C. Transactions That Raise Partnership Tax Issues

Several of Enron's structured transactions relied on partnership tax rules to shift basis to assets that would be depreciated or sold, in order to maximize depreciation deductions or minimize taxable gain on sale. The reported tax benefits (and corresponding financial statement benefits) depended on the application of partnership tax rules, including rules that require allocation of tax attributes associated with contributed assets, and rules that permit basis to be shifted to partnership assets when the partnership makes distributions. For example, Project Tomas (done in 1998) relied on some of these rules in order to dispose of a portfolio of low-basis leased assets without gain recognition. Projects Condor (done in 1999) and Tammy I and II (done in 2000 and 2001) also relied on these rules to shift basis to depreciable assets. The "unwind" strategies of Projects Condor, Tammy I and Tammy II also relied on rules protecting a corporation from recognition of gain on the sale or exchange of its stock.[443]

This section of the Report begins with a brief discussion of relevant partnership tax rules and then describes in detail Projects Tomas, Condor, Tammy I and Tammy II.

1. Discussion of relevant partnership tax law rules

In general

In general, partnerships are not treated as separate taxpayers for Federal income tax purposes. The income of the partnership is taxed to the partners. Items of income, gain, loss, deduction and credit generally are allocated to the partners in accordance with the partnership agreement. Partnership income, unlike corporate income, is thus subject to one level of Federal income tax, which is imposed at the partner level. As a result of the different tax rules applying to partnerships and corporations, taxpayers have structured transactions attempting to combine the benefits contained in each set of rules.[444]

The four structured transactions undertaken by Enron that are described in this section of the Report (Projects Tomas, Condor, and Tammy I and II) utilize the partnership tax rules, and their interaction with corporate tax rules, to attempt to achieve favorable tax treatment.

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[443] Sec. 1032. This rule of present law is described above in Part III.A.1., Discussion of relevant corporate tax laws.

[444] For an example of taxpayers attempting to take advantage of the benefits of both the corporate and partnership rules, *see* Prop. Treas. Reg. sec. 1.337(d)-3 (gain recognition upon certain partnership transactions involving a corporate partner's stock), Notice 89-37, 1989-1 C.B. 679, and Notice 93-2, 1993-2 C.B. 292.

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Contributions to partnerships generally tax-free

Generally, a partner does not recognize any gain or loss on a contribution of property to a partnership.[445] The partnership also does not recognize gain or loss when property is contributed.

Liquidation of a partner's interest

Tax-free distributions of partnership property

Generally, a partner and the partnership do not recognize gain or loss on the distribution of partnership property.[446] This includes distributions in liquidation of a partner's interest. There are, however, a number of exceptions to this general rule of non-recognition on a distribution of partnership property.

Taxable partnership distributions

One such exception is that a partner must recognize gain to the extent that any money distributed exceeds the partner's basis in its partnership interest immediately before the distribution.[447]

Two additional exceptions, enacted in 1989 and 1992, provide that gain or loss is recognized on a distribution of partnership property, if a partner contributed property with built-in gain or built-in loss, and either (1) the property is distributed to another partner within seven years of its contribution, or (2) the contributing partner receives a distribution of other property within seven years of the contribution.[448]

In general, this gain recognition rule does not apply to a distribution of property that the distributee partner contributed to the partnership.[449] However, if the property distributed is an interest in an entity (e.g., corporate stock), the exception from gain recognition does not apply to the extent the value of the interest is attributable to property contributed to the entity after the entity was contributed to the partnership.

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[445] Sec. 721(a).

[446] Sec. 731(a) and (b).

[447] Sec. 731(a)(1). The term "money" includes marketable securities; however, marketable securities are excluded from the definition of money for purposes of gain recognition on the distribution if the distributee partner contributed the security to the partnership. Sec. 731(c).

[448] Secs. 704(c)(1)(B) and 737.

[449] Secs. 704(c)(1)(B) and 737(d).

Tax basis of distributed property received in liquidation of partnership interest

The basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction).[450]

Election to adjust basis of partnership property

When a partnership distributes partnership property, generally, the basis of partnership property is not adjusted to reflect the effects of the distribution or transfer. The partnership is permitted, however, to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.[451] The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the application of a limitation, for example. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution. The allocation of the increase or decrease in basis of partnership property is made in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.[452]

Disguised sales of property through partnerships

In 1984, Congress enacted a rule providing that if there is a transfer of money or other property by a partner to a partnership and there is a related transfer of money or other property by the partnership to such partner, the two transfers (when viewed together) may be properly characterized as a taxable sale or exchange of property.[453]

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[450] Sec. 732(b).

[451] Sec. 754.

[452] Sec. 755.

[453] Sec. 707(a)(2)(B). Treasury, in regulations issued in 1956, had recognized the possibility that a contribution of property coupled with a distribution of money or other consideration may, in substance, be a sale or exchange of property. See Treas. Reg. secs. 1.721-1(a) and 1.731-1(c)(3).

The regulations provide 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, by the partner to the partnership only if based on all the facts and circumstances (1) the transfer of money or other consideration would not have been made but for the transfer of property and (2) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.[454] The regulations then provide ten factors that may tend to prove the existence of a sale.[455]

If the two transfers are made within a two-year period (without regard to the order of the transfers), then the transfers are presumed to be a sale of the property unless the facts and circumstances clearly establish otherwise.[456] If, however, the two transfers are more than two years apart, then the transfers are presumed not to be a sale of the property unless the facts and circumstances clearly establish otherwise.[457]

Adjustment to basis of assets of a distributed corporation controlled by a corporate partner

In December 1999, Congress enacted a rule requiring a reduction in the basis of stock distributed by a partnership to a corporate partner, in certain circumstances. The provision was enacted in response to the perceived abuse of the interaction of the tax-favored treatment of partnership distributions and the tax-free treatment of certain corporate liquidations.[458] The Congress was concerned that the downward adjustment to the basis of property distributed by a partnership to a low-basis partner may be nullified if the distributed property is corporate stock. The corporate partner could then liquidate the distributed corporation, eliminating the stock and owning assets directly, so that the stock basis reduction would have no effect.[459]

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[454] Treas. Reg. sec. 1.707-3(b)(1).

[455] Treas. Reg. sec. 1.707-3(b)(2).

[456] Treas. Reg. sec. 1.707-3(c)(1).

[457] Treas. Reg. sec. 1.707-3(d).

[458] Sec. 732(f) was enacted in the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, section 538(a) (December 17, 1999). Section 732(f) is effective for distributions made after July 14, 1999. However, in the case of a corporation that is a partner in a partnership as of July 14, 1999, section 732(f) is effective for distributions made to that partner from that partnership after June 30, 2001 (approximately a two-year deferred effective date).

[459] Generally, section 332 provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80 percent of the stock (by vote and value).

The provision provides for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner, and after the distribution the corporate partner controls the distributed corporation.[460] The amount of the reduction in basis of property of the distributed corporation generally equals the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution over (2) the corporate partner's basis in that stock immediately after the distribution.[461]

Partnership allocations with respect to contributed property

Allocations to contributing and non-contributing partners to reflect pre-contribution gain or loss

The partnership rules generally provide that a partner's distributive share of partnership income, gain, loss, or deduction is allocated to the partner in accordance with the partner's interest in the partnership.[462] However, a special rule requires that income, gain, loss, and deduction with respect to contributed property must 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 to the partnership.[463] The purpose of this rule is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under regulations promulgated by the Treasury Department, three different allocation methods are generally reasonable in carrying out the purpose of this rule.[464] However, 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.[465]

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[460] For this purpose, the term "control" means ownership of stock meeting the requirements of section 1504(a)(2) (generally, an 80-percent vote and value requirement).

[461] Sec. 732(f)(1). The provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation. Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Sec. 732(f)(3).

[462] Sec. 704(b).

[463] Sec. 704(c).

[464] The methods are the traditional method, the traditional method with curative allocations, and the remedial method. Treas. Reg. sec. 1.704-3.

[465] Treas. Reg. sec. 1.704-3(a)(10).

Sale of partnership interest with pre-contribution gain or loss

If a contributing partner transfers a partnership interest, pre-contribution built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner.[466] 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.[467]

Basis of a partner's interest in a partnership

In general, a partner's basis in its partnership interest is increased by that partner's distributive share of partnership income and is decreased by that partner's distributive share of partnership losses.[468] Increasing the partner's basis in this manner ensures that a partner is taxed only once on its distributive share of partnership income, and deducts its share of partnership loss only once. In addition, a partner's basis is increased by the partner's distributive share of non-taxable income so that the partner does not lose the benefit of that type of income.

Sale of stock contributed to a partnership

In Rev. Rul. 99-57,[469] the IRS addressed the tax treatment of gain on the sale of a corporate partner's stock that it had previously contributed to the partnership. In the ruling, the IRS concluded that the corporate partner's share of the gain resulting from the partnership's sale of the stock was not subject to tax. Effectively, the IRS treated the corporate partner as owning an undivided interest in its own corporate stock, and that as such it does not recognize gain or loss on the receipt of money or other property in exchange for the its own stock.[470] In addition, the corporate partner increased its basis in its partnership interest thereby preserving the non-recognition result of the transaction in accordance with the policy underlying section 1032 (preventing a corporation from recognizing gain or loss when dealing in its own stock). A similar analysis would apply to a transaction in which a corporate partner is allocated a loss from a transaction involving the disposition of stock of the corporate partner held by the partnership.

In Notice 99-57,[471] the IRS stated its intent to promulgate regulations under section 705 to address certain situations in which gain or loss may be improperly created by adjusting the

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[466] Treas. Reg. sec. 1.704-3(a)(7).

[467] *Id.*

[468] Sec. 705(a).

[469] 1999-2 C.B. 678 (Dec. 20, 1999). For an example of an earlier agency decision applying partnership aggregate principles to section 1032, see Priv. Ltr. Rul. 9822002 (Oct. 23, 1997).

[470] Section 1032.

[471] 1999-2 C.B. 693 (Dec. 20, 1999).

basis of a partnership interest for partnership income that is not subject to tax, or for partnership losses or deductions that are permanently denied, with respect to a partner. The regulations will apply to situations in which a corporation acquires an interest in a partnership that holds stock in that corporation, and a section 754 election is not in effect. In those situations, a corporate partner may increase the basis in its partnership interest under section 705 only by the amount of its portion of the section 1032 gain that the partner would have realized had a section 754 election been made. The IRS also stated that the regulations will apply to situations in which the price paid for a partnership interest reflects built-in gain or accrued income items that will not be subject to income tax, or built-in loss or accrued deductions that will be permanently denied, when allocated to the transferee partner, and the partnership has not made a section 754 election. The IRS also warned that it may challenge any transaction within the scope of the Notice under the anti-abuse provisions of Treas. Reg. sec. 1.701-2.[472]

Proposed regulations on partnership distributions of corporate stock

Similarly, under Notice 89-37,[473] which was issued in response to a well-known transaction engaged in by the May Company,[474] the IRS addressed certain situations in which gain may be avoided through the use of a partnership and stock of a corporate partner. The notice states that if a partnership distributes to a corporate partner the stock of such corporation or the stock of an affiliate of such corporation after March 9, 1989, the distribution is characterized as a redemption of the corporate partner's stock with "property consisting of its partnership interest." In other words, gain recognition will apply instead of the general partnership non-recognition provisions on distributions of property. In addition, the Notice also states that if a partnership acquires stock of a corporate partner after March 9, 1989, the IRS intends to treat the acquisition as resulting in a "deemed redemption" of the corporate partner's stock.[475] In such case, the deemed redemption rule will apply so that "gain will be recognized at the time of, and to the extent that, the acquisition has the economic effect of an exchange by a corporate partner of its interest in appreciated property for an interest in its stock [or stock of an affiliate] owned or acquired by the partnership."

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[472] On January 3, 2001, the Treasury and the IRS published a notice of proposed rulemaking under section 705 (REG-106702-00, 2001-4 I.R.B. 424). On March 28, 2002, the Treasury and the IRS issued final regulations under section 705 (T.D. 8986, 67 Fed. Reg. 15112 (March 29, 2002)). On March 28, 2002, the Treasury Department and the IRS issued a notice of proposed rulemaking under section 705, addressing remaining issues that Treasury and the IRS considered during the development of the final regulations (REG-16748-01, 67 Fed. Reg. 15132 (March 29, 2002)).

[473] 1989-1 C.B. 679.

[474] In this transaction, a corporate partner contributed property with a built-in gain to a partnership. The partnership made a distribution of corporate stock.

[475] In the Notice, the IRS stated that the deemed redemption rule would apply to other transactions, including partnership purchases of a corporate partner's stock, disproportionate distributions, and amendments to the partnership agreement.

In December 1992, Treasury issued proposed regulations interpreting the Notice.[476] The proposed regulations, which have not been finalized, describe the tax consequences of a distribution of a partner's stock after the application of the deemed redemption rule.

The IRS has stated "further study is appropriate for cases in which affiliation did not exist prior to a distribution of stock by a partnership to a corporate partner, but rather results from such distribution."[477] As a result, the proposed regulations will be amended to limit their application to cases in which affiliation exists immediately before the deemed redemption or distribution.

Partnership anti-abuse regulations

In late 1994, the Treasury Department issued regulations containing two anti-abuse rules relating to subchapter K. The first rule focuses on the intent of subchapter K, which is to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements: (1) the partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose; (2) the form of each partnership transaction must be respected under substance over form principles; and (3) 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 partner's economic agreement and clearly reflect the partner's income.[478] 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, 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, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.[479]

The second rule permits the Commissioner to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or regulations.[480] However, this second rule does not apply to the extent that a provision of the Code (or regulations) prescribes the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.[481]

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[476] PS-91-90, 1993-2 I.R.B. 29; 57 Fed. Reg. 59324 (December 15, 1992).

[477] Notice 93-2, 1993-2 C.B. 292.

[478] Treas. Reg. sec. 1.701-2(a).

[479] Treas. Reg. sec. 1.701-2(b).

[480] Treas. Reg. sec. 1.701-2(e).

[481] *Id.*

Summary

The present-law rules discussed above were integral to effectuating the beneficial tax results sought by Enron in Projects Tomas, Condor, Tammy I, and Tammy II. Project Tomas uses the partnership distribution rules in connection with the corporate tax-free liquidation provisions to generate tax deductions without an economic outlay. Projects Condor, Tammy I, and Tammy II use the partnership allocation rules and the non-recognition treatment accorded to dealings in one's own stock to purportedly enable Enron to generate tax deductions without an economic outlay.

2. Project Tomas

Brief overview

Project Tomas was structured to increase the tax basis of a portfolio of leased assets that Enron liquidated. The increased basis of the assets eliminated approximately $270 million of taxable gain for Enron on the disposition of the property. The transaction involved the assumption, and repayment, of debt to increase the basis of the assets without an economic outlay. At the same time, Enron took the position that tax savings from the transaction generated financial accounting earnings of $18.1 million for 1998, and $18.4 million for 2000.

The transaction involved the formation of a partnership between an existing Enron subsidiary holding low-basis leased assets, and two subsidiaries of Bankers Trust. By contributions to the partnership, and later liquidation of the Enron subsidiary's interest in the partnership, the Bankers Trust subsidiaries acquired the leased assets. Later, through the partnership, they would start to sell them off.

When the partnership was formed, the Enron subsidiary, PGH, contributed both the portfolio of depreciable assets that had high value but a low tax basis, and all the stock of another corporation, Oneida. The Bankers Trust partners contributed cash for small partnership interests. The partnership assumed a large amount of debt. Oneida, the corporation whose stock the partnership held, received valuable assets in the form of notes receivable from a Bankers Trust affiliate. After a period of time, the partnership distributed the stock of Oneida back to the Enron affiliate, PGH, in redemption of its partnership interest. The basis of the Oneida stock was reduced, under the tax law, to equal the amount of PGH's low basis in its partnership interest.

At the same time, the partnership made a 754 election to increase the basis of the depreciable assets it retained. The basis increase was equal to the amount of the reduction in basis of the distributed Oneida stock. No corresponding reduction in the basis of Oneida's assets, however, was required under the law in effect at the time of the transaction. Thus, the basis of those assets was unaffected by the distribution of corporate stock, while the amount of the reduction in stock basis resulting from the distribution was added to the basis of the partnership's remaining assets. In effect, this amount of basis was duplicated in the transaction, and this duplicated amount of basis was shifted from the corporate stock to the partnership's other assets, that is, the portfolio of leased assets. Gain on their later sale would be reduced by this increase in basis.

Background[482]

Reported tax and financial statement effects

Enron reported that it was not subject to tax on approximately $270 million of built-in gain.[483] This tax benefit is attributable to the step-up in the basis and subsequent disposition of the leased assets without Federal income tax on the built-in gain.[484] Since the transaction was put in place in 1998, subsequent tax legislation has changed some of the tax results of this type of transaction.[485]

Enron reported annual financial statement benefits from the Tomas transaction of $18.1 million for 1998, and $18.4 million for 2000.[486] It is represented that current management is not aware of any reversals of these financial statement benefits.[487]

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[482] The information regarding Project Tomas was obtained from Joint Committee staff interviews of Mr. Hermann and Mr. Maxey, as well as from documents and information provided by Enron and the IRS.

[483] Enron Corp. Presentation to Joint Committee on Taxation staff, Washington, D.C., June 7, 2002, at 26. Appendix B, Part I contains this document.

[484] The Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001 (which is contained in Appendix B, Part I) showed that the estimated current tax benefit attributable to Project Tomas was $109 million as of the end of 2001.

[485] Sec. 538 of Pub. L. No. 106-170, the "Ticket to Work and Work Incentives Improvement Act of 1999," provided for a corresponding reduction in the basis of assets of a distributed corporation controlled by a corporate partner.

[486] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 13, 2003, answer 101.

[487] *Id.* Another Enron calculation of the financial statement benefits of Project Tomas differed. The Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001 (which is contained in Appendix B, Part I) showed that the net income for financial reporting purposes from Project Tomas totalled approximately $113 million through 2001. The yearly financial statement income or loss shown was $55.99 million in 1998, $9.85 million in 1999, and $51.29 million in 2000, with losses of under $10 million estimated or projected for 2001 through 2004, and smaller amounts of income projected annually through 2010.

Development of Project Tomas[488]

Portland General Holdings ("PGH"), a wholly-owned Enron subsidiary acquired in 1997, held "burned-out" leases of depreciable property. These leased assets were held through subsidiaries of PGH. The leased assets consisted of property such as commercial aircraft, containers for containerized shipping, and rail cars, as well as other types of assets such as an acid-recovery plant used in making pickles. The leases were "burned out" in the sense that the tax basis of the leased property had been reduced to approximately $8 million, a small fraction of the property's value, by depreciation deductions. Nevertheless, the property had substantial economic value of approximately $280 million (not taking into account nonrecourse debt of approximately $170 million).

In December of 1997, Enron received a letter from Arthur Andersen regarding a technique for "permanent gain deferral."[489] The letter described "a technique through which a corporate partner may redeem its partnership interest while minimizing any potential tax consequences on the redemption."[490] The letter urged, "[b]ecause of the substantial benefits that the product provides, and the possibility of legislative action, you should be advised to utilize the technique now, as its shelf life may be limited."[491]

At Enron, Project Tomas was approved by the Enron Board of Directors Executive Committee at a meeting on March 2, 1998.[492] At a meeting of the Board of Directors of Enron Corp. on May 4-5, 1998, Mr. John Duncan reported to the Board that the Executive Committee had approved Project Tomas.[493]

Although $250 million of debt used in the transaction was incurred in July of 1998, the Enron tax department was still considering modifications to the series of transactions involved in Project Tomas during August of 1998.[494]

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[488] Like several other transactions in which Enron affiliates engaged, Project Tomas was named after a recent hurricane beginning with the letter "T."

[489] Letter from Robert P. Palmquist of Arthur Andersen to Mr. David Maxey of Enron dated Dec. 11, 1997, EC2 000038050 - EC2 000038052.

[490] *Id.*

[491] *Id.*

[492] Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., March 2, 1998, EC2 000037991 - EC2 000037994.

[493] Minutes, Meeting of the board of Directors, Enron Corp., May 4-5, 1998, EC2 000037995 - EC2 000037996.

[494] Project Tomas, August 4, 1998, EC2 000038005 - EC2 000038018; Project Tomas, August 14, 1998, EC2 000038019 - EC2 000038032.

Project Tomas' tax goal was to increase the tax basis of the "burned-out" leased property without incurring tax, permitting elimination or reduction of gain (or increase of loss) on the later sale of the depreciable property (or greater depreciation deductions in the future). The transaction was designed to result in the liquidation of these assets for Enron. At the same time, the financial accounting goal was to increase earnings. The financial accounting treatment (to increase earnings) was the opposite of the tax treatment (to eliminate or reduce gains).

Implementation of Project Tomas

PGH, a wholly-owned Enron affiliate acquired in 1997, owned a portfolio of leased assets through subsidiaries.[495] In total, the leased assets had a fair market value of approximately $280 million and were encumbered by non-recourse debt totaling approximately $170 million. The tax basis of the leased assets was approximately $8 million.

PGH also owned all the stock of Oneida Leasing, Inc. ("Oneida"). Oneida had no significant assets at the beginning of the transaction.

On July 17, 1998, PGH borrowed approximately $250 million on a recourse basis from Toronto Dominion, an unrelated Texas bank.[496] This recourse debt was not secured by any property, although Enron guaranteed the debt. On the same date, PGH contributed the $250 million cash proceeds to its subsidiary, Oneida. Oneida in turn loaned $250 million to Enron in exchange for Enron's demand promissory note, also dated July 17, 1998.[497] Thus, the $250 million cash proceeds were cycled from PGH through its subsidiary, Oneida, and then back to Enron, the guarantor of the Toronto Dominion debt. PGH was still liable on its $250 million recourse debt to the Toronto Dominion bank.

On September 9, 1998, PGH formed a partnership with two affiliates of Bankers Trust. PGH's two partners were BT Leasing and EN-BT Delaware. The partnership was named Seneca Leasing Partners, L.P. ("Seneca"). The three partners of Seneca contributed assets to the partnership in exchange for their interests in the partnership.

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[495] One of the subsidiaries was Columbia Willamette Leasing, Inc. ("CWL"). CWL in turn owned all the stock of Rail Leasing, Inc. ("Rail Leasing"). CWL held 16 groups of leased assets (the aircraft, containers for shipping, and similar large assets), and Rail Leasing held one lot of leased rail cars. On September 4 and September 10, 1998, CWL and Rail Leasing merged into their parent corporation, PGH. As a result of these two mergers, PGH owned all of the assets formerly held by CWL and Rail Leasing, which consisted of the 17 groups of leased assets.

[496] The loan was due on or before October 30, 1998.

[497] The terms of the demand note were that Enron agreed to pay the principal amount upon the earlier of demand or July 31, 2003.

On September 15 and 30, 1998, PGH transferred the leased assets to the Seneca partnership.[498] PGH also transferred all of the Oneida stock to Seneca on September 15, 1998. In exchange for the assets and stock it contributed, PGH received a 95-percent limited partnership interest.

PGH's limited partnership interest in Seneca provided for a floating preferred return on approximately $68 million of its capital in the partnership. This limited partnership interest also included a retirement right, permitting PGH to withdraw from the partnership after two years.[499] On September 16, 1998, PGH transferred its limited partnership interest to PGH LLC, a Delaware limited liability company formed two days before that was disregarded (treated as part of PGH) for Federal income tax purposes.

BT Leasing, one of the two Bankers Trust affiliates that were partners in Seneca, contributed approximately $9 million cash to Seneca in exchange for a four-percent general partnership interest. The other partner, EN-BT Delaware, contributed approximately $2 million cash to Seneca in exchange for a one-percent general partnership interest.[500]

On September 15, 1998, the partnership, Seneca, assumed the $250 million recourse debt from PGH to Toronto Dominion. As a result, BT Leasing and EN-BT Delaware, as general partners of Seneca, became primarily liable on the debt. Enron remained as guarantor of this $250 million debt for two more days until the debt was repaid.

On September 15, 1998, the $250 million PGH had borrowed in July from Toronto Dominion changed hands several times. On that date, but prior to the contribution of Oneida stock to the partnership, Enron transferred approximately $250 million cash to Oneida in satisfaction of Enron's July 17 demand promissory note to Oneida. Oneida loaned approximately $250 million on a recourse basis to Bankers Trust in exchange for Bankers Trust's

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[498] The fair market value of the 17 leased assets remained at approximately $280 million on PGH's transfer to the partnership and the non-recourse debt encumbering the assets remained at approximately $170 million. As of September 15, PGH transferred 16 of the 17 groups of assets, and was obligated to transfer the 17th leased asset (a Mack Truck facility) or its cash equivalent value to Seneca, and did transfer the 17th leased asset to Seneca on September 30, 1998.

[499] Under the retirement right associated with this partnership interest, at any time after two years from September 30, 1998, PGH LLC, as the transferee of PGH's 95 percent limited partnership interest in Seneca, could exercise its right to compel the partnership to liquidate its interest in exchange for assets of the partnership. PGH LLC was to receive distributions in an amount equal to the positive balance in its capital account (adjusted to account for revaluation of partnership assets), plus the amount of nonrecourse debt assumed by it.

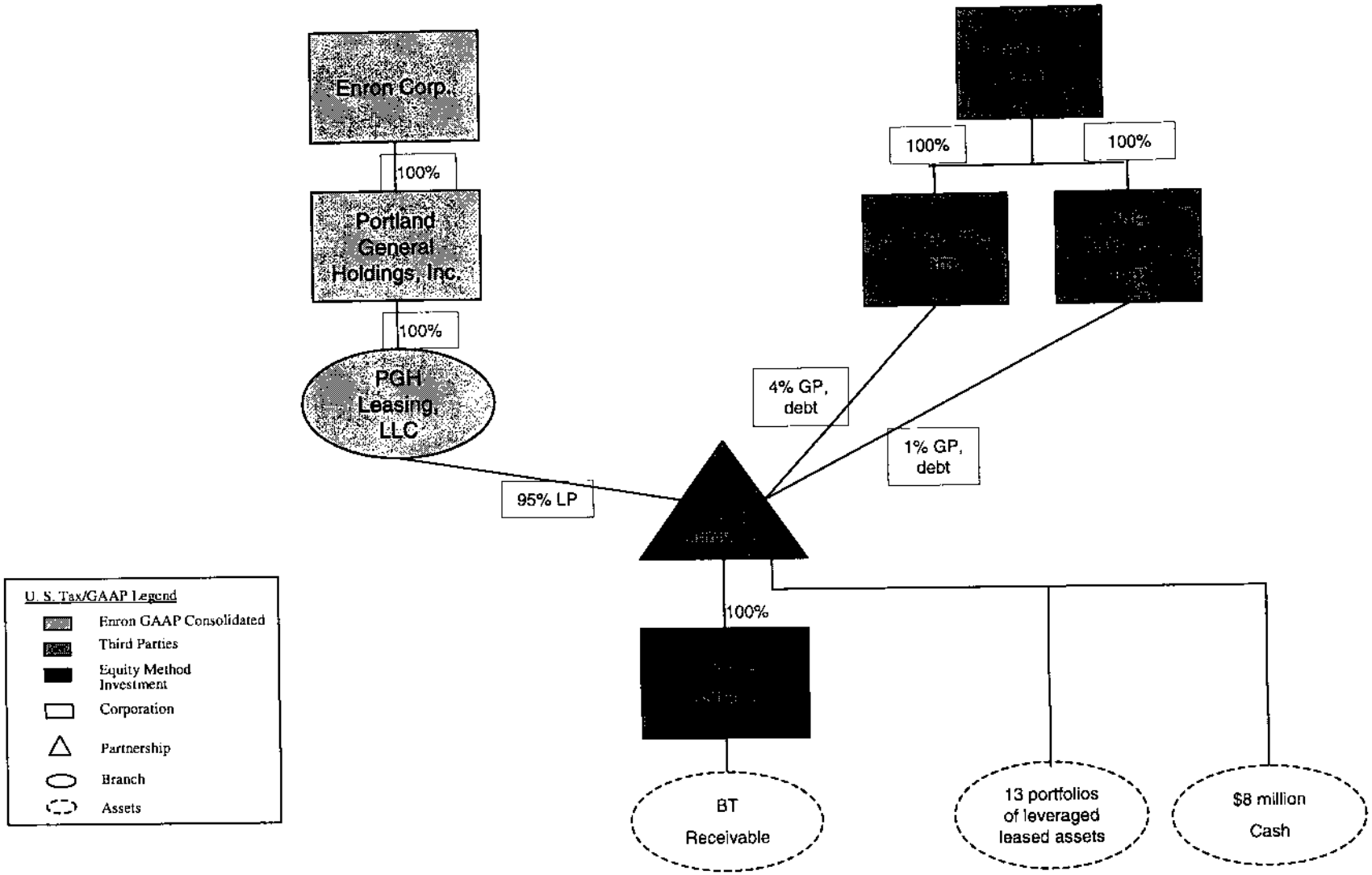
[500] BT Leasing and EN-BT Delaware were to pay all ordinary and necessary expenses of Seneca in exchange for a management fee of $300,000 per year. Pursuant to a service agreement dated September 15, 1998, Oneida was required to pay BT Leasing $300,000 per year to act as its agent to engage in the business of owning and operating a portfolio of leased equipment.

demand promissory note. In turn, Bankers Trust loaned approximately $250 million on a recourse basis to Seneca in exchange for Seneca's note. Seneca repaid $250 million to Toronto Dominion on September 17, 1998.

The end result of the borrowings and repayments on September 15 and 17 among Enron, PGH, Oneida, Seneca, and Bankers Trust was that Oneida held a note receivable from Bankers Trust for approximately $250 million.

The following diagram depicts the structure of Project Tomas after the formation of and contributions to the partnership in September, 1998.

Project Tomas
Structure as of September 30, 1998



Less than two years later, in June 2000, PGH LLC (the wholly-owned company to which PGH had transferred its partnership interest in Seneca) gave notice of its intent to withdraw from the Seneca partnership. Pursuant to the retirement right under PGH LLC's 95-percent limited partnership interest, this notice triggered a public bid valuation process to determine the retirement price. The actual distribution of Oneida stock did not take place until just over two years after the last contribution of property by PGH to the Seneca partnership on September 30, 1998.

On October 2, 2000 (two years and two days after the last contribution to the partnership on Scpptember 30, 1998), PGH LLC's interest in the partnership was liquidated. Seneca distributed the Oneida stock to PGH LLC, the Enron subsidiary, in liquidation of its partnership interest. Because the value of Oneida stock was greater than PGH LLC's capital account in the partnership, PGH LLC also assumed debt of Seneca.[501] The amount of debt assumed was approximately equal to the excess of the value of Oneida stock over PGH LLC's capital account.

Under the tax rules, PGH LLC's basis in the distributed Oneida stock was equal to PGH LLC's basis in its partnership interest (adjusted for the debt assumed in liquidation). As a result, the basis of the Oneida stock was required to be reduced in the hands of PGH LLC.

Seneca made a section 754 election and increased the basis of its remaining property, the leased assets.[502] PGH's low basis in its stock of Oneida would become irrelevant on a liquidation of Oneida into PGH, under the partnership tax rules then in effect, because at that time, the basis of the property inside Oneida was not required to be reduced corresponding to the reduction in the basis of Oneida stock.

Role of outside advisors

Bankers Trust signed an engagement letter dated September 15, 1998, agreeing to serve as Enron's exclusive financial advisor for the transaction.[503] The letter provides that a partnership would be structured between Enron representatives and Bankers Trust

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[501] Oneida issued a demand promissory note to Bankers Trust for $156 million on October 2, 2000 (the date PGH LLC's interest in the Seneca partnership was liquidated). On that same date, Bankers Trust demanded payment of the $156 million, and the note was cancelled. Meanwhile, Bankers Trust agreed to pay Oneida $21 million, in a demand promissory note also dated October 2, 2000. Demand Promissory Note, $156,005,946, October 2, 2000 (ECx000007853 - ECx000007855); Letter of Bankers Trust to PGH Leasing, LLC, Attention: Mr. R. Davis Maxey (October 2, 2000), ECx000007871; Cancelled - Demand Promissory Note, $156,005,946, October 2, 2000, ECx000007872 - ECx000007874; Demand Promissory Note, $21,661,889.67, October 2, 2000, ECx000007876 - ECx000007878.

[502] In April 1999, two of the leased assets were sold to the lessees and a third lease was renegotiated and renewed.

[503] Letter of Brian J. McGuire of Bankers Trust to Mr. Richard A. Causey of Enron, dated September 15, 1998, EC2 000038045 - EC2 000038049. Appendix B, Part VI contains this document.

representatives for purposes of the transaction. Bankers Trust agreed to advise and assist in designing an appropriate structure for the transaction and to perform other services. Bankers Trust would be paid fees of $10 million. This amount did not include fees for additional services such as leased asset management and disposition fees, swaps, bridge financing, valuation services and other services. As of June 4, 2001, Bankers Trust was paid an estimated $11.875 million in project fees in connection with Project Tomas.[504]

The opinion letter regarding the Federal tax issues in the transaction[505] was provided by Akin, Gump, Strauss, Hauer & Feld, L.P. ("Akin, Gump"), and was dated November 23, 1998 (after the formation of and contributions to the partnership in September, 1998). In its opinion letter, Akin, Gump concluded that (1) mergers of PGH subsidiaries holding the leased assets should be treated as corporate liquidations, (2) Seneca should be treated as a partnership for Federal tax purposes, (3) PGH's transfers of the leased assets and the stock of Oneida to Seneca should be tax-free contributions to a partnership, (4) neither the Seneca's receipt of the leased assets subject to $170 million nonrecourse debt, nor Seneca's assumption of the $250 million recourse debt, should be treated as a disguised sale taxable to PGH, (5) the nonrecourse debt should be allocated to PGH first to the extent of the partnership's minimum gain, second to the extent of PGH's precontribution gain, and third, in accordance with its 95-percent profit share, (6) PGH LLC will disregarded for Federal tax purposes, (7) no gain should be recognized in the event PGH LLC exercises its retirement right and receives distributions of cash, the leased assets and stock of Oneida, no gain should be recognized to PGH LLC (except to the extent cash distributed exceeds its basis), because the exceptions for distributions of property the partner contributed should apply, and (8) the foregoing opinions should not be subject to change under the business purpose doctrine, section 269 (relating to acquisitions made to evade or avoid income tax), the substance-over-form doctrine, or the section 701 partnership anti-abuse regulations. Akin, Gump was paid fees of $813,694 in connection with Project Tomas.[506]

In addition, the firm of Andrews & Kurth provided legal counsel with respect to aircraft sales that were planned to take place following operation of the partnership created in the Project Tomas transactions.[507] Accounting support was provided by Arthur Andersen.[508]

As of June 4, 2001, project fees had been paid to several parties in connection with Project Tomas, in addition to Bankers Trust and Akin, Gump. Arthur Andersen, Enron's auditor,

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[504] Estimated Project Fees Paid to Date, 6/4/2001, EC2 000036379. Appendix B, Part I, contains this document.

[505] Appendix C, Part VI to this Report contains the Akin, Gump tax opinion letter Enron received in connection with Project Tomas (EC2 000033917 - EC2 000033979).

[506] Estimated Project Fees Paid to Date, 6/4/2001, EC2 000036379. Appendix B, Part I, contains this document.

[507] Project Tomas, Advisory History, EC2000037987.

[508] *Id.*

was paid fees of $252,593 in connection with Project Tomas. In addition, another $600,000 in fees was paid to "others" in connection with the transaction.[509]

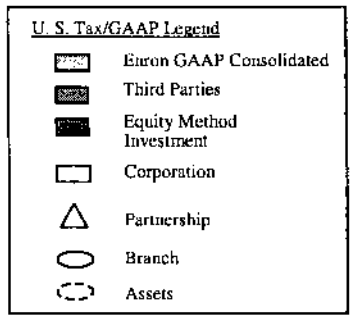
Subsequent developments

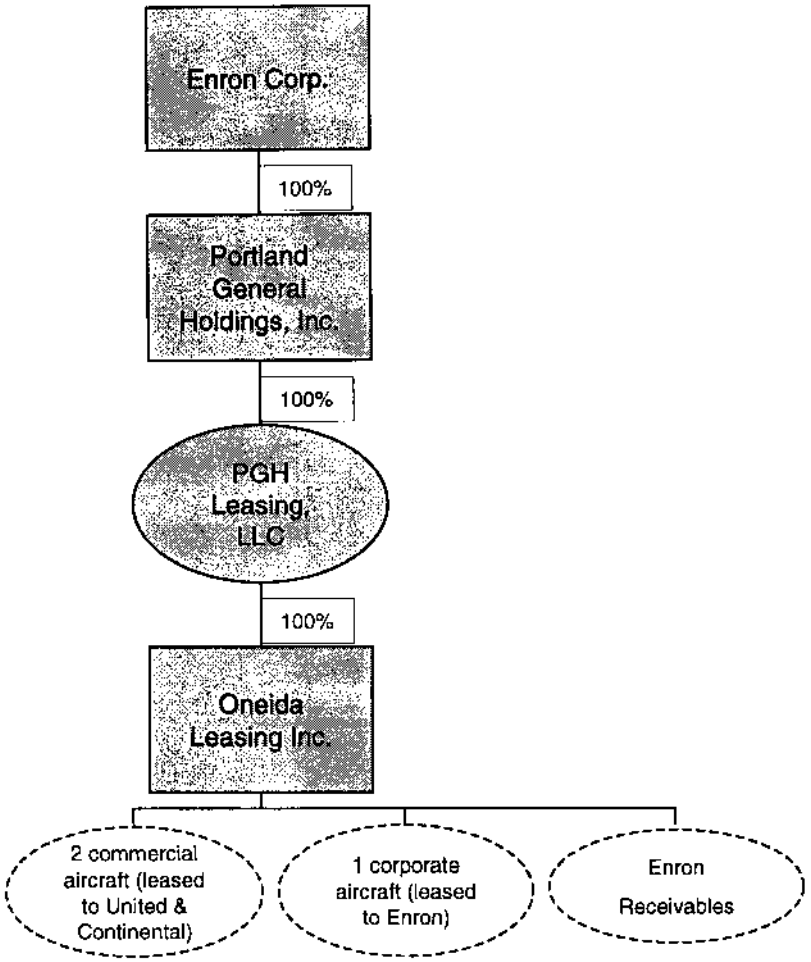
PGH LLC's interest in the Seneca partnership was liquidated on October 2, 2000, just over two years after the assets had been contributed to the partnership in September, 1998. After the liquidation of PGH's LLC interest, the leased assets remained in the partnership. The partnership was owned by the remaining two partners, the two Bankers Trust affiliates (BT Leasing and EN-BT Delaware). Thus, Enron no longer had an interest in the leased assets held by the partnership.

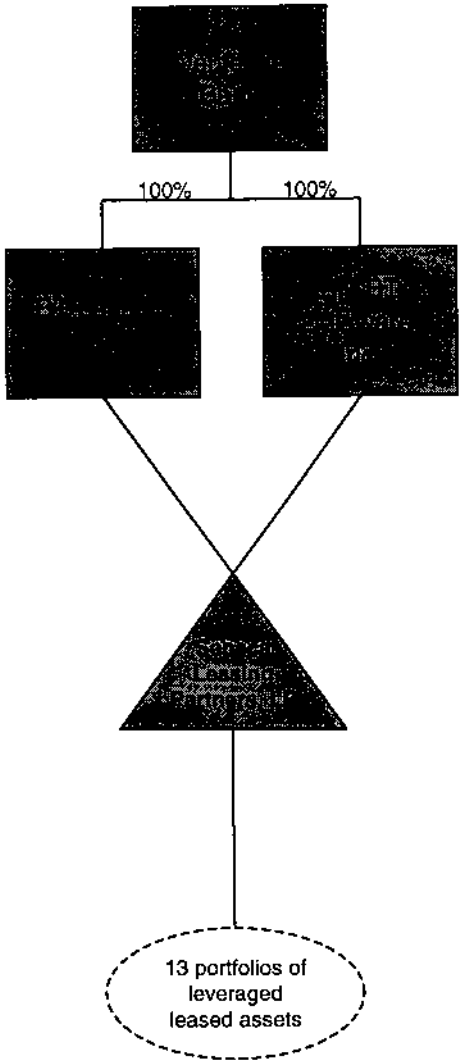
The following diagram depicts the structure of Project Tomas after the liquidation of the partnership interest of the Enron affiliate, PGH LLC, on October 2, 2000.

[509] Estimated Project Fees Paid to Date, 6/4/2001, EC2 000036379. Appendix B, Part I, contains this document.

Project Tomas
Structure as of December 31, 2001







After PGH LLC's interest in Seneca was liquidated in October, 2000, the Seneca partnership sold 18 of its assets on three dates in December, 2000.[510] The sale price for 11 of these assets was reported to be equal to the tax basis, due to the basis increase claimed pursuant to the Tomas transaction. Thus, the Seneca partners (the Bankers Trust affiliates) would have had no taxable gain to report with respect to these 11 sales. In addition to the sales in 2000, the Seneca partnership had sold four assets during 1999, at least one at a loss.[511]

Later, in December 2001, Oneida collected on a "large Deutsche Bank receivable."[512] Bankers Trust had been acquired by Deutsche Bank, so this receivable may have been the note receivable from Bankers Trust for $250 million that Oneida entered into in 1998, in the course of Project Tomas.[513]

One of the representations made by PGH described in the Akin, Gump opinion letter was that PGH intended "that Oneida acquire a substantial portfolio of lease equipment that will further diversify the Partnership's portfolio of equipment."[514] In July 2000, Oneida had acquired two leased assets.[515] These two assets were aircraft, one a Boeing 747 leased to United Airlines, and the other a McDonnell-Douglas DC-9 leased to Continental Airlines. This acquisition preceded by a few months the October, 2000, distribution of Oneida's stock by the Seneca partnership in liquidation of the partnership interest of Enron's subsidiary, PGH LLC. Towards the end of 2001, after Oneida had been distributed to PGH, Enron contacted 13 potential counterparties in connection with disposing of the aircraft. In June, 2002, the sale of the two commercial aircraft by Oneida for $10.3 million (reduced by approximately $4 million of back

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[510] December 11, 20 and 21, 2000, as provided in Exhibit XX -- Sales of Leased Assets by Seneca Leasing Partners, L.P., EC2 000054818. Appendix B, Part VI, contains this document.

[511] The assets sold in by Seneca in 1999 were: Acid Recovery Plant, sold 4/1/99 for $4,649,500 (though the tax basis was $1,278,230, giving rise to a tax loss); Rail Cars (CSX 1998-1), sold 1/4/99 for $8,908,000; Rail Cars (SOO Line 1989), sold 8/2/99 for $32,198; and Tank Cars (GATC 86-1), sold 2/12/99 for $13,871. The tax basis for the latter three items was not stated on Exhibit XX -- Sales of Leased Assets by Seneca Leasing Partners, L.P., EC2 000054818. Appendix B, Part VI, contains this document.

[512] Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001. Appendix B, Part I contains this document.

[513] Oneida also held a demand promissory note of Bankers Trust for $21 million, dated October 2, 2000 (the date PGH LLC's interest in the Seneca partnership was redeemed). Demand Promissory Note, $21,661,889.67, October 2, 2000, ECx000007876 - ECx000007878.

[514] Akin, Gump opinion letter at 10. Appendix C, Part VI, contains this document.

[515] Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001. Appendix B, Part I contains this document.

rent and interest due) was approved by Enron.[516] Oneida also acquired a corporate aircraft that was leased to Enron.[517]

Discussion

The result of the series of transactions comprising Project Tomas was that Enron had disposed tax-free of a portfolio of leased assets that had a built-in gain of $270 million, while the tax basis of assets that Enron received in exchange (i.e., assets held by Oneida) was not reduced. Further, the $270 million built-in gain ultimately was not taxed to the Bankers Trust affiliates that (through the partnership) commenced selling off the portfolio of leased assets.

This permanent tax saving associated with Project Tomas resulted in a significant financial accounting benefit to Enron. Enron could not immediately utilize some types of tax benefits, such as increased deductions or losses, as it was already in a loss position with NOL carryovers. Rather, the permanent tax saving that led to the financial statement benefits from Project Tomas arose from the fact that the Enron received Oneida's underlying assets with a high tax basis without incurring an economic cost (i.e., the recognition of gain on disposed leased assets).

Sale of the leased assets

Central to the structure of Project Tomas was the use of a partnership as a means of exchange between Enron and Bankers Trust of the leased assets that Enron disposed of. Several provisions of present law, designed to prevent the characterization of an otherwise taxable sale as a tax-free partnership contribution and distribution, are implicated in the transaction.

Receipt of property that the Enron affiliate had contributed to the partnership.–Seneca's distribution of the Oneida stock raises the issue of the potential for gain recognition under the "seven-year" rule of present law. Under this rule, gain or loss is recognized on a distribution of partnership property, if a partner contributed property with built-in gain or built-in loss (i.e., the leased assets), and that partner receives a distribution of other property (i.e., stock of a corporation, Oneida, holding a large note) within seven years of the contribution.[518] If this gain recognition rule applied in Project Tomas, PGH LLC would be required to include in income the pre-contribution gain of approximately $270 million on the leased assets when Seneca distributed the Oneida stock.

The transaction is structured so as to rely on the exception providing that this gain recognition rule does not apply to a distribution of property that the distributee partner

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[516] Enron Risk Assessment and Control - Deal Approval Sheet, dated June 26, 2002. EC2 000038061 - EC2 000038065. Appendix B, Part VI contains this document.

[517] Enron Corp. Presentation to Joint Committee on Taxation staff, Washington, D.C., June 7, 2002, Appendix at A-8. Appendix B, Part I contains this document.

[518] Sec. 737.

contributed to the partnership.[519] However, the present-law exception goes on to provide if the property distributed is an interest in an entity (e.g., corporate stock), the exception from gain recognition does not apply to the extent the value of the interest is attributable to property contributed to the entity after the entity was contributed to the partnership. Although the Akin, Gump opinion letter refers to several examples in the regulations in which partnership distributions of stock were taxed to the extent of the value added to a corporation after its stock is contributed to the partnership, the opinion letter does not apply this notion to Seneca's distribution of the Oneida stock. The Akin, Gump opinion letter does not address the point that the $250 million in value was contributed by PGH to Oneida less than two months before the Oneida stock was contributed to the partnership, nor that Enron paid $250 million to Oneida in satisfaction of its note on the same day, September 15, that the Oneida stock was contributed to the partnership. Whether there should be a link between these events as part of an overall planned transaction is not addressed.

Disguised sale treatment.–The tax opinion letter does not discuss whether the contribution of leased assets and the distribution of Oneida stock, taken together, should be characterized as a disguised sale.[520] The Akin, Gump opinion letter refers to the distribution of the Oneida stock hypothetically, "in the event that PGH exercises the retirement right."[521] Nevertheless, it could be inferred that the transaction was deliberately structured to attempt to avoid the disguised sale rules, by ensuring that the partnership distribution does not take place until two years and two days after the last contribution.

Treasury regulations provide a presumption that a transaction does not amount to a disguised sale if the transfer of property and the related contribution of property to the partnership take place more than two years apart.[522] Under these regulations, such transfers are presumed not to be a sale "unless the facts and circumstances clearly establish that the transfers constitute a sale."[523] The two-year presumption in the regulations has two aspects. First, if the contributing and distributing transfers are made within two years, there is presumed to be a sale, unless the facts and circumstances clearly establish there is not a sale. Disclosure to the IRS is required.[524] Second, if the contributing and distributing transfers are made more than two years

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[519] Sec. 737(d). Akin, Gump opinion letter at 33-34. Appendix C, Part VI contains this document.

[520] The tax opinion does discuss whether the partnership's taking the leased assets subject to $170 million of nonrecourse debt, and the partnership's assumption of $250 million of recourse debt, constitute disguised sales of all or part of the leased assets or the Oneida stock PGH contributed to the partnership. Based on a technical analysis applying debt proceeds tracing rules, the opinion concludes that neither constitutes a disguised sale. Akin, Gump opinion letter at 26. Appendix C, Part VI contains this document.

[521] Akin, Gump opinion letter at 31. Appendix C, Part VI contains this document.

[522] Treas. Reg. sec. 1.707-3(d).

[523] *Id.*

apart, the transfers are presumed not to be a sale, unless the facts and circumstances clearly establish that the transfers constitute a sale.[525] No disclosure is required.

Structuring a transaction so that the partnership contribution and distribution are two years and two days apart, as in the case of Project Tomas, may be a fact indicating that a sale should be presumed. Further, the fact that PHG LLC had a "retirement right" under the partnership agreement, permitting it to compel the partnership to liquidate its interest in the partnership after two years, may be a fact indicating that PGH LLC bore very little risk during the two-year period and that it effectively was disposing of the leased assets despite its retention of a 95-percent interest in the partnership during the two-year period. For the IRS to administer this determination based facts and circumstances may be difficult, however, without any requirement of disclosure in the case of transfers more than two years apart.

Partnership anti-abuse rules.–The partnership anti-abuse regulations state 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 (the tax rules governing partnerships), the Commissioner can recast the transaction for Federal tax purposes to achieve tax results that are consistent with the intent of subchapter K.[526] The opinion letter concludes that this rule should not result in recasting the transaction to provide that the Oneida stock was never contributed to the partnership, because PGH LLC has a low basis in the Oneida stock upon its distribution. However, the fact that PGH LLC had easy access to the high-basis, high-value assets Oneida held through the simple expedient of liquidating Oneida[527] cannot be dismissed as irrelevant to the rules of partnership taxation,[528] as it was available to achieve the tax savings that were central to Project Tomas. The use of a partnership to achieve the tax-free disposition of built-in gain assets should be considered inconsistent with the intent of subchapter K, within the meaning of these regulations.

Tax legislation over the past two decades has included several provisions intended to prevent the use of partnerships as a vehicle to disguise sales of assets as tax-free transactions. In 1984, Congress enacted the rule providing that if there is a transfer of money or other property

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[524] Treas. Reg. sec. 1.707-3(c).

[525] Treas. Reg. sec. 1.707-3(d).

[526] Treas. Reg. sec. 1.701-2(b).

[527] Sec. 332, discussed in the Akin, Gump opinion letter at 48. Appendix C, Part VI contains this document.

[528] This argument is made in the Akin, Gump opinion letter at 48. Appendix C, Part VI contains this document. Partnership tax legislation enacted in 1999, before the distribution of Oneida stock was consummated, would have applied to this transaction and required that the basis of Oneida's assets be reduced, except for a transition rule providing a two-year window for distributions from existing partnerships. See Pub. L. No. 106-170, section 538(a) (December 17, 1999), enacting section 732(f).

by a partner to a partnership and there is a related transfer of money or other property by the partnership to such partner, the two transfers (when viewed together) may be properly characterized as a sale or exchange of property and will therefore be treated as such. In 1989 and 1992, Congress added rules requiring gain recognition with respect to appreciated property contributed to a partnership in the event that distributions (either of the contributed property to a noncontributing partner, or of other property to the contributing partner) are made within seven years of the contribution.[529] Though it postdates the initiation of Project Tomas, in 1999, Congress enacted rules providing that the basis of a corporation's assets is reduced to parallel the reduction in the basis of the corporation's stock when it is distributed to a partner with a low basis in its partnership interest.[530] The enactment of these rules indicates a concern over the use of partnerships to transfer property among persons in a manner that avoids tax that would be due on sale of the property. Project Tomas' use of partnership rules for a tax-free disposition of the leased assets owned by Enron affiliates to the Bankers Trust affiliates, who remained as partners after the Enron affiliate retired from the partnership, contravenes the intent of this legislation in subchapter K.

Use of debt

In the Project Tomas transaction, the basis increase to the leased assets arose from recent debt incurred by an Enron affiliate and guaranteed by Enron. Whether this debt had real economic substance apart from its use to facilitate tax benefits in the transaction could be questioned. This debt was cycled through Oneida, assumed by the partnership and was paid off by the partnership within two months of when the debt was incurred. As the proceeds of the debt were passed from one party to the transaction to another, a debt obligation of Bankers Trust to Oneida was created that later may have served as Bankers Trust's "payment" to Enron in the "sale" of the leased assets. The purpose, function, and economic substance of debt whose proceeds are rapidly cycled through parties to a complex transaction warrant close examination.

Business purpose

Scrutiny of Project Tomas as a whole, rather than as numerous separate pieces of a complex series of transactions, gives a different picture of the goal of the transaction. While the tax opinion concluded that utilizing the lease management expertise of Bankers Trust was an appropriate business purpose for the transaction, it also concluded that the expectation of financial accounting benefits constituted a business purpose.[531] The tax benefits with respect to a transaction that satisfies the literal requirements of a particular tax provision may not be respected if the transaction fails the statutory rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate the purported tax benefits in

[529] Secs. 704(c)(1)(B) and 737.

[530] Sec. 732(f).

[531] Akin, Gump opinion letter at 7. Appendix C, Part VI contains this document.

tax-motivated transactions. Therefore, any analysis of whether the tax benefits in Project Tomas would be respected must take into account the applicability of these doctrines.[532]

Duplication of tax basis of assets

The opinion letter for Project Tomas did not address the issue of whether the basis of Oneida's assets should be reduced to parallel the reduction in the basis of the Oneida stock when it was distributed to a partner with a low basis in its partnership interest.[533] The provision that would require such a reduction in the basis of Oneida's assets was not enacted until 1999.[534] This provision was designed to prevent taxpayers from nullifying the downward basis adjustment to property distributed by a partnership to a corporate partner with a low basis in its partnership interest. If the property distributed to a corporate partner is corporate stock, then a subsequent liquidation of the corporation so distributed could nullify the required adjustment to the stock basis, if the basis of the distributed corporation's assets is not also reduced.

Enron was made aware of the likelihood of legislative change in this area as Project Tomas was being planned. The December 11, 1997, letter from Arthur Andersen to Enron setting forth an early version of the Project Tomas transaction describes this technique, and notes that among the possible risks of doing such a transaction would be the risk that Congress would change the rule, identifying it as "a possible target for legislative change."[535] The letter concluded, "[b]ecause of the substantial benefits this product provides, and the possibility of legislative action, you should be advised to utilize the technique now, as its shelf life may be

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[532] For detailed information on the present law rules and judicial doctrines applicable to tax motivated transactions and related recommendations and developments, *see e.g.*, Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint Committee on Taxation, *Description of the "CARE Act of 2003,"* (JCX-04-03), February 3, 2003; Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters,* 54 SMU L. Rev. 1 (2001).

[533] The opinion letter did refer to possible legislation, but concludes that Congress "has chosen not to revise the Code in such a fashion." Akin, Gump opinion letter at 48. The provision was enacted on December 17, 1999 (Pub. L. No. 106-170).

[534] Sec. 732(f). In the case of a partnership already in existence on July 14, 1999, the rule applied to distributions after June 30, 2001. The distribution of the Oneida stock by the Seneca partnership took place on October 2, 2000.

[535] Letter from Robert P. Palmquist of Arthur Andersen to David Maxey of Enron Corp., dated December, 11, 1997, EC2 000038050 – EC2 000038052. Appendix B, Part VI contains this document.

limited."[536] The assets of the distributed corporation, Oneida, consisted principally of a note from Bankers Trust.[537] If the basis of the note had been reduced, Enron affiliates would have been subject to tax on the gain when the notes were collected or when Oneida was liquidated.

In enacting the downward basis adjustment rule[538] in 1999, Congress directly addressed the type of basis duplication that occurred in the Tomas transaction. Had the downward basis adjustment rule applied to the Tomas transaction, Enron would not have been able to take the position that the transfer of the portfolio of leased assets to the Bankers Trust affiliates that remained as Seneca partners would result ultimately in no tax to Enron or its affiliates. Gain would have resulted from liquidation of Oneida or sale or other disposition of the assets held by Oneida. Project Tomas was the only transaction of this type in which Enron engaged.

Recommendations

To dispose of the leased assets with a stepped-up basis without incurring tax, Enron formed a partnership with Bankers Trust, which in essence served as an accommodation party in the transaction. Without a willing though unrelated third party to hold the leased assets through a partnership for at least two years before selling them off, the tax savings and financial statement benefits claimed through the use of this structure would not have been possible. Use of accommodation parties to achieve results under tax rules that contemplate parties with adverse interests can give rise to unintended results. The Joint Committee staff recommends that use of accommodation parties under the tax rules be addressed.

The Joint Committee staff recommends that the period for which disclosure is required under the disguised sale regulations should be extended beyond two years, and a more detailed disclosure of the source of permanent book-tax differences should be required. Congress has repeatedly enacted legislation to limit the utility of partnerships as vehicles for the tax-free disposition of assets. However, enforcement some of these rules, especially those involving a facts and circumstances determination, may be difficult without adequate disclosure of the transactions to the IRS. For example, extending the disclosure requirement under the disguised sale rules to seven years, the period applicable to contributions and distributions under the pre-contribution gain rules,[539] could make a facts and circumstances determination by the IRS both more likely to occur and easier for the IRS to administer. Despite the possible recordkeeping burden it might impose on taxpayers, a longer disclosure period would facilitate examination of tax motivated transactions without impeding legitimate joint ventures.

For the IRS to identify this transaction on Enron's voluminous tax return may be difficult without specific signposts pointing to it, because the high basis in Oneida's assets would be

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[536] *Id.*

[537] Oneida also acquired two commercial aircraft, which it sold in 2002, and a corporate jet leased to Enron.

[538] Sec. 732(f).

[539] Secs. 704(c)(1)(B) and 737.

recovered primarily as depreciation deductions over time, or as the absence of gain recognition on receipt of payment on a note Oneida held. As a corollary to increased disclosure of contributions to and distributions from partnerships, a more detailed or earlier disclosure to the IRS of the source of permanent book-tax differences could facilitate the discovery of questionable transactions on audit.

3. Project Condor

Background

Brief overview

Project Condor[540] was structured to generate approximately $930 million of Federal income tax deductions without incurring any economic outlay. In addition, because there was no corresponding financial statement expense, the tax savings associated with these deductions were anticipated to generate approximately $330 million after-tax financial statement income. Enron intended to report the $330 million of financial statement income over the anticipated 16-year life of the structure, whereas the $930 million of Federal income tax deductions were not anticipated to be available to offset Enron's taxable income until beginning in 2015.

The structure involved the use of an existing partnership, Whitewing Associates, LP ("Whitewing LP"), between Enron Corp. and an outside investor (the "Osprey Invesors") that held Enron Corp. preferred stock.[541] In 1999, purportedly in connection with a restructuring of the partnership, Houston Pipe Line Company ("HPL"), a wholly owned subsidiary of Enron Corp., contributed natural gas pipelines and related storage facilities (the "Bammel Assets") with a fair market value of approximately $930 million and minimal tax basis[542] to Whitewing in return for a preferred partnership interest. The contributed assets were immediately leased back to HPL for a period of 18 years.

Because the fair market value of the Bammel Assets was different than their adjusted tax basis, the partnership tax rules operate to specially allocate the taxable income of the partnership to take into account the tax consequences of this disparity (the "pre-contribution gain").[543] Enron planned to use these rules to allocate $930 million of deductions to Enron Corp. and to allocate $930 million of income to HPL over a 16-year period. Because Enron Corp. and HPL were both members of the Enron consolidated group, the allocation and the offsetting allocation, in essence, equalized so as not to create any additional tax liability for the consolidated group. However, under the partnership tax rules, the special allocation of income and deductions results

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[540] The information regarding Project Condor was obtained from Joint Committee staff interviews of Robert J. Hermann, R. Davis Maxey, James A. Ginty, and Anne Marie Tiller, as well as from documents and information provided by Enron Corp. and the Internal Revenue Service.

[541] The primary purpose of the original transaction between Enron and the Osprey investors had been to convert debt to equity. EC2 000037507.

[542] Enron reported that the assets had $31 million of tax basis and a fair market value of $930 million.

[543] Sec. 704(c).

in a reduction of Enron Corp.'s tax basis in its partnership interest to zero[544] and an increase in HPL's tax basis in its partnership interest from zero to $930 million.[545]

The strategy anticipated distributing the Bammel Assets back to HPL in redemption of its Whitewing preferred partnership interest after 16 years. Under the partnership tax rules, HPL would ascribe its partnership tax basis to the Bammel Assets. Thus, the tax basis would be "stepped-up" from zero to $930 million and HPL could begin to depreciate the Bammel Assets for Federal income tax purposes. The Enron preferred stock held by the partnership would be "stepped-down" by a corresponding amount; however, Enron Corp. could use one of several strategies to avoid recognizing any taxable gain with respect to such stock.

Reported tax and financial statement effects

Project Condor generated approximately $88 million in net earnings for financial reporting purposes through the third quarter of 2001.[546] Project Condor had no impact on Enron's tax return through 2001[547] other than the deduction of approximately $2 million of transaction costs.[548]

Development of Project Condor

The development of the tax aspects of Project Condor began as early as December of 1998.[549] Correspondence between Deloitte & Touche LLP ("Deloitte & Touche"), and Mr. Maxey and other Enron tax personnel indicate that during the early months of 1999 various

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[544] The $930 million of deductions would have exceeded Enron Corp.'s tax basis, thus resulting in some deductions being suspended under sec. 704(d). However, the structure envisioned Enron Corp. purchasing the interest of the Osprey Investors or contributing cash to alleviate this problem.

[545] Sec. 705.

[546] In December 2001, Enron recorded an $84.1 million financial accounting charge in order to place a valuation reserve against the previously reported earnings. The Project Condor materials in Appendix B contain an opinion letter to Chase Securities, Inc. from Arthur Andersen regarding the the financial accounting implications of a transaction that mirrors Project Condor. Enron indicated that it was unclear why Chase Securities, Inc. received this opinion or why they sent it to Enron. Presumably, that Chase was marketing or engaging a transaction similar to Project Condor and was interested in ascertaining the accounting benefits of such transaction. EC2 000037515 - EC2 000037520.

[547] The approximately $930 million of tax deductions to be generated by Project Condor were projected to be available beginning in 2015.

[548] Information obtained from a summary discussion of Project Condor. EC2 000037455. Enron stated it was amortizing the transaction costs over a three-year period.

[549] Structured Transactions Group Summary Nov. 2001 - Project Condor.

models were developed to evaluate the benefits to Enron of engaging in the tax strategy.[550] The models used differing assumptions as to assets contributed, the tax basis of the assets contributed, and residual value of the contributed property.

In April 1999, a draft presentation was prepared for Project Condor providing a broad overview of the transaction structure, financial accounting impacts, the tax benefits of the transaction, and the risks of the transaction and mitigating factors.[551] The presentation materials identified the following transaction risks (1) the need for a business purpose, (2) a fiscal year 2000 budget proposal that would tighten the standards applicable to corporate tax shelters and basis shifting transactions, and (3) a general risk of law change. The primary mitigating factors listed were that (1) the transaction would occur as part of an overall restructuring of an existing partnership, (2) the budget proposals were not expected to receive Congressional support and could be structured around, and (3) the transaction could be unwound at any time and the complications on an "unwind" are minimized since the transaction occurs mainly between two Enron entities. A subsequent presentation document indicated that another mitigating factor was that the audit risk is very low because no position is taken on Enron's consolidated tax return until assets are distributed from the Whitewing structure (anticipated to be 2015).[552]

The evaluation of the proposed transaction continued into the summer months and on August 20, 1999, an engagement letter between Enron and Deloitte & Touche was signed.[553] The agreement provided that Deloitte & Touche would advise Enron on structuring a preferred return partnership interest to be issued out of an existing entity.

At a special meeting of the Board of Directors of Enron on September 17, 1999, the Board of Directors was presented with a broad overview of the proposed restructuring of the Whitewing partnership, including the redemption of Whitewing's existing Enron preferred stock in exchange for a new class of Enron preferred stock and the contribution of merchant assets to the Whitewing structure. Following the presentation, the Board of Directors approved a resolution authorizing Enron to undertake the transactions involved in the refinancing of approximately $1 billion of mandatory convertible preferred stock of Enron.

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[550] A memo from Steven E. Klig of Deloitte & Touche to Mr. Maxey dated February 27, 1999 provided a summary of various alternatives and detailed schedules of the implications of these alternatives for the anticipated sixteen year period of the structure. EC2 000037456 - EC2 000037481.

[551] There is no indication of who prepared or received copies of the presentation materials. The Project Condor materials in Appendix B contain the presentation materials. EC2 000037482 - EC2 000037493.

[552] Discussion materials for Project Condor dated November 9, 1999. EC2 000037500.

[553] Richard J. Causey on behalf of Enron and Stephen E. Klig on behalf of Deloitte & Touche signed the agreement.

Enron's stated business purpose for contributing the Bammel Assets to the Whitewing LP structure was to provide enhanced collateral to support the Osprey Investors investment, thereby reducing the overall financing cost to Enron.

Implementation of Project Condor

HPL Asset Holdings LP ("HPL Asset Holdings"), a Delaware limited partnership, was formed on November 9, 1999. On November 10, 1999, HPL and Enron Corp.[554] contributed property to HPL Asset Holdings in return for partnership interests. HPL transferred the Bammel Assets[555] to HPL Asset Holdings in return for a 99.89 percent limited partner interest and a 0.01 percent general partner interest.[556] Enron contributed $1 million to HPL Asset Holding in return for a 0.10 percent limited partnership. The Bammel Assets contributed by HPL had adjusted tax basis of approximately $30 million and an ascribed fair market value of $930 million. The Bammel Assets were immediately leased back to HPL for a period of 18 years.[557]

Immediately following the contribution, HPL assigned its general partnership interest to Blue Heron I LLC, ("Blue Heron") a single member limited liability company owned by Whitewing LP, in exchange for an interest in Blue Heron. Immediately thereafter HPL assigned its interest in Blue Heron and its 99.89 percent limited partnership interest in HPL Asset Holding to Whitewing LP in exchange for a preferred partnership interest in Whitewing LP. HPL, immediately thereafter, contributed its limited partnership interest in Whitewing LP to Kingfisher I LLC ("Kingfisher"), a single member Delaware limited liability company owned by HPL.[558]

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[554] Enron's interest was legally held by Peregrine I LLC. Because Enron Corp. elected to disregard Peregrine I LLC for Federal income tax purposes, Enron Corp. is considered the owner for Federal income tax purposes. As such, this Report reflects Enron Corp. as the owner rather than Peregrine.

[555] The Bammel Assets consisted of an underground natural gas storage reservoir and related facilities, the storage facility equipment, and the Houston Loop and Texas City Loop natural gas pipelines and related assets.

[556] Information contained in Agreement of Limited Partnership of HPL Asset Holdings. Ecx000002059.

[557] The lease agreement between HPL Asset Holding and HPL required the parties to obtain an appraisal to determine the fair value and residual value of the Bammel Assets for purposes of computing the appropriate base rent between the related parties. This was to be performed by December 31, 1999. The appraisal was never done.

[558] Because HPL elected to disregard Kingfisher I LLC for Federal income tax purposes, HPL is considered the owner of the Whitewing partnership interest for Federal income tax purposes. As such, this Report reflects HPL as the owner rather than Kingfisher I LLC.

As a result of the aforementioned steps, Whitewing LP owned a 99.89 percent limited partnership interest and 0.01 percent general partnership interest in HPL Asset Holdings[559] and Enron Corp. owned a 0.10 percent limited partnership interest in HPL Asset Holdings. In addition, the Osprey Investors and HPL owned preferred partnership interests of Whitewing LP with Enron Corp. and a partnership between Enron Corp. and the Osprey Investors owning the remaining interests in Whitewing LP.

Because the Bammel Assets contributed by HPL had a minimal tax basis and an ascribed value of $930 million at the time of contribution, the assets were subject to the tax allocation rules of section 704(c). HPL Asset Holdings elected to use the remedial allocation method under section 704(c) with respect to the Bammel Assets.[560] For purposes of section 704(c), HPL Asset Holdings elected to recover the Bammel Assets using the 150-percent declining balance method over 15 years.[561]

The amended Whitewing LP partnership agreement contains special provisions that allocate 100 percent of the depreciation deductions associated with the Bammel Assets to Enron and 100 percent of the income, gains, deductions and losses associated with the Bammel Assets to Enron and HPL.[562] Thus, the allocations required under section 704(c) and any income or loss in the Bammel Assets would impact only Enron and its affiliate, HPL. The special partnership provision, in connection with the section 704(c) allocation rules, would cause Enron Corp.'s tax basis in Whitewing to decrease by $930 million and HPL's to increase by $930 million over the recovery period of the Bammel Assets.

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[559] Whitewing's interest in HPL Asset Holdings was legally owned by Blue Heron. However, Whitewing disregarded Blue Heron for Federal income tax purposes. Thus, Whitewing is considered the owner of the HPL Asset Holding partnership interest for Federal income tax purposes. As such, this Report reflects Whitewing as the owner rather than Blue Heron.

[560] As a result of HPL contributing its partnership interests in HPL Asset Holdings to Whitewing LP (and Blue Heron), the regulations under section 704(c) require that Whitewing LP allocate its distributive share of HPL Asset Holdings income and loss with respect to the section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. Treas. Reg. sec. 1.704-3(a)(9).

[561] Asset Class 46.0 ascribed a recovery period of 15 years to assets used in the commercial and contract carrying of natural gas by means of pipes. See Rev. Proc. 87-56,1987-2 CB 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 CB 785).

[562] The Osprey Investors had no economic interest in the income, gain, loss, or deduction associated with the Bammel Assets. E 28035 - E28036.

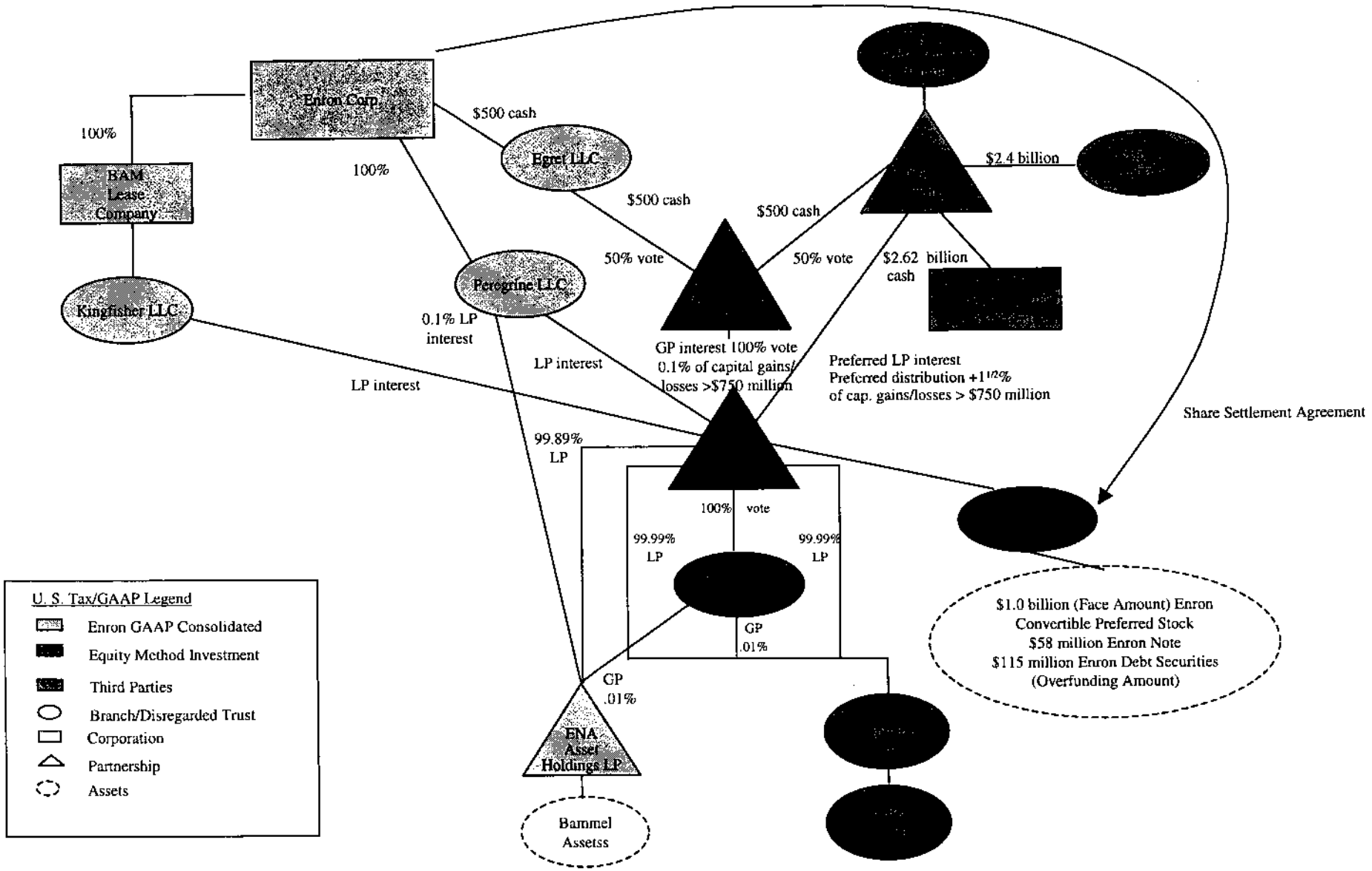
The strategy envisioned distributing the Bammel Assets back to HPL after 16 years, in redemption of HPL's partnership interest.[563] Under the partnership tax rules, HPL would ascribe its partnership tax basis (as increased through the partnership allocations) to the distributed pipeline. Thus, it was anticipated that the tax basis in the Bammel Assets would be "stepped-up" from approximately zero to $930 million. Whitewing, if a section 754 election were made, would be required to decrease the basis of the remaining partnership property by an offsetting amount. The strategy anticipated that Whitewing's only asset at such time would be Enron stock. As such, the Enron stock would be reduced by $930 million. However, Enron Corp. could avoid recognizing the inherent gain in the Enron stock either through section 1032 or by other tax strategies. Thus, Project Condor would result in an additional $930 million of tax deductions without any economic outlay.

The diagram on the next page depicts the Project Condor structure.

[563] Although the Whitewing partners generally had no right to a return of capital contributions, a special provision of the partnership agreement permitted HPL to request a distribuion of the Bammel Assets to the extent of its capital account. E28035

Confidential

Project Condor
Structure as of December 31, 2001



Role of outside advisors

Deloitte & Touche promoted the strategy and was the tax advisor on the structuring of the preferred partnership structure. In addition, Vinson & Elkins was engaged to provide tax advice on the transaction including a tax opinion regarding the Federal income tax treatment of certain partnership events and activities.

Deloitte & Touche was paid $8.325 million for its services.[564] Vinson & Elkins was paid $1.2 million for its services.[565]

Subsequent developments

In June 2001, Enron Corp. sold HPL stock to American Electric Power ("AEP"), an unrelated party. In connection with the sale, HPL transferred its leasehold interest in the Bammel Assets and its interest in Whitewing LP to BAM Lease Company, a wholly owned subsidiary of Enron. In addition, BAM Leasing Company subleased the Bammel Assets to AEP for 30 years with a option to extend for an additional 20 years.[566]

Discussion

Project Condor was specifically structured to take advantage of the interaction between the partnership allocation and basis rules and section 1032, which provides for the nonrecognition of gain or loss to a corporation on the receipt of money or other property in exchange for stock of such corporation. Described in its simplest form, Project Condor purports to permit Enron to shift approximately $930 million of tax basis from Enron's own stock to the Bammel Assets owned by HPL, a wholly owned subsidiary of Enron. Under the strategy devised in Project Condor, the benefits of the increased tax basis would inure over a 16-year period and would not be available for use on Enron's consolidated tax return until the end of that

[564] Engagement letter between Deloitte & Touche and Enron Corp. dated August 20, 1999. EC2 000037496 - EC2000037498.

[565] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated Jan 13, 2003, answer 57.

[566] As mentioned above, Enron did not obtain an appraisal of the Bammel Assets in 1999 as required under the original lease agreement. Enron ascribed a value of approximately $930 million to the Bammel Assets for purposes of section 704(c). In 2001, in connection with the sale of HPL to AEP, an internal Enron memorandum valued the Bammel Assets at $460 million. EC2 000054384. Because no independent appraisal was done in 1999, it is not clear whether the value of the Bammel Assets declined by 50 percent between 1999 and 2001 or whether the original valuation ascribed by Enron was grossly overstated to maximize the tax benefits of Project Condor.

period (2015). However, and potentially more important to Enron, the strategy permitted Enron to begin to record the benefits immediately for financial accounting purposes.[567]

Business purpose

A determination of whether Enron should be entitled to the tax benefits Project Condor purported to provide necessarily involves an analysis regarding Enron's satisfaction of the literal requirements of the tax rules as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate claimed tax benefits in tax-avoidance transactions.[568]

Partnership allocations

Project Condor's strategy involved the use of the remedial allocation method under section 704(c) to allocate deductions to Enron while allocating an offsetting amount of income to HPL. As described in more detail in present law, these rules were enacted in order to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under these rules, the required allocations generally have significant tax implications to the partners.[569] However, when related parties are involved, the shifting of income and deductions among the partners, which would normally have significant economic implications to each partner, is no longer a concern. Thus, a taxpayer is potentially able to use the required allocation rules to shift tax attributes among related entities to its advantage without any economic implications to the taxpayer.

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[567] This occurs in certain situations because Statement of Financial Accounting Standard 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes. See the Background and Rationale section to this part of the Report, which contains a general explanation of relevant aspects of Financial Accounting Standard No. 109, Accounting for Income Taxes.

[568] For detailed information of the present law rules and judicial doctrines applicable to tax avoidance transactions and related recommendations and developments, *see e.g.*, Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint Committee on Taxation, *Description of the "CARE Act of 2003,"* (JCX-04-03), February 3, 2003; Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters,* 54 SMU L. Rev. 1 (2001).

[569] In many situations, the allocation method chosen by the partnership to account for the pre-contribution gain can be one of most contentious tax negotiations between the partners because of the tax implications to the respective partners.

Highlighting that the allocation had no economic impact on the Enron partners, the Whitewing partnership agreement contained a special provision that allocated 100 percent of the depreciation deductions associated with the Bammel Assets to Enron (instead of its ratable ownership share). Normally, such a special allocation would be detrimental to the contributing partner as it would result in additional taxable income to such partner, but because both Enron and HPL were part of the Enron consolidated tax return, the allocations had no impact on the consolidated group's taxable income.

The use of the remedial allocation method and the special provision allocating 100 percent of the Bammel Assets depreciation to Enron Corp. facilitated the maximization of the purported tax benefits of the structure. Without these items Enron Corp. and HPL would have been able to effectuate a basis shift between themselves of only a portion of the $930 million value.[570] However, through these items, a basis shift of the full $930 million value of the Bammel Assets could be accomplished at no economic cost and the exit strategy could be undertaken.

Partnership basis rules on liquidating distributions and section 754 adjustments

The strategy anticipated distributing the Bammel Assets back to HPL in redemption of its Whitewing preferred partnership interest after 16 years. Under the partnership rules, HPL ascribes its partnership tax basis to the Bammel Assets. Thus, the tax basis would be "stepped-up" from zero to $930 million and HPL could begin to depreciate the Bammel Assets for Federal income tax purposes. It was anticipated that the only remaining asset of Whitewing would be Enron stock, and that the stock would be "stepped-down" by a corresponding amount. However, Enron Corp. could use one of several strategies to avoid recognizing any taxable gain with respect to such stock under section 1032. The permanent exclusion of this gain allowed Enron to report a financial accounting benefit with respect to the transactions.[571]

Application of May Company regulations

If finalized, it is possible that the transaction would be subject to proposed regulations regarding gain recognition upon certain partnership transactions involving a partner's own stock.[572] Specifically, under the proposed regulations, the contribution of the Bammel Assets to the Whitewing partnership (which held Enron preferred stock) may have resulted in a deemed

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[570] The exact amount would depend on the partnership ownership percentages and operations.

[571] If the partnerships held assets other than Enron stock, then instead of a permanent exclusion of gain, the transactions would have generated only a deferral of gain (because Enron eventually would pay tax with respect to the assets) with no resulting financial statement income.

[572] Prop. Treas. Reg. sec. 1.337(d)-3(d). These regulations apply to transactions or distributions occurring after March 9, 1989. *See also*, Notice 89-37, 1989-1 C.B. 679, and Notice 93-2, 1993-2 C.B. 292 (effective date of proposed regulations under sec. 1.337(d)-3).

redemption requiring gain recognition by HPL.[573] In addition, if Whitewing distributed to Enron its own stock (or the stock of an affiliate), the distribution would be characterized as a redemption (or an exchange of the stock of the partner) for a portion of the partner's partnership interest with a value equal to the stock distributed.[574] Thus, gain could be recognized on that portion of the distribution.[575]

In evaluating the risks of the proposed regulations to Project Condor, Enron stated that, in off-the-record discussions, Treasury Department personnel had indicated that the regulation will never be finalized, and even if finalized, the regulation would take a different form.[576] Because the regulations have not been finalized, they are not authoritative at this time.[577]

Application of partnership allocation anti-abuse rule

The section 704(c) regulations upon which Enron relied to trigger the basis shift state that generally, the remedial allocation method is a reasonable method for allocating pre-contribution gain.[578] However, an anti-abuse rule states that an allocation method is not reasonable if the contribution of the 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 partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[579] Although the allocations between the Enron entities offset for tax purposes, considering that Enron had prearranged all of the steps to cause a substantial reduction of its tax

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[573] Because of the special allocations, distribution rights, and Enron Corp. being a partner, it is not certain that HPL would be considered to have exchanged appreciated property for an interest in Enron stock.

[574] Prop. Treas. Reg. sec. 1.337(d)-3(e).

[575] *Id.*

[576] The Project Condor materials in Appendix B contain part of an interoffice memorandum regarding the proposed restructuring of Whitewing LP from Anne Marie Tiller dated February 26, 1999. EC 000850731- EC00850735. See also, Project Condor materials in Appendix B, document titled "Nighthawk Restructuring Summary." EC 000850800 - EC 000850801. Enron called the overall restructuring of which Project Condor was a part Project Nighthawk and Project Daybreak.

[577] For the legal authority attributed a proposed regulation, see *Freesen v. Commissioner*, 84 TC 920 (1985) (proposed regulations carry no more weight than position or argument advanced by party on brief), *Estate of H.A. True, Jr. v. Commissioner*, 82 T.C. Memo 2001-167 ("we [courts] accord them [proposed regulations] no more weight than a litigating position").

[578] Treas. Reg. sec.1.704-3(a)(1).

[579] Treas. Reg. sec. 1.704-3(a)(10).

liability, and made affirmations that it would complete the steps,[580] the anti-abuse rule should apply to preclude the use of the remedial allocation method in this situation.[581] If the anti-abuse rule does not preclude this type of activity, then the meaningfulness of this rule must be questioned.[582]

Application of partnership anti-abuse regulations

Subchapter K contains two anti-abuse rules relating to partnerships.[583] These rules state 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, 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, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.[584]

One factor that is potentially indicative of abuse is whether substantially all of the partners are related. Using the Whitewing partnership superficially provided Enron with an unrelated partner (the Osprey investors). However, a review of the documents indicates that the

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[580] In order for Enron to record the financial accounting benefits of such transaction it was required to reasonably represent to its independent auditor that it has a planning strategy that, without incurring significant cost, would enable it to retire or dispose of the Enron shares without incurring a tax cost.

[581] Treasury Regulation 1.704-3(a)(1) states that an allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. However, related parties acting in concert should be a situation that warrants the imposition of the anti-abuse rule. In this situation, had Enron used the traditional allocation method the tax results it was intending to obtain would not have been available. It is also possible that the traditional method with curative allocations would not have precluded it from obtaining the desired results.

[582] Interestingly, neither the Vinson & Elkins tax opinion nor any of the tax advice the Joint Committee staff reviewed from Deloitte & Touche discussed the application or potential application of the section 704(c) anti-abuse rule. However, Enron internal documentation indicates that the application of the remedial allocation method should not run afoul of the rule and, in fact, follows it to the letter. The document indicates that the anti-abuse regulation is not applicable because in this case, the tax consequences are not being "shifted" but are instead being allocated to the partner whose contribution of property had the built-in gain. EC 000850646. This reading of the regulation results in the remedial allocation never being subject to the anti-abuse rule, a result specifically rejected by the Treasury Department in the issuance of the final regulations (TD 8585, 1995-1 CB 120). The Project Condor materials in Appendix B contain the internal document in its entirety. EC 000850644- EC 000850647.

[583] Treas. Reg. sec. 1.701-2.

[584] Treas. Reg. sec. 1.701-2(b).

unrelated partner did not share in any of the economic income or loss in the Bammel Assets. Specifically, any income, gain, loss, or deduction associated with the Bammel Assets was allocated solely to Enron or HPL. In addition, the partnership agreement contains a special provision that requires the distribution of Bammel Assets to HPL upon HPL's request.[585] These facts reflect that, substantively, these transactions were solely between Enron and its wholly owned subsidiary HPL.

Another factor that is potentially indicative of abuse is the lack of a business purpose. Enron's stated business purpose for engaging in the structure was to enhance the collateral of the Whitewing LP structure to lower it's financing cost with the Osprey investors. However, the amended and restated Whitewing LP agreement was completed on September 24, 1999. The partnership agreement permits, but does not require, Enron to make further capital contributions to Whitewing.[586] As described above, the Osprey investor had no economic interest in the income, gain, loss, or deduction with respect to the Bammel Assets. In reality, the reviewed documents indicate that the Whitewing LP partnership and its financial restructuring were used to facilitate a transaction that arguably had no business relationship to the overall financial restructuring.

Recommendations

Partnership allocations between members of the same affiliated group (and, in general, related parties) may not have the same economic consequences as allocations between unrelated partners. As a result, related partners can use the partnership allocation rules inappropriately to shift basis among assets. Although the Joint Committee staff believes that the partnership allocation anti-abuse rules should apply to preclude the tax benefits Project Condor purported to generate, the Joint Committee staff recommends strengthening of the anti-abuse rules relating to partnership allocations for property contributed to a partnership, especially in the case of partners that are members of the same consolidated group, to ensure that the allocation rules are not used to generate unwarranted tax benefits.

In addition, transactions that use partnership tax rules and section 1032 to obtain unintended tax results appear to continue unabated. The Treasury Department has issued guidance addressing certain situations in which gain or loss may be improperly created by adjusting the basis of a partnership interest for partnership income that is not subject to tax under section 1032, but as with many tax-motivated transactions, it is difficult to keep pace with the promoters of these ideas. In light of this activity, the Joint Committee staff believes that further guidance is needed to address the interaction of the partnership basis rules with the corporate nonrecognition of gain rules under section 1032. Of particular concern is gain being excluded by

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[585] Absent this special provision, the Whitewing LP partners had no ability to request a distribution of their capital contributions.

[586] The Whitewing partnership agreement permitted Enron or an affiliate to make additional capital contributions in exchange for additional partnership interests so long as such interests are subordinate to the Osprey Investors preferred interest in Whitewing.

virtue of section 1032 that is attributable to a downward basis adjustment mandated by a section 754 election.

The Joint Committee staff recommends that either (1) section 1032 limit the nonrecognition of any realized gain allocated to the corporate partner to the extent that the gain is attributable to an economic benefit accruing to the corporate partner, or (2) that the partnership basis rules should be altered to preclude an increase in basis to an asset if the offsetting basis reduction would be allocated to stock of a partner (or related party). For example, if a partnership sells the stock at a gain and the gain is due not to appreciation in the value of the stock but rather to a decrease in the basis of the stock (as required by a section 754 election), then the realized gain is not due to an economic benefit accruing to the partner (i.e., increase in stock value). Rather, it is simply due to a reduction to the basis of the stock that was offset by an increase in basis to another asset. Consequently, the corporate partner should not be permitted to utilize section 1032 to avoid recognition of the realized gain allocated to it (or to have increased the basis of an asset)

In addition, the Joint Committee staff believes that the proposed regulations under section 337, relating to partnership acquisitions of stock of a corporate partner, would preclude taxpayers from engaging in these types of transactions. The Joint Committee staff recommends that final regulations on this subject should be issued expeditiously.

4. Projects Tammy I and Tammy II

Brief overview

Projects Tammy I and Tammy II were structured to generate financial statement benefits attributable to an increase in tax basis (in excess of book basis) in the Enron South office building and other depreciable assets. In a simplified version of the transaction, Enron Corp. and several of its subsidiaries contributed assets with significant unrealized built-in gains to a newly-formed partnership. Financial institutions provided $500 million of financing to the partnership in exchange for a preferred interest. Following the formation of the partnership, Enron and all but one of the Enron partners transferred approximately 95 percent of their partnership interests to a single Enron affiliate. The partnership then sold built-in gain assets, with the gain (and the resulting basis increases) allocated almost entirely to the single Enron affiliate -- giving the single Enron affiliate a high basis in its partnership interest. The partnership was to use the sales proceeds to: (1) purchase a low value depreciable asset, (2) purchase Enron preferred stock, and (3) repay the financial institutions.

In a later year, the partnership would distribute the low value depreciable asset to the single Enron affiliate in redemption of its partnership interest. The depreciable asset would inherit the single Enron affiliate's high basis in its partnership interest. The only remaining asset in the partnership would be Enron preferred stock. The Enron partners then could implement exit strategies to avoid the recognition of gain with respect to the Enron preferred stock.

Project Tammy I – background[587]

Reported tax and financial statement effects

Project Tammy I was projected to generate $1.09 billion in Federal income tax deductions (without any economic outlay) resulting primarily from enhanced depreciation deductions attributable to the Enron South office building. These deductions were anticipated to be available to offset Enron's taxable income beginning in 2007. The tax savings associated with these deductions would have generated approximately $406.5 million of financial statement income. The financial statement income would accrue during the years 2001 through 2005.[588]

In actuality, Enron did not report a financial statement benefit with respect to Project Tammy I for year 2001. As to the Federal income tax benefits, Project Tammy I was terminated prior to their realization. However, the three dispositions by the partnership in year 2001 did result in the recognition of gain (which was offset by losses from the Enron consolidated group).

Development of Project Tammy I

Deloitte & Touche proposed the idea for Project Tammy I to Enron. Enron held appreciated non-core business assets that it planned to sell. Enron had sufficient net operating losses to offset the projected gains from such sales. Project Tammy I was a mechanism that allowed Enron to shift basis to another asset held by the Enron consolidated group (resulting in greater future depreciation deductions).

The transaction was the product of collaboration between the Enron tax department and Deloitte & Touche, Akin Gump, and Vinson & Elkins. Much time was spent on identifying the proper Enron assets to place in the project structure. In addition, the structure originally contemplated an intercompany sale of the partnership interests. The structure later was revised to involve a tax-free transfer of the partnership interests.

On August 7, 2000, the Finance Committee of Enron Corp.'s Board of Directors approved Project Tammy I for recommendation to the Enron Corp. Board of Directors. At the Enron Corp. Board of Directors meeting (held later that day), Rebecca C. Carter presented a report of the Finance Committee's action, and the Board of Directors approved and ratified Project Tammy I.[589] On May 1, 2001, the Enron Corp. Board of Directors adopted and ratified all of the actions taken with respect to Project Tammy I and authorized the creation of a new

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[587] The information regarding Project Tammy I was obtained from Joint Committee staff interviews of James A. Ginty, Robert J. Hermann, Robert D. Maxey, and Alicia L. Goodrow, as well as from documents and information provided by Enron and the IRS.

[588] The General Background Materials in Appendix B contain the Structured Transactions Group, Summary of Project Earnings & Cash Flows, November 2001.

[589] Agenda item #5(c) of the Meeting of the Finance Committee of the Enron Corp. Board of Directors, August 7-8, 2000, EC 000043879, 000043966-43972.

series of Enron preferred stock in the amount of $1 billion to be sold to a subsidiary of the partnership.[590]

Implementation of Project Tammy I

The implementation of Project Tammy I involved several steps that were to be executed over a period of years. The steps involved: (1) the formation of a partnership, (2) a transfer of the partnership interests, (3) a sale of the built-in gain assets, and (4) certain post-sale events.

Formation of the partnership.–The initial step in the implementation of Project Tammy I was the formation of the partnership through which the reallocation of built-in gain would occur. The partnership, called Enron Finance Partners, LLC ("Enron Finance"), was formed on July 14, 2000, with three members of the Enron consolidated group being the initial members.[591] New members were admitted to the partnership during October and November 2000.

On November 28, 2000, Enron Finance's membership interests were reclassified into Class A Members, Class B Members, and Class C Members. The managing member of the partnership[592] owned the Class A Membership interest, the Enron consolidated group members owned the Class B Membership interests, and Zephyrus LLC ("Zephyrus"), through which the minority interest was held,[593] owned the Class C Membership interest.

In exchange for their membership interests, the members contributed various assets and had various liabilities assumed by Enron Finance. Zephyrus contributed $500 million in exchange for its Class C Membership interest.[594] The Class B Members contributed several assets with significant unrealized built-in gain. For example, Enron Corp. contributed 11.5 million shares of EOG Resources, Inc. stock with an agreed fair market value of $485.875

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[590] Minutes of the Meeting of the Enron Corp. Board of Directors, May 1, 2001, EC 000049817-49828.

[591] The three members were Smith Street Land Company ("Smith Street"), Enron Capital Investments Corp., and Enron Global Exploration & Production, Inc. Smith Street was developing the Enron South office building.

[592] Enron Finance Management, LLC, a disregarded entity from its sole owner, Enron, was the sole manager of Enron Finance.

[593] Zephyrus was a Delaware limited liability company formed on November 17, 2000. Its initial members were Chase Equipment Leasing, Inc., 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 an aggregate of $481.725 million in their capacities as "lenders" and $18.275 million in their capacities as "certificate purchasers," for a total of $500 million in minority interest financing.

[594] Zephyrus received ten membership units evidencing the Class C Membership interest. Each Class C unit represented a capital contribution of $50 million. The Class C Membership interest was to have been redeemed sometime in year 2005.

million (subject to a debt of approximately $461.5 million) and a tax basis of approximately $40.71 million. Another Class B Member executed an option that allowed Enron Finance to purchase (for $1) the stock of Enron Renewable Energy Corp. with an agreed fair market value of $550 million (subject to a debt of approximately $524 million) and a tax basis of approximately $200 million.[595] Another Class B Member contributed all of the outstanding stock of Enron Oil & Gas India Ltd. with an agreed fair market value of $550 million (subject to a debt of $523.2 million).[596] Other built-in gain assets contributed to Enron Finance included the outstanding stock of Enron LNG Power (Atlantic) Ltd., with an agreed fair market value of $260 million (subject to a debt of $118.750 million) and a tax basis of $14.283 million, and a partnership interest in Enron Capital Management III Limited Partnership with an agreed fair market value of $99.083 million (subject to a debt of $93.634 million) and a tax basis of $21.288 million.[597]

Collectively, the Class B members (i.e., Enron Corp. and its subsidiaries) contributed property with a gross value of approximately $1.95 billion (subject to a debt of $1.85 billion) and an estimated tax basis of $500 million. In each instance, the contributing member remained liable for the debt that Enron Finance had assumed in connection with the contributions.

Transfers of partnership interests.–The second step of the transaction involved a transfer of the partnership interests within the Enron consolidated group. In this regard, Enron and all but one of the Class B members contributed 95 percent of their respective Class B Membership interests to Enron Capital Investments Corp. (the other Class B Member) in exchange for Enron Capital Investments common stock.[598] Each contributor remained liable for the debt that Enron Finance had previously assumed. After the transfers, Enron Capital Investments Corp. owned more than 98 percent of the Class B Membership interests in Enron Finance, and the other Class B members (Enron Corp., Smith Street, Enron Global, Enron Caribbean Basin, and Boreas

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[595] The option was intended to transfer tax ownership of the Enron Renewable Energy Corp. stock to Enron Finance without requiring the approval of the Federal Energy Regulatory Commission to transfer the stock. Discussion material for Project Tammy, June 30, 2000, EC2 000037666.

[596] Enron's tax basis in the Enron Oil & Gas India Ltd. stock is unclear.

[597] Capital contribution schedule for Project Tammy I as of May 30, 2002, EC 000851323.

[598] On November 21, 2000, Enron, Smith Street, Enron Global, and Enron Caribbean Basin LLC contributed their interests to Enron Capital Investments Corp. On December 11, 2000, Boreas Holdings agreed to contribute 95 percent of its Class B Membership interest in Enron Finance in exchange for Enron Capital Investments Corp. stock with a value of $5.177 million. ECx000005165-5167.

Holdings) collectively owned less than two percent of the Class B Membership interests.[599] The net value of the transferred Class B Membership interests was $95,302,656.[600]

Sale of built-in gain assets.–Following the transfers of the Class B Membership interests to Enron Capital Investments Corp., Enron Finance was to sell the unrealized built-in gain assets.[601] Enron Finance, through a lower-tiered partnership,[602] sold the following assets: (1) the stock of Enron Oil & Gas India Ltd. for $388 million,[603] (2) the stock of EOG Resources, Inc. for approximately $400 million,[604] and (3) an interest in an East Coast power plant.[605]

Post-sale events.–Enron Finance was to use the sales proceeds to: (1) purchase the Enron South office building from Smith Street, (2) purchase newly-issued Enron preferred stock and (3) redeem the Class C Membership interest held by Zephyrus.[606] Thereafter, Enron Finance was to distribute the Enron South office building to Enron Capital Investment Corp. in liquidation of its partnership interest, leaving the Enron preferred stock as Enron Finance's only asset. The precise exit strategy with respect to the Enron preferred stock was unclear -- one option under

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[599] ECx000005156.

[600] ECx000005155.

[601] As discussed below, this would result in the recognition of the built-in gain (of which 95 percent would have been allocated to Enron Capital Investments Corp., thereby increasing its tax basis in its partnership interest).

[602] Enron Finance contributed the assets to Enron Intermediate Holdings (a disregarded entity), which, in turn, contributed the assets to Enron Asset Holdings. Enron Asset Holdings continues to hold the unsold assets.

[603] A revised agreement was signed on January 22, 2002, with a sales price of $350 million. Enron Deal Approval Sheet for EOGIL Divestiture, EC2 000037748-37752.

[604] Enron Risk Assessment and Control Deal Approval Sheet for Cerberus (involving the divestiture of the EOG stock), EC2 000037753-61. The EOG Resources, Inc. stock had already been monetized for approximately $517.5 million through an arrangement with the Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A. ("Rabobank"). As part of the arrangement, Enron North America entered into an equity swap with Rabobank to make up any shortfall between the $517.5 million and the proceeds from the disposition of the EOG Resources, Inc. stock.

[605] Enron transaction history of Project Tammy I, EC2 000037647.

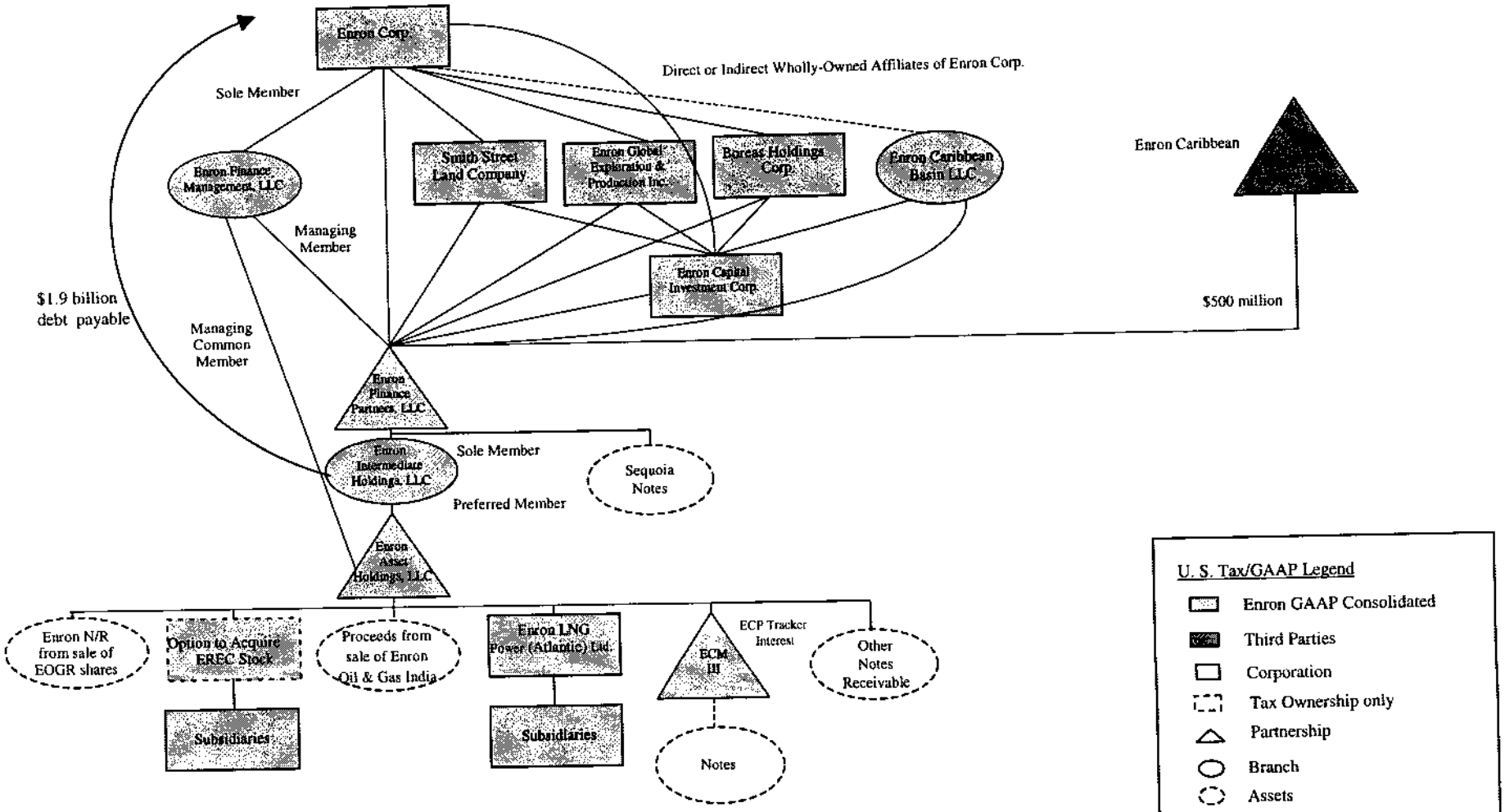
[606] As originally planned, Enron Asset Holdings was to purchase approximately $630 million of Enron Corp. preferred stock in September 2000, using the proceeds from the monetization of the EOG Resources, Inc. stock. As previously discussed, the Enron Corp. Board of Directors did not approve the issuance of a new class of Enron Corp. preferred stock until May 1, 2001. Enron Asset Holdings never purchased the Enron Corp. preferred stock, nor did it purchase the Enron South office building.

consideration was for Enron Finance to distribute the stock to the remaining partners (all members of the Enron consolidated group) in liquidation of their partnership interests.[607]

The diagram on the next page depicts the Project Tammy I structure as of December 31, 2001.

[607] Discussion material for Project Tammy I dated June 30, 2000, pgs. EC2 000037662-37665.

Project Tammy I
Structure as of December 2001



Role of outside advisors

Deloitte & Touche promoted the idea of Project Tammy I to Enron and was a principal advisor with respect to its structuring. Deloitte & Touche received fees totaling $8 million in connection with the transaction.[608] Vinson & Elkins acted as Enron's corporate and tax counsel in Project Tammy I and received fees totaling $698,775 for its services. Vinson & Elkins provided a tax opinion in connection with the transaction. In the opinion, Vinson & Elkins concluded that (1) no gain or loss "should" be recognized by Enron or the other Class B Members upon the contributions of the assets to Enron Finance; (2) no gain or loss "should" be recognized by Enron Capital Investments Corp. or the Class B Members on the contribution of 95 percent of their interests to Enron Capital Investments Corp.; (3) 95 percent of the built-in gain with respect to the contributed assets "should" be allocable to Enron Capital Investments Corp. by reason of the contribution, and on the subsequent sale of the contributed assets, Enron Capital Investments Corp.'s basis in its partnership interest "should" be increased by the built-in gain allocated to it; and (4) the creation and use of Enron Finance "should" not be disregarded as a sham and should not be subject to the partnership anti-abuse rules.

Akin, Gump also served as tax counsel to Enron and received fees totaling $235,234 for its services.[609]

Appendix C, Part VIII to this Report contains the tax opinion Enron received in connection with Project Tammy I.

Subsequent developments

Enron's bankruptcy foreclosed the ability to recognize the anticipated financial and tax benefits with respect to Project Tammy I. Enron and Zephyrus are in litigation/settlement discussions over defaults in payments related to the minority interest financing. In addition, some groups are reviewing some of the asset sales, and a number of issues are expected to be

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[608] The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/2001), EC2 000036379.

[609] Other law firms that were involved in Project Tammy I included LeBouef, Lamb, Greene & Mac (received fees totaling $219,231) and Freshfields Bruckhaus Deringer (received fees totaling $145,000).

Arthur Andersen acted as Enron's principal advisor on accounting and financial statement issues in connection with Project Tammy I and received a fee of $152,250 in connection with the transaction.

JP Morgan Chase led the group of financial institutions that invested $500 million in Project Tammy I (through Zephyrus). JP Morgan Chase received fees totaling $2.289 million in connection with the transaction.

presented to the creditors committee.[610] The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001.

Project Tammy II – background[611]

Project Tammy II employed the same structure as Project Tammy I. The only differences were the assets to be sold and the depreciable asset(s) that would benefit from the increased tax basis. As originally contemplated, the primary asset Enron Corp. intended to sell through the Project Tammy structure was its interest in Portland General Electric Company ("PGE"). However, in order to reduce its exposure in connection with an IRS audit of the transaction, the Enron tax department decided to create two separate Project Tammy structures to dispose of the unwanted assets. Project Tammy II was the vehicle through which Enron was to sell its PGE stock. Enron never identified the depreciable assets that were to benefit from the increased tax basis.

Reported tax and financial statement effects

Project Tammy II was expected to generate approximately $1.06 billion of Federal income tax deductions (without any economic outlay) resulting primarily from enhanced depreciation deductions attributable to unidentified depreciable assets. These deductions were anticipated to be available to offset Enron's taxable income beginning in 2007. In addition, the tax savings associated with these deductions would have generated approximately $370 million of financial statement income. The financial statement income would accrue during the years 2002 through 2005.[612]

In actuality, Enron did not report a financial statement benefit with respect to Project Tammy II. As to the Federal income tax benefits, Project Tammy II was terminated prior to their realization. However, the two dispositions by the partnership in 2001 did result in the recognition of gain (which was offset by losses from the Enron consolidated group).

Development of Project Tammy II

As previously discussed, Projects Tammy I and II relied on the same legal analysis and involved similar structures (except for the assets to be sold and the depreciable asset(s) that

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[610] The Project Tammy I materials in Appendix B contain the Project Tammy I deal basics, EC2 000037649.

[611] The information regarding Project Tammy II was obtained from Joint Committee staff interviews of R. Davis Maxey, Robert J. Hermann, and Alicia L. Goodrow, as well as from documents and information provided by Enron, the IRS, and filings with the United States Bankruptcy Court in the Southern District of New York.

[612] The General Background Materials in Appendix B contain the Structured Transactions Group, Summary of Project Earnings & Cash Flows, November 2001.

would benefit from the increased tax basis).[613] The primary motivation for using multiple projects was to reduce Enron's IRS audit exposure with respect to the transactions.

On April 30, 2001, Finance Committee of Enron Corp.'s Board of Directors approved Project Tammy II for recommendation to the full Board of Directors. At the Enron Corp. Board of Directors meeting held the following day, Herbert S. Winokur, Jr. presented a report of the Finance Committee's action, and the Board of Directors approved and ratified Project Tammy II.[614] At the same time, the Board authorized the creation of a new series of Enron Corp. preferred stock in the amount of $1 billion that was to be sold to a subsidiary of the partnership.[615]

Implementation of Project Tammy II

Like Project Tammy I, the implementation of Project Tammy II involved several steps that were to be executed over a period of years. The steps involved: (1) the formation of the partnership, (2) the transfer of the partnership interests, (3) the sale of the partnership's built-in gain assets, and (4) certain post-sale events.

Formation of the partnership.–The initial step was the formation of the partnership that would be used to reallocate the built-in gains. The partnership, called Enron Northwest Finance, LLC ("Enron Northwest"), was formed on May 2001, with Enron Corp., Enron Property & Services Corp. ("Enron Property"), and JILP-LP[616] (all members of the Enron consolidated group) as the initial members.[617]

In exchange for a Class B Membership interest in Enron Northwest, the members contributed various assets and had various liabilities assumed by Enron Northwest.[618] Enron Corp. contributed the following assets:

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[613] Current Enron management is not aware of any written documentation prepared by Deloitte & Touche in connection with the development and implementation of Project Tammy II. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 98.

[614] Agenda item #8(c) of the Meeting of the Enron Corp. Board of Directors, EC 000049507, ENE 0000001542, 15550-15555.

[615] *Id.*

[616] JILP-LP was a wholly-owned subsidiary of Enron North America.

[617] Enron Finance Management, a disregarded entity from its sole owner (Enron Corp.) was the sole manager of Enron Northwest. Enron Finance Management contributed $1,000 to Enron Northwest for its Class A Membership interest. Enron Finance Management also acted as the sole managing member in the Project Tammy I structure.

[618] In each instance, the contributing member remained liable on the debt that was assumed by Enron Northwest in connection with the particular transfer.

(1) An agreement that granted Enron Northwest an option to purchase (for $1) all the stock of PGE (a wholly-owned subsidiary of Enron) with an agreed fair market value of $2.1 billion and a tax basis of approximately $1.25 billion ("PGE Option"),

(2) 3,276,811 common units of EOTT Energy Partners, LP (the "EOTT Units") with an agreed fair market value of $58,491,076, and a zero tax basis, and

(3) A derivative interest that tracked the economic value of its limited partnership interest in Joint Energy Development Investments, LP ("JEDI") relating to an indirect interest in 67,849 shares of common stock of Hanover Compressor.

Enron Property assigned to Enron Northwest a $200 million demand note issued by Enron to Enron Property with an agreed fair market value of $200 million.

JILP-LP contributed a derivative interest that tracked the economic value of its limited partnership interest in Ponderosa Assets, LP relating to an interest in 1,680,840 shares of common stock of Hanover Compressor.

In the aggregate, the Class B members (i.e., Enron Corp. and its subsidiaries) contributed property with a gross value of approximately $2.1 billion (subject to liabilities of $2 billion) and an estimated tax basis of $1 billion. In each instance, the contributing member remained liable for the debt that Enron Northwest had assumed in connection with the contributions.[619]

Enron Northwest was designed to raise $500 million of minority interest financing, but the financing was never arranged.[620]

Transfers of partnership interests.–Following the formation of the partnership, Enron Corp. contributed 2.715 percent of its Class B Membership interest in Enron Northwest to Enron Property (another holder of a Class B Membership interest). JILP-LP contributed 95 percent of its Class B Membership interest in Enron Northwest to Enron Property in exchange for shares of Enron Property common stock.

Sale of built-in gain assets.–In the second half of 2001, Enron Northwest, through a lower-tiered partnership, sold (1) the EOTT Units for $64.55 million (all of which was gain),[621]

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[619] Enron Northwest contributed the assets (and transferred the liabilities) to Enron Northwest Intermediate LLC, which in turn, contributed the assets to Enron Northwest Assets, LLC. Enron Northwest Assets, LLC continues to hold the unsold assets.

[620] Project Tammy II Tax Overview, EC2 000037764; Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 94.

[621] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 95.

and (2) the derivative interest in the Hanover Compressor stock.[622] In October 2001, Northwest Natural Gas Company entered into an agreement to purchase the PGE stock from Enron (and Enron Northwest Assets, LLC). Because of issues raised by Enron's bankruptcy, however, the purchase was never consummated. The parties terminated the agreement in May 2002.[623]

Post-sale events.–Project Tammy II effectively was terminated before Enron Northwest purchased either the depreciable asset for distribution to Enron Property or the Enron Corp. preferred stock.[624]

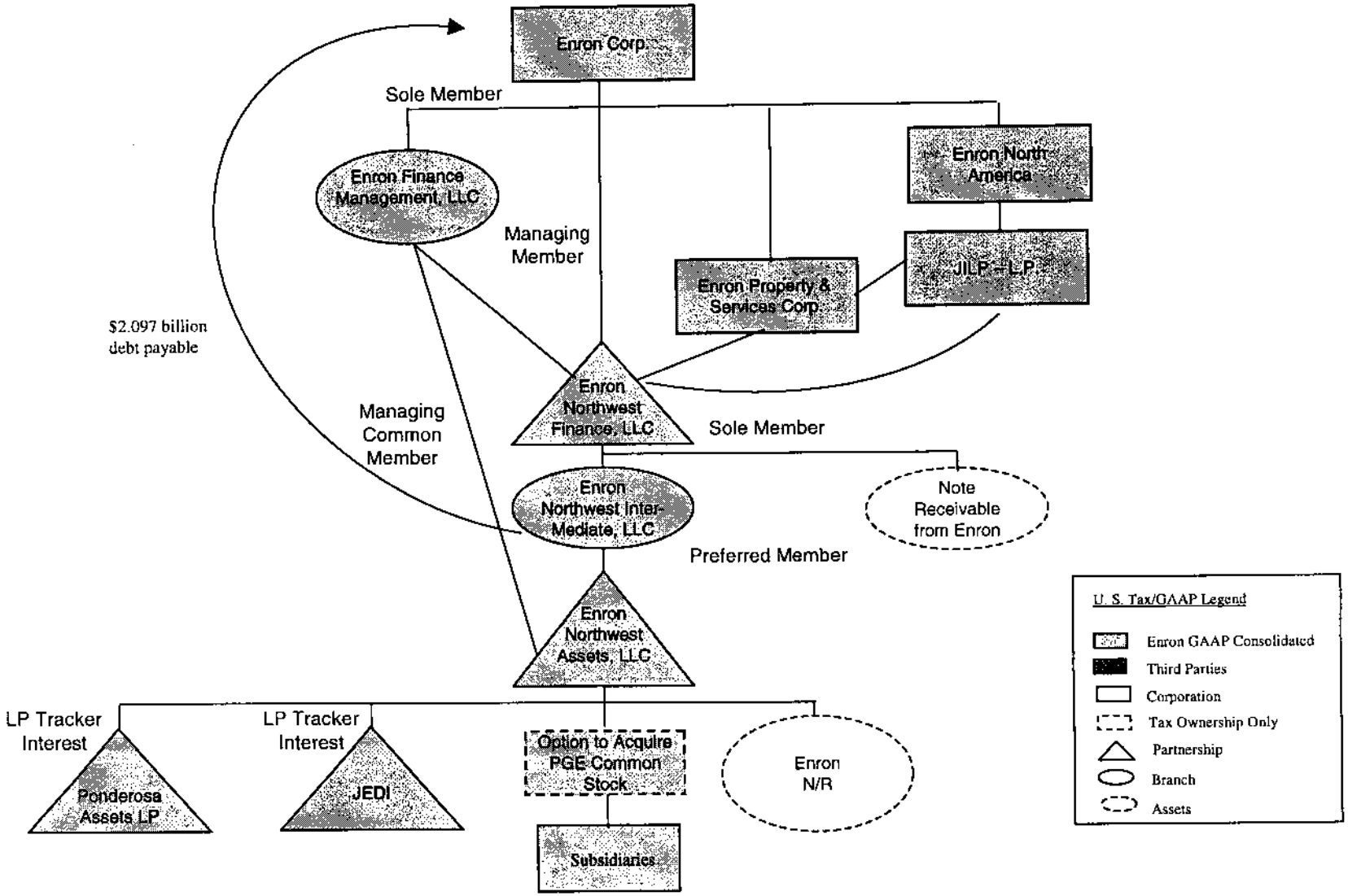
The diagram on the next page depicts the Project Tammy II structure.

[622] Project Tammy II Tax Overview, EC2 000037766.

[623] *See In re Enron Corp., et al.*, Motion of Enron Corp., et al., for an Order, Pursuant to Sections 105, 363(b), and 365 of the Bankruptcy Code and Rules 2002, 6004 and 9013 of the Federal Rules of Bankruptcy Procedure, Authorizing and Approving (a) the Execution and Delivery of Termination Agreements in connection with the PGE Option Agreement, (b) the Execution and Delivery of a Tax Allocation Agreement, and (c) the Consummation of the Transactions Contemplated Therewith, Filed by Debtors and Debtors in Possession, U.S. Bankruptcy Court (S.D.N.Y.), Dec. 6, 2002.

[624] Current Enron management is not aware that any replacement asset was ever identified. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 97.

Project Tammy II
Structure as of December 2001



Role of outside advisors

Vinson & Elkins acted as corporate and tax counsel to Enron on Project Tammy II. Deloitte & Touche advised Enron with respect to the tax structuring and other related matters. Enron did not receive any tax opinions in connection with Project Tammy II.[625]

Subsequent developments

Enron's bankruptcy foreclosed the ability to recognize the anticipated financial and tax benefits with respect to Project Tammy II. Pursuant to a motion filed and approved by the bankruptcy court, effective December 23, 2002, Enron Corp., Enron Northwest Intermediate LLC, and Enron Northwest terminated the PGE Option and the assumption of the Enron Corp. liabilities.

The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001.

Discussion[626]

Similar to Project Condor, the transactions in Projects Tammy I and II were designed to generate a total of over $2 billion in additional depreciable tax basis via the shifting of tax basis (in excess of book basis) to long-lived assets. The expected tax benefits were the result of the interaction of the partnership tax rules that address the allocation of built-in gains with respect to contributed assets,[627] the partnership basis rules on liquidating distributions,[628] and, depending on the exit strategy, the interaction of the partnership basis rules and the corporate nonrecognition rules in exchanges involving a corporation's own stock.[629] These rules are discussed below.

Under the strategy devised in Projects Tammy I and II, the benefits of the increased tax basis (in the form of greater depreciation deductions) would inure over a 39-year period and was not expected to be reflected in Enron's consolidated tax return until 2007. However, and

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[625] The Project Tammy II materials in Appendix B contain the Project Tammy II deal basics, EC2 000037767; Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 99.

[626] Enron's bankruptcy effectively prevents Enron from realizing the tax benefits that were contemplated in Projects Tammy I and II. Nevertheless, this section discusses the tax benefits that Enron sought to achieve from the transactions (without regard to the bankruptcy).

[627] Sec. 704(c).

[628] Sec. 732(b).

[629] Secs. 705 and 1032.

potentially more important to Enron, the strategy permitted Enron to begin recording the benefits immediately for financial accounting purposes.[630]

Partnership allocations

One of the first steps in the implementation of Projects Tammy I and II involved the contribution of built-in gain assets by members of the Enron consolidated group to a partnership. As previously discussed, present law requires that any income, gain, loss, and deduction with respect to contributed property must be shared among the partners so as to take account of the variation between the tax basis of the property to the partnership and its fair market value at the time of contribution.[631] The purpose of this rule is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. However, the regulations under section 704(c) state that when a contributing partner transfers a partnership interest (or a portion of such interest), built-in gain or loss (proportionate to the interest transferred) must be allocated to the transferee partner as it would have been allocated to the transferor partner.[632] Therefore, in Projects Tammy I and II, when the various members of the Enron consolidated group transferred 95 percent of their partnership interests (the "transferring members") to another Enron partner the "single Enron affiliate"),[633] a corresponding amount of the built-in gain on the contributed property had to be allocated to the single Enron affiliate. Typically, such a transaction does not present a problem and results in an appropriate tax and economic result. Under this rule, the sale of the built-in gain assets will result in 95 percent of the built-in gain being allocated to the single Enron affiliate, with a corresponding increase in the affiliate's tax basis in the partnership interest.[634]

In Projects Tammy I and II, the transferring members remained liable on the indebtedness that Enron Finance (in Tammy I) and Enron Northwest (in Tammy II) assumed in connection with the formation of the partnerships.[635] Similarly, when the transferring members contributed their 95 percent partnership interests to the single Enron affiliate, the transferring members

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[630] *See* the Background and Rationale section to this part of the Report which contains a general explanation of relevant aspects of Financial Accounting Standard No. 109, Accounting for Income Taxes.

[631] Sec. 704(c)(1)(A).

[632] Treas. Reg. sec. 1.704-3(a)(7).

[633] The single Enron affiliate was Enron Capital Investments Corp. in Project Tammy I and Enron Property in Project Tammy II.

[634] Whether the gain is allocated to the single Enron affiliate or to Enron Corp. is irrelevant because both partners are members of the Enron consolidated group (and the gain will be offset by consolidated net operating losses).

[635] By remaining liable on the indebtedness, the contributing partners avoided any gain recognition that would have resulted by virtue of having been deemed to receive a distribution of money in excess of the partners' basis. *See* secs. 752(b) and 731(a)(1).

remained liable on their respective amount of indebtedness (presumably to avoid a deemed distribution or discharge on the transfer).

The contribution of the 95 percent partnership interests has the effect of splitting each partnership interest into two components: (1) a five percent equity interest that guarantees partnership debt (which the transferring partners retained), and (2) a 95 percent equity interest (which the transferring partners transferred to the single Enron affiliate). In general, when a part of a larger property is sold, the tax basis is equitably apportioned among the parts for determining gain or loss.[636] This determination is usually not difficult to make. However, the determination becomes much more difficult when dealing with a transfers of a non-economic property interest. This is what occurred in Projects Tammy I and Tammy II. While the 95 percent equity interest had economic value as measured by the value of the partnership assets, the interest was uneconomical if the associated tax liabilities embedded in the partnership interest are considered. Enron determined that the single Enron affiliate would take a zero basis in the 95 percent equity interest.[637] This result, coupled with the partnership allocation rules, enabled Enron to shift tax basis to a depreciable asset in excess of its value.

The following example illustrates how the basis shift occurred. Assume that a partnership has a single long-lived depreciable asset with a value of $1 billion, a tax basis of $200 million, and a $900 million partnership liability that the partner ("transferor partner") guarantees.[638] The transferor partner has a $200 million basis in its partnership interest. Assume further that the transferor partner transfers 95 percent of its partnership interest (with no guarantee of the liability) to another partner, and that the transferee partner ultimately will receive an interest in the long-lived asset in a liquidating distribution. The transferee partner has received an interest in partnership property worth $95 million (95 percent x $100 million value) with an associated tax liability of $266 million ($800 million of sec. 704(c) gain x 95 percent x 35 percent tax rate).[639] The unresolved question is what portion of the transferor partner's $200

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[636] Treas. Reg. sec. 1.61-6(a).

[637] This conclusion was based on an interpretation of Rev. Rul. 84-53, 1984-1 C.B. 159. This revenue ruling involves the determination of tax basis in connection with a sale of a partial partnership interest to an unrelated purchaser. In Projects Tammy I and II, the transactions involved a tax-free transfer of a partial interest to members of the same consolidated group.

[638] This hypothetical is similar to an example that Steve Klig of Deloitte & Touche provided to Alicia Goodrow of Enron, in a message dated October 23, 2001, regarding the application of Rev. Rul. 84-53 to Project Tammy I. The Project Tammy I materials in Appendix B contain a Message from Steven E. Klig to Alicia L. Goodrow, subject: Tammy Example.

[639] While the built-in gain will give rise to $760 million in greater future depreciation deductions ($800 million x 95 percent), unrelated taxpayers (without capital losses) generally would be unwilling to realize $760 million of current year gain in exchange for $760 million in future depreciation deductions. If the partner could force an immediate liquidation of the partnership, then the transferee partner would be entitled to receive $95 million and would have a $665 million capital loss (that would offset most of the $760 million of gain).

million basis should be ascribed to the transferred interest. Under similar facts, Enron apportioned a zero basis to the transferred partnership interest because the transferee partner (i.e., the single Enron affiliate) did not assume any of the liabilities. While there is support for this position,[640] the result is difficult to justify and easy to manipulate (particularly when the transferor and transferee are related). A more theoretically sound approach may be to apply principles similar to the excess loss account rules of the consolidated return regulations,[641] (that allow downward basis adjustments below zero) to the transferee partner's interest. The basis reduction rules of section 358(h) also might serve as a useful model.[642] These approaches more accurately reflect the underlying economics of the transfer, and would negate the tax and financial accounting benefits that Enron sought to achieve from Projects Tammy I and II.[643]

To summarize, the partnership built-in gain rules generally provide appropriate economic results with respect to partnerships whose partners have adverse interests. When the partners are related, however, the section 704(c) rules may be manipulated to produce uneconomic and unwarranted results. This was the case in Project Condor, and the pattern continued in Projects Tammy I and Tammy II.

Partnership basis rules on liquidating distributions and section 754 adjustments

In Projects Tammy I and II, the partnership was to use the proceeds from the sale of the built-in gain assets to purchase (1) a low value depreciable asset(s) and (2) a new series of Enron preferred stock. Subsequently, the low value depreciable asset(s) was to be distributed to the single Enron affiliate in liquidation of the affiliate's high basis partnership interest. Under the

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[640] *See*, Rev. Rul. 84-53, 1984-1 C.B. 159 (situation four).

[641] The excess loss account rules allow negative adjustments to a consolidated member's stock basis that exceed the shareholder's basis in such stock. The resulting negative amount is the shareholder's excess loss account in the stock and is treated as negative basis. Treas. Reg. sec. 1.1502-19.

[642] Section 358(h), previously discussed in the corporate section of this Report, mandates a basis reduction in stock received by a transferor in connection with a tax-free transfer (but not below its fair market value) by the amount of any liability that is assumed in the exchange which was not treated as money received by the taxpayer. If the resulting outside basis is lower than the partnership's basis in the asset, then basis reduction principles similar to section 732(f), previously discussed in this section of the Report, also may be appropriate.

[643] The idea of using low-basis high value assets to maximize the financial accounting benefits in Project Tammy I was not lost on the Deloitte & Touche advisors. As Steven E. Klig from Deloitte & Touche noted in an electronic message to the Enron tax department, "THE MORAL OF THE STORY IS THAT THE HIGHER THE BASIS OF THE BUILT-IN GAIN PROPERTY TRANSFERRED TO THE PARTNERSHIP, THE SMALLER THE SHIFT IN BUILT-IN GAIN AS A PERCENTAGE OF TOTAL BUILT-IN GAIN." EC2 000054817. The Project Tammy I materials in Appendix B contain an Electronic Message from Steven E. Klig to Alicia L. Goodrow, subject: Tammy Example, at 2.

partnership tax laws, the depreciable asset(s) would take a tax basis equal to the affiliate's basis in its partnership interest. This results in larger depreciation deductions over the life of the depreciable asset (or a larger loss on the sale of such asset). This was the tax benefit that Enron sought to achieve.[644]

The excess of the basis of the depreciable asset in the hands of the single Enron affiliate over its basis in the hands of the partnership immediately prior to the distribution would trigger a downward basis adjustment in some or all of the remaining partnership property assuming that a section 754 election was in effect. If the only remaining partnership property was Enron preferred stock and it was of a similar character to the depreciable asset, then the partnership would be required to reduce its basis in the Enron preferred stock, thereby creating built-in gain on the Enron preferred stock.[645] This is a desirable result -- Enron would not recognize gain when the partnership sells the Enron preferred stock,[646] but Enron would increase its basis in the partnership interest by its proportionate share of the gain. The permanent exclusion of this gain allowed Enron to report a financial accounting benefit with respect to the transactions.[647]

Business purpose

As is the case with several of Enron's structured transactions, any analysis of whether the tax benefits in Projects Tammy I and II would be respected must take into account the applicability of the relevant rules and judicial doctrines regarding tax-motivated transactions.[648]

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[644] *See* generally Christopher H. Hanna, *Partnership Distributions: Whatever Happened to Nonrecognition?* 82 Ky. L. J. 465, 488-92 (1994) (various examples, ranging from a bag of peanuts to a typewriter, in which a low value, low basis asset would receive a high basis on liquidation of a partner's interest).

[645] The depreciable asset distributed to the single Enron affiliate should be section 1231(b) property (assuming it was held by the partnership for more than one year). If the partnership distributes the depreciable asset and is required to make a downward adjustment to the basis of its remaining partnership property, the downward adjustment must be made to property of a similar character, i.e., capital assets or section 1231(b) property. *See* sec. 734(c), sec. 755(b), and Treas. Reg. sec. 1.755-1(c). The Enron preferred stock should be a capital asset and therefore the downward adjustment would be made to it.

[646] Sec. 1032.

[647] If the partnerships held assets other than Enron stock, then instead of a permanent exclusion of gain, the transactions would have generated only a deferral of gain (because Enron eventually would pay tax with respect to the assets) with no resulting financial statement income.

[648] For detailed information of the present law rules and judicial doctrines applicable to tax motivated transactions and related recommendations and developments, *see, e.g.,* Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July

The Vinson & Elkins tax opinion states that Enron engaged in the transaction "to secure $500 million of financing from unrelated banks through a structure that would provide favorable 'minority interest' treatment."[649] The tax opinion discusses a Tax Court memorandum decision[650] in which the court respected a partnership arrangement that yielded significant tax benefits because the taxpayer established that the investment had a valid non-tax business purpose. The tax opinion states that "[c]learly, [Project Tammy I] serves an important business purpose as it facilitates the raising of $500 million of funds for use within the Enron Group," and on this basis, concludes that the transaction should not be treated as a sham or without substance.[651]

The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose.[652] While a proper analysis of the non-tax business purpose requires a more thorough knowledge of the relevant facts and circumstances (which is beyond the scope of this Report), some general observations are appropriate. The tax opinion apparently accepts as fact the notion that the partnership structure "facilitates" the borrowing, but fails to explain how it facilitates the borrowing. The tax opinion also fails to analyze (1) recent court cases that have disregarded the existence of a partnership structure that serves little business purpose other than to achieve tax benefits,[653] or (2) the possibility that a court may separate a transaction in which independent activities with non-tax objectives are combined with an unrelated transaction having only tax-avoidance objectives in order to establish an overall business purpose.[654]

22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint Committee on Taxation, *Description of the "CARE Act of 2003,"* (JCX-04-03), February 3, 2003; Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters,* 54 SMU L. Rev. 1 (2001).

[649] Opinion Letter from Vinson & Elkins to Enron Corp., February 9, 2001, Appendix C, Part VIII, at 19.

[650] *Salina Partnership LP v. Commissioner*, 80 T.C.M. 686 (2000)

[651] Opinion Letter from Vinson & Elkins to Enron Corp., February 9, 2001, Appendix C, Part VIII, at 19-20.

[652] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999); *Peerless Indus. v. Commissioner*, 1994-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

[653] *See, e.g., ASA Investerings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000).

[654] *ACM Partnership v. Commissioner*, 157 F.3d 231, 256 at n. 48 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999). Otherwise, any tax-motivated transaction that is combined with, for example, a borrowing, would be respected.

Of greater concern is the fact that the opinion letter regards and analyzes each element of the transaction (i.e., the contributions to the partnership, the transfer of the partnership interests, and the allocation of the built-in gain) as if the steps were independent and isolated. The tax opinion fails to consider the tax consequences of the anticipated exit strategy and does not provide an overall evaluation of the transaction (notwithstanding that the tax opinion describes the strategy).[655] Project Tammy I was a multi-step, orchestrated arrangement, whose tax and financial statement benefits were known to Enron, the promoter, and the accountants[656] long before Vinson & Elkins issued its tax opinion. Ignoring the exit strategy and failing to provide an overall evaluation should call into question (1) the tax advisor's compliance with the relevant tax shelter opinion standards,[657] and (2) Enron's reliance on the tax opinion to establish reasonable cause and good faith.[658]

Recommendations

The Joint Committee staff recommendations regarding Project Condor[659] include recommendations regarding the partnership allocation rules under section 704(c) and corporate

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[655] Opinion Letter from Vinson & Elkins to Enron Corp., February 9, 2001, Appendix C, Part VIII, at 7-8.

[656] Arthur Andersen provided an opinion regarding the appropriate application of GAAP to the transaction in June, 2000. EC2 000037676-000037685.

[657] Proposed regulations under Circular 230, Regulations Governing Practice Before the IRS, provide that, in rendering a tax shelter opinion to a client, the advisor must not rely on unreasonable factual assumptions. An unreasonable factual assumption includes "a factual assumption that the practitioner knows or has reason to believe is incorrect, incomplete, inconsistent with an important fact, or another factual assumption, or implausible in any material respect." Circular 230, Prop. Sec. 10.35(a)(1)(ii)(A). Even the standards applicable to marketed tax shelter opinions provides, "[a] practitioner who provides a tax shelter opinion analyzing the Federal tax effects of a tax shelter investment shall . . .[w]here possible. . .provide an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized. Where such an overall evaluation cannot be given, the opinion should fully describe the reasons for the practitioner's inability to make an overall evaluation." Circular 230, Sec. 10.33(e).

[658] An accuracy-related penalty is not imposed with respect to any portion of any underpayment if the taxpayer can show that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Sec. 6664(c)(1). Reliance on a tax opinion constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Among the elements needed to establish such reliance, "[t]he advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances." Treas. Reg. sec. 1.6664-4(c)(1)(i).

[659] Project Condor is discussed in this partnership section of the Report (following Project Tomas).

nonrecognition of gain rules under section 1032. Those recommendations also are appropriate with respect to Projects Tammy I and Tammy II. In addition, the Joint Committee staff believes that further guidance is needed regarding the apportionment of tax basis upon the transfer of a partial partnership interest (particularly when the transfer involves related parties).