sentence of section 6(b) below if the Employee's death was to occur at such time or (b) the projected cash surrender value of the Policy upon Employee's attainment of 100 years of age (determined based upon the Insurer's assumptions prevailing at the time of any such action or inaction) would be less than $250,000.

6. <u>Collection of Death Proceeds</u>.

a. Upon the death of the Employee prior to the termination of this Agreement during the Employee's lifetime, the Company and the Partnership shall cooperate with the beneficiary or beneficiaries designated by the Partnership to take whatever action is necessary to collect the death benefit provided under the Policy. When such benefit has been collected and paid as provided herein, this Agreement shall thereupon terminate.

b. Upon the death of the Employee prior to the termination of this Agreement during the Employee's lifetime, the Company shall have the unqualified right to receive $1,250,000 of such death benefit in a single lump sum cash payment; provided, however, that if the Employee's employment with the Company has terminated for any reason whatsoever (other than death) prior to the date upon which the Company has paid all five of the annual premium payments provided for in section 3(b) above, then the amount of the death benefit payable to the Company shall be reduced to an amount equal to the aggregate premium payments made by the Company pursuant to section 3(b) above on or before the date of such termination. The balance of the death benefit provided under the Policy, if any, shall be paid directly to the beneficiary or beneficiaries designated by the Partnership, in the manner and in the amount or amounts provided in the beneficiary designation provision of the Policy. In no event shall the amount payable to the Company hereunder exceed the insurance benefits payable at the death of the Employee. No amount shall be paid from such insurance benefits to the beneficiary or beneficiaries designated by the Partnership until the full amount due the Company hereunder has been paid. The parties hereto agree that the beneficiary designation provision of the Policy shall conform to the provisions hereof.

c. Notwithstanding any provision hereof to the contrary, in the event that, for any reason whatsoever, no death benefit is payable under the Policy upon the death of the Employee prior to the termination of this Agreement during the Employee's lifetime and in lieu thereof the Insurer refunds all or any part of the premiums paid for the Policy, the Company and the Partnership's designated beneficiary or beneficiaries shall have the unqualified right to share such premiums based on the respective cumulative contributions by the Company and the Partnership thereto. For purposes of the preceding sentence, the Partnership shall be deemed to have made a premium payment with respect to the Policy on the effective date of this Agreement in an amount equal to $200,112.

7. <u>Termination of the Agreement During the Employee's Lifetime</u>.

a. This Agreement may be terminated by the Partnership at any time during the Employee's lifetime upon written notice to the Company and payment to the Company by the Partnership at the time of such notice of a single lump sum cash payment in the amount of $1,250,000; provided, however, that if the Employee's employment with the Company has terminated for any reason whatsoever (other than death) prior to the date upon which the Company has paid all five of the annual premium payments provided for in section 3(b) above, then the amount of such required payment to the Company by the Partnership shall be reduced to an amount equal to the aggregate premium payments made by the Company pursuant to section 3(b) above on or before the date of such termination. Upon receipt of such amount, the Company shall release the collateral assignment of the Policy by the execution and delivery of an appropriate instrument of release.

b. This Agreement shall automatically terminate, during the Employee's lifetime, without notice, upon the occurrence of any of the following events: (1) total cessation of the Company's business; (2) bankruptcy, receivership or dissolution of the Company; or (3) mutual written consent of the parties. If this Agreement terminates for a reason described in the preceding sentence, then for sixty (60) days after the date of the termination of this Agreement, the Partnership shall have the option of obtaining the release of the collateral assignment of the Policy to the Company. To obtain such release, the Partnership shall repay to the Company the total amount of the premium payments made by the Company hereunder, less any indebtedness secured by the Policy which was incurred by the Company and remains outstanding as of the date of such termination, including any interest due on such indebtedness. Upon receipt of such amount, the Company shall release the collateral assignment of the Policy by the execution and delivery of an appropriate instrument of release. If the Partnership fails to exercise such option within such sixty (60) day period, then, at the request of the Company, the Partnership shall execute any document or documents required by the Insurer to transfer the interest of the Partnership in the Policy to the Company. Alternatively, the Company may enforce its right to be repaid the amount of the premiums on the Policy paid by it from the cash surrender value of the Policy under the collateral assignment of the Policy; provided that in the event the cash surrender value of the Policy exceeds the amount due the Company, such excess shall be paid to the Partnership. Thereafter, neither the Partnership nor any person claiming under the Partnership shall have any further interest in and to the Policy, either under the terms thereof or under this Agreement.

8. **Insurer Not a Party**. The Insurer shall be fully discharged from its obligations under the Policy by payment of the Policy death benefit to the beneficiary or beneficiaries named in the Policy, subject to the terms and conditions of the Policy. In no event shall the Insurer be considered a party to this Agreement, or any modification or amendment hereof. No provision of this Agreement, nor of any modification or amendment hereof, shall in any way be construed as enlarging, changing, varying, or in any other way affecting the obligations of the Insurer as expressly provided in the Policy, except insofar as the provisions hereof are made a part of the Policy by the collateral assignment executed by the Partnership and filed with the Insurer in connection herewith.

9. **Named Fiduciary. Determination of Benefits, Claims Procedure and Administration.**

a. The Company is hereby designated as the named fiduciary under this Agreement. The named fiduciary shall have authority to control and manage the operation and administration of this Agreement, and it shall be responsible for establishing and carrying out a funding policy and method consistent with the objectives of this Agreement.

b. (1) **Claim.** A person who believes that he or she is being denied a benefit to which he or she is entitled under this Agreement (hereinafter referred to as a "Claimant") may file a written request for such benefit with the Company, setting forth his or her claim. The request must be addressed to the Company at its then principal place of business.

(2) **Claim Decision.** Upon receipt of a claim, the Company shall advise the Claimant that a reply will be forthcoming within ninety (90) days and shall, in fact, deliver such reply within such period. The Company may, however, extend the reply period for an additional ninety (90) days for reasonable cause.

If the claim is denied in whole or in part, the Company shall adopt a written opinion, using language calculated to be understood by the Claimant, setting forth: (i) the specific reason or reasons for such denial; (ii) the specific reference to pertinent provisions of this Agreement on which such denial is based; (iii) a description of any additional material or information necessary for the Claimant to perfect his or her claim and an explanation why such material or such information is necessary; (iv) appropriate information as to the steps to be taken if the Claimant wishes to submit the claim for review; and (v) the time limits for requesting a review under subsection (3) and for review under subsection (4) hereof.

(3) **Request for Review.** With sixty (60) days after the receipt by the Claimant of the written opinion described above, the Claimant may request in writing that the Company review its determination. Such request must be addressed to the Company, at its then principal place of business. The Claimant or his or her duly authorized representative may, but need not, review the pertinent documents and submit issues and comments in writing for consideration by the Company. If the Claimant does not request a review of the Company's determination within such sixty (60) day period, he or she shall be barred and estopped from challenging the Company's determination.

(4) **Review of Decision.** Within sixty (60) days after the Company's receipt of a request for review, it will review the determination. After considering all materials presented by the Claimant, the Company will render a written opinion, written in a manner calculated to be understood by the Claimant, setting forth the specific reasons for the decision and containing specific references to the pertinent provisions of this Agreement on which the decision is based. If special circumstances require that the sixty (60) day time period be extended, the Company will so notify the Claimant and will render the decision as soon as possible, but no later than one hundred twenty (120) days after receipt of the request for review.

10. __Amendment__. This Agreement may not be amended, altered or modified, except by a written instrument signed by the parties hereto, or their respective successors or assigns, and may not be otherwise terminated except as provided herein.

11. __Binding Effect__. This Agreement shall be binding upon and inure to the benefit of the Company and its successors and assigns, and the Employee, the Partnership, and their respective successors, assigns, heirs, executors, administrators, and beneficiaries.

12. __Notice__. Any notice, consent or demand required or permitted to be given under the provisions of this Agreement shall be in writing, and shall be signed by the party giving or making the same. If such notice, consent or demand is mailed to a party hereto, it shall be sent by United States certified mail, postage prepaid, addressed to such party's last known address as shown on the

records of the Company. The date of such mailing shall be deemed the date of notice, consent or demand.

13. Taxes. The Company makes no guarantees and assumes no obligations or responsibilities with respect to the Employee's or the Partnership's federal, state, or local income, estate, inheritance, and gift tax obligations, if any, under this Agreement, the Policy, or the collateral assignment of the Policy to the Company.

13. Governing Law. This Agreement, and the rights of the parties hereunder, shall be governed by and construed in accordance with the laws of the State of Texas.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement in triplicate on this the 18Th day of December, 1996, effective as of December 13, 1996.

ENRON CORP.

By: Charles A LeMaistre
Name: Charles A. LeMaistre
Title: Chairman, Compensation Committee of Board of Directors

"COMPANY"

Kenneth L. Lay

"EMPLOYEE"

KLL & LPL FAMILY PARTNERSHIP, LTD.

By:
Name: Kenneth L. Lay
Title: Managing Partner

"PARTNERSHIP"

EC 000752797

EXHIBIT A

The following life insurance policy is subject to the attached Split Dollar Agreement:

Insurer:	Transamerica Occidental Life Insurance Company
Insured:	Kenneth L. Lay
Policy Number:	92539069
Face Amount:	$11,887,900
Effective Date of Policy:	October 14, 1996

VEHOU02:55791.1
12/13/96

EC 000752798

SPLIT DOLLAR AGREEMENT

THIS SPLIT DOLLAR AGREEMENT (this "Agreement") is made and entered into effective as of May 23, 1997, by and among **ENRON CORP.**, a Delaware corporation, with principal offices and place of business in Houston, Texas (hereinafter referred to as the "Company"), **JEFFREY K. SKILLING**, an individual residing in Houston, Texas (hereinafter referred to as the "Employee"), and **MARK DAVID SKILLING**, an individual residing in the State of California, in his capacity as the Trustee of the Jeffrey Keith Skilling Family 1996 Trust under irrevocable trust agreement dated December 31, 1996 (hereinafter referred to as the "Owner"),

WITNESSETH THAT:

WHEREAS, the Employee is currently employed by the Company; and

WHEREAS, the Employee wishes to provide life insurance protection for his family under a policy of life insurance (hereinafter referred to as the "Policy") insuring the life of the Employee, which Policy is described in Exhibit A attached hereto and by this reference made a part hereof, and which is being issued by Massachusetts Mutual Life Insurance Company (hereinafter referred to as the "Insurer"); and

WHEREAS, the Company is willing to pay a portion of the premiums due on the Policy as an additional employment benefit for the Employee, on the terms and conditions hereinafter set forth; and

WHEREAS, the Owner will be the owner of the Policy and, as such, will possess all incidents of ownership in and to the Policy; and

WHEREAS, the Company wishes to have the Policy collaterally assigned to it by the Owner, in order to secure the repayment of the amounts which it will pay toward the premiums on the Policy;

NOW, THEREFORE, in consideration of the premises and of the mutual promises contained herein, the parties hereto agree as follows:

1. <u>Acquisition of Policy</u>. The Owner will contemporaneously purchase the Policy from the Insurer in the total face amount of $8,000,000. The parties hereto agree that they shall take all reasonable action necessary to cause the Insurer to issue the Policy, and shall take any further reasonable action which may be necessary to cause the Policy to conform to the provisions of this Agreement. The parties hereto agree that the Policy shall be subject to the terms and conditions of this Agreement and of the collateral assignment filed with the Insurer relating to the Policy.

2. <u>Ownership of Policy</u>. The Owner shall be the sole and absolute owner of the Policy, and may exercise all ownership rights granted to the owner thereof by the terms of the Policy, except as may otherwise be provided herein.

EC 000752568

3. **Payment of Premiums; Provision of Information.**

a. On or before the due date of each annual Policy premium, or within the grace period provided therein, the Owner shall pay to the Insurer an amount equal to the annual cost of current life insurance protection on the life of the Employee, measured by the Insurer's current published minimum premium rate for standard risks. Upon request, the Owner shall promptly furnish the Company evidence of timely payment of such premium. If the Owner fails to make such timely payment, the Company, in its sole discretion, may elect to make the Owner's portion of the premium payment, which payment shall be recovered by the Company as provided herein.

b. On or before the due date of each annual Policy premium, or within the grace period provided therein, the Company shall pay to the Insurer the difference between (1) $115,250 and (2) the amount of such annual Policy premium paid by the Owner pursuant to Section 3(a) above. Upon request, the Company shall promptly furnish the Owner evidence of timely payment of such premium. Notwithstanding any provision herein to the contrary, the Company shall have no obligation (i) to make more than four annual premium payments in the amount specified in the preceding provisions of this paragraph or (ii) to make any premium payments on or after the date the Employee's employment with the Company terminates for any reason whatsoever.

c. The Company shall annually furnish to the Employee a statement of the amount of income, if any, reportable by the Employee for federal and state income tax purposes as a result of the payment of Policy premiums by the Company. The Owner and the Employee shall promptly furnish the Company with (1) copies of any information or notices provided by the Insurer from time to time with respect to the Policy and (2) any other material or information relating to the Policy and reasonably requested by the Company from time to time.

4. **Collateral Assignment.** To secure the repayment to the Company of the amount of the premiums on the Policy paid by it hereunder, the Owner has, contemporaneously herewith, assigned the Policy to the Company as collateral under a separate assignment instrument. The collateral assignment of the Policy to the Company shall not be terminated, altered or amended by the Owner, without the express written consent of the Company. The parties hereto agree to take all action necessary to cause such collateral assignment to conform to the provisions of this Agreement and to be accepted by the Insurer. Without limiting the scope of the preceding provisions of this section, the parties hereto agree that the Company shall have an interest in the cash surrender value and the death benefits under the Policy to secure the amounts due to the Company hereunder, which interest shall in no event be less than the aggregate premium payments made with respect to the Policy by the Company pursuant to section 3 above.

5. **Limitations on Owner's Rights in Policy.** The Owner shall not sell, assign, transfer, borrow against or withdraw from the cash surrender value of the Policy, surrender, or cancel the Policy without, in any such case, the express written consent of the Company. Further, the Owner shall not change the beneficiary designation provision of the Policy, change the elected death benefit option provisions thereof, decrease or increase the face amount of insurance, fail to make premium payments, take any other action, or fail to take any action if, as a result of any such action or inaction, (a) the aggregate death benefits payable under the Policy at any given time would be less than the portion of the death benefits payable to the Company pursuant to the first sentence of section 6(b) below if the Employee's death was to occur at such time or (b) the cash surrender value of the Policy would be

reduced (provided, however, that this clause shall not prevent the Owner from taking any action, or failing to take any action, if, as a result thereof, the cash surrender value of the Policy is reduced to an amount that is at least equal to the aggregate amount of premium payments made by the Company hereunder).

6. **Collection of Death Proceeds**.

a. Upon the death of the Employee prior to the termination of this Agreement during the Employee's lifetime, the Company and the Owner shall cooperate with the beneficiary or beneficiaries designated by the Owner to take whatever action is necessary to collect the death benefit provided under the Policy. When such benefit has been collected and paid as provided herein, this Agreement shall thereupon terminate.

b. Upon the death of the Employee prior to the termination of this Agreement during the Employee's lifetime, the Company shall have the unqualified right to receive a portion of such death benefit in a single lump sum cash payment in an amount equal to the aggregate amount of premium payments made by the Company hereunder. The balance of the death benefit provided under the Policy, if any, shall be paid directly to the beneficiary or beneficiaries designated by the Owner, in the manner and in the amount or amounts provided in the beneficiary designation provision of the Policy. In no event shall the amount payable to the Company hereunder exceed the insurance benefits payable under the Policy at the death of the Employee. No amount shall be paid from such insurance benefits to the beneficiary or beneficiaries designated by the Owner until the full amount due the Company hereunder has been paid. The parties hereto agree that, upon the request of the Company, the beneficiary designation provision of the Policy shall conform to the provisions hereof.

c. Notwithstanding any provision hereof to the contrary, in the event that, for any reason whatsoever, no death benefit is payable under the Policy upon the death of the Employee prior to the termination of this Agreement during the Employee's lifetime and in lieu thereof the Insurer refunds all or any part of the premiums paid for the Policy, the Company and the Owner's designated beneficiary or beneficiaries shall have the unqualified right to share such premiums based on the respective cumulative contributions by the Company and the Owner thereto.

7. **Termination of the Agreement During the Employee's Lifetime**.

a. This Agreement may be terminated by the Owner at any time during the Employee's lifetime upon written notice to the Company and payment to the Company by the Owner at the time of such notice of a single lump sum cash payment in an amount equal to the aggregate premium payments made by the Company pursuant to section 3 above on or before the date of such termination. Upon receipt of such amount, the Company shall release the collateral assignment of the Policy by the execution and delivery of an appropriate instrument of release.

b. This Agreement shall automatically terminate, during the Employee's lifetime, without notice, upon the occurrence of any of the following events: (1) total cessation of the Company's business; (2) bankruptcy, receivership or dissolution of the Company; (3) termination of the Employee's employment with the Company for any reason whatsoever; (4) failure of the Owner to timely pay to the Insurer the Owner's portion of the premium, if any, due hereunder, unless the Company elects to make such payment on behalf of the Owner as provided herein; or (5) mutual written consent of the parties. If this Agreement terminates for a reason described in the preceding sentence, then for sixty (60) days after the date of the termination of this Agreement, the Owner shall have the option of obtaining the release of the collateral assignment of the Policy to the Company. To obtain such release, the Owner shall repay to the Company the total amount of the premium payments made by the Company hereunder, less any indebtedness secured by the Policy which was incurred by the Company and remains outstanding as of the date of such termination, including any interest due on such indebtedness. Upon receipt of such amount, the Company shall release the collateral assignment of the Policy by the execution and delivery of an appropriate instrument of release. If the Owner fails to exercise such option within such sixty (60) day period, then, at the request of the Company, the Owner shall execute any document or documents required by the Insurer to transfer the interest of the Owner in the Policy to the Company. Alternatively, the Company may enforce its right to be repaid the amount due it hereunder from the cash surrender value of the Policy under the collateral assignment of the Policy; provided that in the event the cash surrender value of the Policy exceeds the amount due the Company, such excess shall be paid to the Owner. Thereafter, neither the Owner nor any person claiming under the Owner shall have any further interest in and to the Policy, either under the terms thereof or under this Agreement.

8. Insurer Not a Party. The Insurer shall be fully discharged from its obligations under the Policy by payment of the Policy death benefit to the beneficiary or beneficiaries named in the Policy, subject to the terms and conditions of the Policy. In no event shall the Insurer be considered a party to this Agreement, or any modification or amendment hereof. No provision of this Agreement, nor of any modification or amendment hereof, shall in any way be construed as enlarging, changing, varying, or in any other way affecting the obligations of the Insurer as expressly provided in the Policy, except insofar as the provisions hereof are made a part of the Policy by the collateral assignment executed by the Owner and filed with the Insurer in connection herewith.

9. Named Fiduciary, Determination of Benefits, Claims Procedure and Administration.

a. **Named Fiduciary**. The Company is hereby designated as the named fiduciary under this Agreement. The named fiduciary shall have authority to control and manage the operation and administration of this Agreement, and it shall be responsible for establishing and carrying out a funding policy and method consistent with the objectives of this Agreement.

b. (1) **Claim.** A person who believes that he or she is being denied a benefit to which he or she is entitled under this Agreement (hereinafter referred to as a "Claimant") may file a written request for such benefit with the Company, setting forth his or her claim. The request must be addressed to the Company at its then principal place of business.

(2) **Claim Decision.** Upon receipt of a claim, the Company shall advise the Claimant that a reply will be forthcoming within ninety (90) days and shall, in fact, deliver such reply within such period. The Company may, however, extend the reply period for an additional ninety (90) days for reasonable cause.

If the claim is denied in whole or in part, the Company shall adopt a written opinion, using language calculated to be understood by the Claimant, setting forth: (i) the specific reason or reasons for such denial; (ii) the specific reference to pertinent provisions of this Agreement on which such denial is based; (iii) a description of any additional material or information necessary for the Claimant to perfect his or her claim and an explanation why such material or such information is necessary; (iv) appropriate information as to the steps to be taken if the Claimant wishes to submit the claim for review; and (v) the time limits for requesting a review under subsection (3) and for review under subsection (4) hereof.

(3) **Request for Review.** Within sixty (60) days after the receipt by the Claimant of the written opinion described above, the Claimant may request in writing that the Company review its determination. Such request must be addressed to the Company, at its then principal place of business. The Claimant or his or her duly authorized representative may, but need not, review the pertinent documents and submit issues and comments in writing for consideration by the Company. If the Claimant does not request a review of the Company's determination within such sixty (60) day period, he or she shall be barred and estopped from challenging the Company's determination.

(4) **Review of Decision.** Within sixty (60) days after the Company's receipt of a request for review, it will review the determination. After considering all materials presented by the Claimant, the Company will render a written opinion, written in a manner calculated to be understood by the Claimant, setting forth the specific reasons for the decision and containing specific references to the pertinent provisions of this Agreement on which the decision is based. If special circumstances require that the sixty (60) day time period be extended, the Company will so notify the Claimant and will render the decision as soon as possible, but no later than one hundred twenty (120) days after receipt of the request for review.

10. **Amendment**. This Agreement may not be amended, altered or modified, except by a written instrument signed by the parties hereto, or their respective successors or assigns, and may not be otherwise terminated except as provided herein.

11. **Binding Effect**. This Agreement shall be binding upon and inure to the benefit of the Company and its successors and assigns, and the Employee, the Owner, and their respective successors, assigns, heirs, executors, administrators, and beneficiaries.

12. **Notice**. Any notice, consent or demand required or permitted to be given under the provisions of this Agreement shall be in writing, and shall be signed by the party giving or making the same. If such notice, consent or demand is mailed to a party hereto, it shall be sent by United States certified mail, postage prepaid, addressed to such party's last known address as shown on the records of the Company. The date of such mailing shall be deemed the date of notice, consent or demand.

13. **Taxes**. The Company makes no guarantees and assumes no obligations or responsibilities with respect to the Employee's or the Owner's federal, state, or local income, estate, inheritance, and gift tax obligations, if any, under this Agreement, the Policy, or the collateral assignment of the Policy to the Company.

14. **Governing Law**. This Agreement, and the rights of the parties hereunder, shall be governed by and construed in accordance with the laws of the State of Texas.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement in triplicate on this the 23rd day of May, 1997.

ENRON CORP.

By: ______________________
Name: Kenneth L. Lay
Title: Chairman and Chief Executive Officer

"COMPANY"

____
Jeffrey K. Skilling

"EMPLOYEE"

Mark David Skilling
____
Mark David Skilling, Trustee of the Jeffrey Keith Skilling Family 1996 Trust

"OWNER"

EC 000752573

EXHIBIT A

The following life insurance policy is subject to the attached Split Dollar Agreement:

Insurer:	Massachusetts Mutual Life Insurance Company
Insured:	Jeffrey K. Skilling
Policy Number:	11 502 764
Face Amount:	$8,000,000
Effective Date of Policy:	May 23, 1997

VEHOU02:72489.1
5/23/97

EC 000752574

ASSIGNMENT OF LIFE INSURANCE POLICY AS COLLATERAL

A. **FOR VALUE RECEIVED**, the undersigned (hereinafter the "Owner") hereby assigns, transfers and sets over to Enron Corp., with principal offices and place of business in Houston, Texas, its successors and assigns (hereinafter the "Assignee"), Policy No.11 502 764 issued by Massachusetts Mutual Life Insurance Company (hereinafter the "Insurer"), and any supplementary contracts issued in connection therewith (said policy and contracts hereinafter the "Policy"), insuring the life of Jeffrey K. Skilling, and all claims, options, privileges, rights, title and interest therein and thereunder (except as otherwise provided herein), subject to all the terms and conditions of the Policy and to all superior liens, if any, which the Insurer may have against the Policy. The Owner, by this Assignment, and the Assignee, by acceptance of the assignment of the Policy to it hereunder, agree to the terms and conditions contained herein.

B. This Assignment is made and the Policy is to be held as collateral security for any and all liabilities and obligations of the Owner to the Assignee, either now existing or that may hereafter arise, under and pursuant to that certain Split Dollar Agreement by and among the Owner, the Assignee, and Jeffrey K. Skilling, dated and effective as of May 23, 1997 (hereinafter the "Split Dollar Agreement"). The liabilities and obligations described in the preceding sentence are hereinafter referred to as the "Liabilities."

C. It is expressly agreed that, without detracting from the generality of the foregoing, the following specific rights are included in this Assignment and pass to the Assignee by virtue hereof:

1. The sole right to collect from the Insurer the net proceeds of the Policy when it becomes a claim by death or maturity;

2. The sole right to surrender the Policy and receive the surrender value thereof at any time provided by the terms of the Policy and at such other times as the Insurer may allow; and

3. The sole right to obtain one or more loans or advances on the Policy, either from the Insurer or, at any time, from other persons, and to pledge or assign the Policy as security for such loans or advances.

D. It is expressly agreed that the following specific rights, so long as the Policy has not been surrendered and to the extent permitted under the Split Dollar Agreement, are reserved by the Owner and excluded from this Assignment and do not pass by virtue hereof:

1. The right to designate and change the beneficiary; and

2. The right to elect any optional mode of settlement permitted by the Policy or allowed by the Insurer.

EC 000752563

However, the reservation of these rights by the Owner shall in no way impair the right of the Assignee to surrender the Policy nor impair any other right of the Assignee hereunder. Further, any exercise of these rights shall be made subject to this Assignment and to the rights of the Assignee hereunder.

E. Notwithstanding the foregoing, the Assignee covenants and agrees with the Owner as follows:

1. Any balance of sums received hereunder from the Insurer remaining after payment of the then existing Liabilities shall be paid by the Assignee to the persons entitled thereto under the terms of the Policy, had this Assignment not been executed;

2. The Assignee will not exercise the right to surrender the Policy, nor the right to obtain policy loans from the Insurer, unless and until there has been default in any of the Liabilities or the Split Dollar Agreement has been terminated, pursuant to its terms; in any event, the Assignee will not exercise any such right until twenty (20) days after the Assignee shall have mailed notice of intention to exercise such right, by first class mail, to the Owner at the address last supplied in writing to the Assignee specifically referring to this Assignment; and

3. The Assignee will, upon request, forward the Policy to the Insurer without unreasonable delay, for endorsement of any designation or change of beneficiary or any election of an optional mode of settlement that has been elected by the Owner.

F. The Insurer is hereby authorized to recognize the Assignee's claims to rights hereunder without investigating the reason for any action taken by the Assignee, the validity or the amount of the Liabilities, the existence of any default therein, termination of the Split Dollar Agreement, the giving of any notice hereunder, or the application to be made by the Assignee of any amounts to be paid to the Assignee. The sole signature of the Assignee shall be sufficient for the exercise of any rights under the Policy assigned hereby and the sole receipt of the Assignee for any sums received shall be a full discharge and release therefor to the Insurer. Payment for all or any part of the sums due under the Policy and assigned herein shall be drawn to the exclusive order of or as directed by the Assignee if, when, and in such amounts as may be requested by the Assignee.

G. The Assignee shall be under no obligation to pay any premium on the Policy nor the principal of or interest on any loans or advances on the Policy, whether or not obtained by the Assignee, or any other charges on the Policy.

H. The exercise of any right, option, privilege or power given herein to the Assignee shall be at the option of the Assignee, and (except as provided herein) the Assignee may exercise any such right, option, privilege or power without notice to, or assent by, or affecting the liability of, or releasing any interest hereby assigned by the Owner.

I. If applicable, the Assignee may take or release other security, may release any party primarily or secondarily liable for any of the Liabilities, may grant extensions, renewals or indulgences with respect to the Liabilities, or may apply the proceeds of the Policy hereby assigned or any amount received on account of the Policy by the exercise of any right permitted under this Assignment to the Liabilities in such order as the Assignee shall determine, without resorting to or regard to other security.

J. As applied to the duties and responsibilities of the Insurer, in the event of any conflict between the provisions of this Assignment and the provisions of the Split Dollar Agreement with respect to the Policy or the Assignee's rights of collateral security therein, the provisions of this Assignment shall prevail. As applied between the Owner and the Assignee, in the event of any such conflict, the provisions of the Split Dollar Agreement shall prevail.

K. The Owner declares that no proceedings in bankruptcy are pending against the Owner and that the Owner's property is not subject to any assignment for the benefit of creditors of the Owner.

SIGNED this 25 day of June, 1997, effective as of May 23, 1997.

Mark David Skilling

Mark David Skilling, Trustee of the Jeffrey Keith Skilling Family 1996 Trust

"OWNER"

This Assignment is hereby accepted and agreed to by the Assignee.

ENRON CORP.

By:
Name: Kenneth L. Lay
Title: Chairman and Chief Executive Officer

"ASSIGNEE"

EC 000752565

STATE OF CALIFORNIA §
§
SAN FRANCISCO COUNTY §

On the 25th day of June, 1997, before me personally came **MARK DAVID SKILLING**, trustee of the Jeffrey Keith Skilling Family 1996 Trust, to me known to be the individual who executed the Assignment on the preceding pages hereof and acknowledged to me that he executed the same.

Notary Public in and for
THE STATE OF CALIFORNIA

My Commission Expires:

February 24, 1999

VEHOU02:72493.1
5/23/97

SUSAN C. LEE
COMM. #1050091
NOTARY PUBLIC-CALIFORNIA
SAN FRANCISCO COUNTY
My Comm. Expires Feb. 24, 1999

EC 000752566

Jeffrey K. Skilling
Split Dollar Premium Payment Schedule
Policy # 11 502 764
Annual Premium: $115,250
Policy Issue Date: 5/27/97
5 year policy

Premium Payment			
Year	Enron	Trustee	Total
1997	$107,673.00	$7,577.00	$115,250.00
1998	$110,191.61	$5,058.39	$115,250.00
1999	$109,867.49	$5,382.51	$115,250.00
2000	$109,388.39	$5,861.61	$115,250.00
2001	$110,870.16	$4,379.84	$115,250.00
Total Paid	**$547,990.65**	$28,259.35	$576,250.00
Rounds to	**$548,000.00**		

EC 000752567