I. STRUCTURED TAX MOTIVATED TRANSACTIONS

A. Background and Rationale

In the early 1990s, Enron engaged in several structured financing transactions in which Enron received upfront payments in exchange for the future delivery of a specified commodity such as crude oil or natural gas ("commodity prepay transactions").[184] The commodity prepay transactions originally were entered into in order to generate current taxable income to use tax credits generated by Enron Oil and Gas that would have otherwise expired. In the mid-1990s, Enron continued its use of structured financing transactions and used other structured transactions to shelter capital gain income on the sale of Enron Oil and Gas stock.[185]

Although providing financial accounting benefits, the early structured transactions, including the commodity prepay transactions, were primarily engaged in for Federal income tax benefits. However, as Enron began to report losses for Federal income tax purposes, the importance of immediate tax deductions declined. At the same time, the importance of financial accounting income to Enron increased. As a result, Enron's focus shifted from structured transactions that could shelter specific tax items to transactions that could generate financial accounting benefits.

Arguably, the primary reason for engaging in most of the subsequent structured transactions after 1996 was for the financial accounting benefits they generated rather than the Federal income tax benefits.[186] Indeed, many of the structured transactions were designed to permit Enron to begin reporting the financial accounting benefits of a transaction immediately even though the Federal income tax benefits (which generated the financial accounting benefit) would not occur until significantly into the future.[187] In some of the structured transactions,

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[184] The commodity prepay transactions are discussed in more detail later in this Part of the Report.

[185] For example, Enron issued investment unit securities (discussed later in this Part of the Report) to monetize part of its investment in Enron Oil and Gas common stock. In addition, Project Tanya and Project Valor were structured transactions that Enron engaged in to shelter taxable income on capital gain on the sale of Enron Oil and Gas stock.

[186] In all of the structured transactions discussed in this Report, except two structured transactions in which Enron was an accommodation party, the origin of the financial accounting benefits was the reduction in Federal income tax that the transaction was anticipated to provide either currently or in the future.

[187] Statement of Financial Accounting Standards 109 ("SFAS 109"), Accounting for Income Taxes, generally provides that assets and liabilities that are recorded at different amounts for financial reporting purposes and income tax purposes create differences for which a deferred tax asset or liability generally must be reported in the financial statements. However, certain basis differences may not result in taxable or deductible amounts in future years when the related asset is recovered or settled because the tax law provides a means for the taxpayer to recover the asset in a tax-free transaction. In such situations, if management reasonably represents that,

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specific attributes intentionally were incorporated to accelerate the recognition of the associated financial accounting income and enable the income to be reported as operating income in lieu of a reduction in income tax expense. In general, operating earnings are more valuable to a business than a reduction in income tax expense because many stock analysts and valuation specialists utilize operating earnings when analyzing the appropriate value and stock price for a business.[188] In addition, because the relevant accounting standard does not use present value concepts, in many cases the reported financial accounting income significantly exceeded the present value of the anticipated Federal income tax benefits.[189]

Organization of the structured transactions group

The general tax-planning group within Enron's corporate tax department initially was responsible for implementing the structured transactions. However, in June of 1998, Mr. Hermann segregated the personnel responsible for the structured transactions into a separate

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without incurring significant cost, the company will use a tax planning action that permits the asset to be recovered in a tax-free transaction, then no deferred taxes are reported in the financial statements. Because no deferred tax asset or liability is reported, such difference will increase or decrease income reported in the financial statements in the year the basis difference arises, irrespective that such tax planning action may not be undertaken for until a later year. In many of the structured transactions, Enron represented that it would use tax-planning actions in the future to recover a basis difference in a tax-free manner and, consequently, did not report deferred taxes on such basis differences (i.e., increased financial accounting income). The Joint Committee staff has not addressed whether the financial accounting treatment reported by Enron is appropriate as it is beyond the scope of the Report.

[188] Commonly, stock analysts and valuation specialists use earnings before income, taxes, and depreciation and amortization ("EBITDA") to value a company. Using EBITDA, stock analysts and valuation specialist ignore the tax expense line in an income statement (among others). Accordingly, because the compensation of a business entity's executive officers often is tied to the market or trading value of the entity, some executives place much greater priority on increasing operating income and are generally less concerned about the entity's net income. For example, an increase in operating earnings of $10 for a company trading at a multiple of fifteen times EBITDA would be expected in increase the market value of a company by $150. From 1997-2001, two Enron structured transactions enabled Enron to increase operating income by a total of approximately $260 million (and to increase net income by approximately $170 million).

[189] The difference between the reported financial accounting income and the present value of the Federal income tax benefits can be significant because, unlike some financial accounting rules, SFAS 109 does not determine deferred tax assets and liabilities on a present value or discounted basis. Enron and its advisors used this rule to devise transactions that could report financial statement benefits that were significantly in excess of the anticipated present value of the Federal income tax benefits. Although not discounting income taxes for financial reporting can result in anomalies, as highlighted by some of the structured transactions, the conceptual and implementation issues with discounting income taxes for financial reporting are numerous and complex.

"structured transactions" group within Enron's corporate tax department.[190] The group apparently was separated due to the increase in the number of structured transactions, the ongoing responsibilities associated with implementing and administering existing structured transactions, and the time expended to review proposed structured transactions. The structured transactions group was modeled after similar groups established by a select group of corporations and financial institutions. Mr. Maxey headed the structured transactions group, which had (at its peak) over twenty-five attorneys and accountants.

The structured transactions group's focus was to synthesize tax, finance, legal, and accounting principles to enhance economic returns to Enron. The structured transactions group effectively was responsible for managing a structured transaction from its inception to final execution. The group handled all aspects of the entities involved in a structured transaction, including the bookkeeping, financial reporting, tax reporting, investor reporting, dividend payments, and corporate governance responsibilities. Although many of these formalities were not tax-related, they were centralized in the structured transactions group as well, because other corporate departments were not always responsive to requests to perform the additional functions required to demonstrate the substance of entities that otherwise generally were ignored for financial accounting purposes and overall corporate management. Effectively, the group operated substantially independent of the remaining tax professionals and, to some extent, operated as a standalone business unit.[191]

Operation of the structured transactions group

The structured transactions group completed 11 large structured transactions over seven years. One additional structured transaction was approved but never implemented because of Enron's bankruptcy. The ideas for the structured transactions primarily were brought to the attention of Enron's corporate tax department via referrals from Enron's finance department or direct calls to Mr. Hermann or Mr. Maxey. The promoters of the transactions comprised a select group of investment banks, law firms, and accounting firms.

In general, Enron would listen to a "pitch" and then evaluate the idea.[192] The structured transactions group used a multistage process to evaluate the ideas. The first part of this process was to determine whether the transaction was technically sound. Enron generally reviewed a

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[190] Although those responsible for the structured transactions were part of the planning group until 1998, for purposes of this Report they are referred to as part of the structured transactions group.

[191] In many cases, Enron tax personnel outside of the structured transactions group had limited knowledge of the transactions being undertaken by the group even when they were responsible for tax matters affecting a business unit that was a party to a transaction.

[192] In addition, Enron tax personnel periodically traveled to New York, Washington D.C., and other locations to seek out tax advantageous transactions.

general tax opinion provided by the promoter[193] and would raise concerns and issues specific to Enron's organization and tax situation. In addition to structured transactions personnel, other senior level tax personnel reviewed aspects of a proposed structured transaction based on their specific technical expertise. For a structured transaction to proceed, Mr. Hermann required counsel to indicate that it could provide a "should" level opinion.[194]

The second part of the process was to fit the structured transaction into Enron's business strategy. Effectively, the structured transaction would need to be attached to an existing transaction that the company was contemplating to provide a purported business purpose for the transaction. Finding a business purpose for a structured transaction was the most important and the most difficult aspect of the development of a structured transaction. For example, an Arthur Andersen memorandum discussing a structured transaction stated "the biggest issue to be resolved [is the] business purpose."[195] The difficulty of obtaining reasonable operational purposes for entering into some of the structured transactions resulted in Enron representing that its business purpose for some structured transactions was the financial accounting benefits obtained.[196] Other structured transactions were able to fit into to an existing business transaction; however, based on the documents reviewed by the Joint Committee staff, their stated business purposes for the structured transactions were lacking or tenuous and, in general, unrelated to underlying business transaction.

If an idea satisfied the technical and business strategy requirements, accounting, finance, legal, and other relevant personnel would become involved in further vetting the idea. If a transaction appeared to satisfy all parties, the transaction generally would be sent to Mr. Causey, Chief Accounting and Information Officer, for approval. Whether additional approvals were

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[193] Generally, the promoters provided a general explanation of the expected accounting treatment for an idea. In some cases, they provided internal opinions or opinions written by accounting firms based upon a hypothetical transaction that effectively mirrored the idea being promoted.

[194] The "should" level requirement was added after the first two structured transactions. Those transactions received "more likely than not" tax opinions.

[195] Memo from Robert P. Palmquist of Arthur Andersen to Robert J. Hermann dated October 27, 1995, item # 4, EC2 000037798, attached in Project Tanya materials in Appendix B.

[196] Projects Steele, Cochise, and Teresa all relied heavily on this "business purpose." However, claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) in these transactions and significantly diminishes the purpose for having a substantial non-tax purpose requirement. *See, e.g., American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner,* 113 T.C. 254, 287 (1999)).

needed depended upon the general Enron corporate approval guidelines for engaging in a transaction. In many cases, the Board of Directors or one of its committees approved the structured transactions.

Once a structured transaction was approved, Enron would enter into an agreement with the promoter detailing the responsibilities of each party and setting forth the compensation to be paid. In general, the engagement letters reviewed by the Joint Committee staff indicate that Enron would pay a fee of approximately $8 to $15 million to the "idea provider" selling the specific transaction and would incur approximately $800,000 to $1.2 million for the legal work including the tax opinion for a transaction.[197]

Besides engaging in structured transactions for its own tax and financial accounting benefits, Enron also acted as an accommodation party, for a fee, in two structured transactions with Bankers Trust. In addition, it appeared that the structured transactions group viewed this role as a new source of value to Enron. Highlighting the transformation of the tax department, Mr. Maxey stated that because of the group's successful completion of structured transactions, "the relationships developed by group members with outside parties have grown, enabling the group to act as facilitator for other entities or to joint venture with other entities to provide similar services to other companies in addition to Enron. In effect, we have created a business segment for Enron that generates earnings and interacts with other entities for profit."[198]

Table 1, below summarizes certain tax and accounting information regarding 12 of Enron's structured transactions. The table shows that Enron's financial accounting benefits that it expected to derive from the structured transactions were front loaded to provide immediate reporting of earnings for its financial statements, even though the bulk of the tax benefits would not be derived, if at all, until well into the future. The table also lists the promoter of the transaction, the primary tax opinion provider, and project fees paid by Enron with respect to each transaction.

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[197] Two exceptions to the general range of fees paid for the idea were the fees paid to Arthur Andersen for Projects Tanya and Valor. Arthur Andersen was paid $500,000 and $100,000, respectively, for the idea and the tax opinion on these transactions. The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/01) for certain structured transactions. EC2 000036379.

[198] Interoffice memorandum dated October 2, 2000 to Richard J. Causey from R. Davis Maxey. EC2 000038284 - EC2 000038285.

Table 1.–Benefits and Fees of Enron's Structured Transactions (1995-2001)
[millions of dollars]

Project Name	Financial Accounting Income through 2001	Total Projected Financial Accounting Income	Federal Tax Savings through 2001	Total Projected Federal Tax Savings	Promoter	Primary Tax Opinion Provider	Total Project Fees
Tanya (1995)	66	66	66	66	Arthur Andersen	Arthur Anderson	0.5
Valor (1996)	---	82	82	82	Arthur Andersen	Arthur Andersen	0.1
Steele (1997)	65	83	39	78	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	11
Teresa (1997)	226	257	-76	263	Bankers Trust	King & Spalding	12
Cochise (1998)	101	143	---	141	Bankers Trust	McKee Nelson, Ernst & Young	16
Apache (1998)	51	167	51	167	Chase Manhattan	Shearman & Sterling	15
Tomas (1998)	37	113	95	109	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	14
Renegade (1998)	1	1	0	0	Bankers Trust	---	---
Condor (1999)	88	328	0	332	Deloitte & Touche	Vinson & Elkins	10
Valhalla (2000)	16	64	0	0	Deutsche Bank	Vinson & Elkins	---
Tammy I (2000)	---	406	0	414	Deloitte & Touche	Vinson & Elkins	9
Tammy II (2001)	---	369	0	370	---	---	---
Totals	**651**	**2,079**	**257**	**2,022**	**N/A**	**N/A**	**87.6**

Notes:
(1) Financial accounting income does not reflect the reversal of many of the reported income amounts due to Enron's bankruptcy filing; (2) Source information for projected financial accounting income is the November Structured Transactions Group Summary of Project Earnings & Cash Flows, November 2001, in Appendix B. Due to Enron's bankruptcy filing, it is likely that many of the financial accounting benefits will not be realized; (3) Federal tax savings computed using a 35 percent tax rate. Because Enron had net operating losses for many of the years the benefits resulted in increased net operating losses rather than an immediate reduction in taxes; (4) Source information for projected federal income tax savings is the November Structured Transactions Group Summary of Project Earnings & Cash Flows, November 2001, in Appendix B; (5) Enron was an accommodation party to Bankers Trust and Deutsche Bank (the successor to Bankers Trust) in Projects Renegade and Valhalla, respectively. Enron was paid $1.375 million for engaging in Project Renegade. Enron's fee for participation in Project Valhalla was in the form of an interest-rate spread on the offsetting loans; and (6) Project fees are based on contractual agreements between Enron and the counterparty. Due to Enron's bankruptcy filing, not all payments have been received by the counterparty to each agreement.

Reporting of activities to management

As the number of transactions entered into by Enron increased, the structured transactions group began preparing reports for Mr. Causey and senior tax personnel summarizing the executed transactions, the cash flow savings by year, the financial statement earnings impact, and new transactions under consideration by the group. This report was updated fairly frequently and was conveyed to appropriate personnel. Appendix B contains the Structured Transactions Group Summaries of Project Earnings & Cash Flows November 2001 report, as well as other reports prepared by the group regarding its activities.

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The following discussion provides an overview of selected tax motivated structured transactions into which Enron entered. The discussion includes information on the development and implementation of each transaction, the reported financial accounting and tax implications, the role of outside advisors in the transaction, a discussion of the relevant tax authorities, and recommendations by the Joint Committee staff.

B. Transactions That Raise Corporate Tax Issues

Beginning in 1995, Enron, in consultation with outside tax advisors, engaged in a series of structured transactions that were designed to satisfy the literal requirements of the corporate tax laws, yet produce results that were not contemplated by Congress and not warranted from a tax policy perspective. Several of the projects were structured to duplicate and accelerate tax deductions. The reported tax benefits (and corresponding financial statement benefits) were predicated on the interaction of the corporate tax-free transfer rules and the basis rules that apply to such transfers. For example, Projects Tanya (done in 1995) and Valor (done in 1996) relied on these rules, along with the rules regarding the treatment of contingent liabilities, to duplicate losses in connection with a widely-marketed transaction known as the "contingent liability" tax shelter. Projects Steele (done in 1997) and Cochise (done in 1999) also relied on these rules to duplicate losses in connection with certain built-in loss assets owned by Bankers Trust.

Project Teresa (done in 1997) relied on the interplay between the corporate redemption and dividends received deduction rules (while avoiding the extraordinary dividend rules), in concert with the partnership basis rules, to purportedly increase Enron's tax basis in its building by approximately $1 billion.

This section of the Report begins with a brief discussion of relevant corporate tax rules and then describes in detail Projects Tanya, Valor, Steele, Cochise, and Teresa.[199]

1. Discussion of relevant corporate tax laws

In general, the Federal income tax laws treat a corporation as a separate entity apart from its shareholders. Corporations and shareholders generally are each subject to tax on distributed corporate income. A corporation pays income tax on its income (regardless of whether such income is distributed to its shareholders), while its shareholders include in their income amounts that the corporation distributes to them.

Tax-free transfers to controlled corporations

A transferor that transfers appreciated (or depreciated) property to a corporation in exchange for stock in the corporation, and immediately after the transfer is in "control" of the corporation, generally does not recognize gain (or loss) on the exchange.[200] However, a transferor does recognize gain to the extent the transferor receives money or other property as part of the exchange.[201]

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[199] The next section of this Report discusses the general partnership tax rules (which is relevant to Project Teresa).

[200] Sec. 351(a). For this purpose, section 368(c) defines "control" as the ownership of stock possessing at least 80 percent of the combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

[201] Sec. 351(b)(1).

If an exchange satisfies the requirements of a tax-free transfer, then the transferor's basis in the stock received in the exchange is the same as the transferor's basis in the property transferred, decreased by (1) the amount of any money or other property received by the transferor and (2) any loss recognized by the taxpayer on the exchange, and increased by the amount of gain (or dividend) recognized by the transferor on the exchange.[202] The transferee corporation's basis in the property received in the exchange generally equals the transferor's basis in such property, increased by any gain recognized by the transferor on the exchange.[203]

Assumption of liabilities

A corporation's assumption of a liability in connection with a transfer of property does not prevent a transaction from qualifying for tax-free treatment, nor is such assumption generally treated as a receipt of money by a transferor.[204] The assumption of a liability does reduce the transferor's basis in the stock received in the exchange,[205] and it may result in the recognition of gain by the transferor to the extent the liabilities assumed exceed the total amount of the adjusted basis of the property transferred.[206] In addition, if it appears that the principal purpose of the transferor with respect to the assumption of the liability was to avoid Federal income tax (or was not a bona fide business purpose), then the assumption is considered to be money received by the transferor on the exchange.[207]

Treatment of certain contingent liabilities

An exception to the basis reduction and gain recognition requirements applies with respect to a liability, the payment of which would give rise to a deduction (and that has not resulted in the creation or increase of basis of any property). A liability that falls within this exception is not treated as money received by the transferor and does not reduce the transferor's basis in the stock received in the exchange.[208] This exception was enacted in 1978 to protect a cash basis taxpayer from having to recognize gain on the transfer of its accounts payable on the incorporation of a going business concern.[209] Although this rule was enacted primarily with cash

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[202] Sec. 358(a).

[203] Sec. 362(a).

[204] Sec. 357(a).

[205] Sec. 358(d)(1).

[206] Sec. 357(c)(1).

[207] Sec. 357(b)(1).

[208] Secs. 357(c)(3)(A) and 358(d)(2).

[209] S. Rep. No. 95-1263, 95th Cong., 2d Sess. 184, *reprinted in* 1978-3 C.B. 482 (1978).

method taxpayers in mind,[210] accrual method taxpayers also have properly relied on the exception. In some cases, however, taxpayers have utilized the exception to achieve tax benefits not envisioned by Congress. Eventually, Congress revisited the tax treatment of assumed liabilities and enacted section 358(h) in 2000.[211] This provision reduces the basis 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 if such liability was not treated as money received by the taxpayer.[212] For this purpose the term "liability" includes any fixed or contingent obligation, without regard to whether the obligation is otherwise taken into account for tax purposes.

Deduction of liabilities by transferee corporation

In general, a transferee corporation may be entitled to a deduction of an assumed liability as appropriate under its method of accounting.[213] In this regard, the IRS has ruled that a transferee corporation may deduct certain environmental liabilities assumed in a tax-free transaction.[214]

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[210] The reasons for change states that "[t]he committee therefore believes that it is appropriate to resolve the ambiguity as to whether for purposes of sections 357(c) and 358(d) the term liabilities includes deductible liabilities of a cash basis taxpayer."

As part of the Technical Corrections Act of 1979, Congress changed the requirement that only cash basis taxpayers could exclude certain liabilities for purposes of sections 357(c) and 358(d). *See* S. Rep. No. 96-498, 96th Cong., 1st Sess. 62 (1979).

[211] Section 358(h), added by The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000).

[212] Sec. 358(h)(1). This rule does not apply to any liability if (1) the trade or business with which the liability is associated is transferred to the person assuming the liability, or (2) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability. Sec. 358(h)(2).

[213] This has not always been the government's position. *See, e.g., Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1948) (in a transfer to which the predecessor of section 351 applied, the transferee corporation could not deduct payments made in satisfaction of tort claims even though the transferor would have been entitled to the deductions if it had made the payments). Over the years, however, the IRS generally has refrained from asserting a *Holdcroft*-type argument.

[214] Rev. Rul. 95-74, 1995-2 C.B. 36. In the ruling, an accrual-basis taxpayer ("P") operated a manufacturing plant on land it owned. When P purchased the land, it was not contaminated by any hazardous waste (but the land became contaminated as a result of P's operations). P transferred all of the assets of the manufacturing business (including the plant and the land) to a newly-formed subsidiary ("S") in exchange for stock. S also assumed the liabilities of the business (including the environmental liabilities) as part of the exchange. Two years later, S began soil and groundwater remediation efforts.

Acquisitions made to avoid income taxes

If a taxpayer engages in certain transactions for the principal purpose of evading or avoiding Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary of the Treasury (the "Secretary") has the authority to disallow the resulting benefits.[215] The Secretary may only exercise this special authority with respect to three defined transactions: (1) if any person or persons acquire, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation; (2) if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, by the acquiring corporation or its stockholders) where the basis of the property is determined by reference to the basis in the hands of the transferor corporation; or (3) if a corporation acquires at least 80 percent control (measured by both vote and value, but excluding certain nonvoting preferred stock) of another corporation, an election pursuant to section 338 is not made, and the acquired corporation is liquidated pursuant to a plan of liquidation adopted within two years after the acquisition date.

Redemptions between related corporations

If one or more persons are in control[216] of each of two corporations, and one corporation ("acquiring corporation") acquires stock of another corporation ("issuing corporation") in exchange for property, then the transaction is treated as a distribution in redemption of the stock of the acquiring corporation.[217] In determining whether the acquisition is to be treated as a distribution in part or full payment in exchange for the stock, reference is made to the stock of the issuing corporation.[218]

If the distribution is treated as a dividend distribution, the transferor and the acquiring corporation are treated in the same manner as if the transferor had transferred the stock so

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The IRS concluded that the contingent environmental liabilities assumed by S were not included in determining P's basis in S stock. In addition, the contingent environmental liabilities were not treated as money received by P. The IRS also concluded that the contingent environmental liabilities were deductible by S or capitalized as appropriate under its method of accounting. The IRS analogized the fact pattern to that in Rev. Rul. 80-198, 1980-2 C.B. 113 (transfer of trade accounts receivable in connection with the incorporation of a sole proprietorship). The IRS stated that, for business reasons, P transferred substantially all of the assets and liabilities of the manufacturing business to S, and P intended to remain in control of S. P would have been able to deduct/capitalize the remediation costs had P incurred the costs.

[215] Sec. 269.

[216] For this purpose, "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. Sec. 304(c).

[217] Sec. 304(a)(1).

[218] Sec. 304(b)(1).

acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a section 351 exchange, and then the acquiring corporation redeemed the stock it was treated as issuing in the transaction.[219] The determination of the amount that is a dividend is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits.[220]

Dividends received deduction

In general, a corporation is entitled to a deduction for a percentage of the amount received as dividends from a domestic corporation that is subject to taxation under Chapter 1 of the Code.[221] The amount of the dividends received deduction generally depends on the corporate shareholder's ownership of the distributing corporation. If the shareholder is a member of the same affiliated group as the distributing corporation (generally 80 percent vote and value), then the dividends may be "qualifying dividends" and a 100 percent dividends received deduction applies.[222] An 80 percent dividends received deduction applies if the corporate shareholder owns 20 percent or more of the vote and value of the stock of the distributing corporation;[223] in other cases, a 70 percent dividends received deduction generally applies.[224] If a corporation is a partner in a partnership that receives a dividend, the corporate partner may be entitled to a dividends received deduction. Little guidance exists in applying the various ownership thresholds under the dividends received deduction to a corporate partner receiving dividends through a partnership.[225]

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[219] Sec. 304(a)(1) last sentence. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1013(a) (August 5, 1997) (change to section 304(a)(1) last sentence). Prior to this change (which took effect on June 9, 1997), the stock that was acquired was treated as having been received by the acquiring corporation as a capital contribution.

[220] Sec. 304(b)(2).

[221] Sec. 243(a).

[222] Sec. 243(a)(3) and (b).

[223] Sec. 243(c).

[224] Sec. 243(a).

[225] In a somewhat analogous situation, the IRS held that two unrelated domestic corporations that form a partnership, each corporation being a 50 percent partner in the partnership, are each treated as owning 50 percent of all of the assets of the partnership. As a result, the partnership's ownership of 40 percent of the stock of a foreign corporation will be treated as owned 20 percent by each corporate partner for purposes of the deemed paid foreign tax credit. Rev. Rul. 71-141, 1971-1 C.B. 211.

Extraordinary dividends

Generally, if a corporation receives an extraordinary dividend with respect to stock and the corporation has not held the stock for more than two years after the dividend announcement date, then the basis of such corporation in the stock is reduced (but not below zero) by the non-taxed portion of the dividends.[226] The non-taxed portion of the dividend is generally the amount of the dividends received deduction with respect to the dividend.[227] An extraordinary dividend means any dividend if the amount of such dividend equals or exceeds ten percent (five percent in the case of preferred stock) of the taxpayer's adjusted basis in such share of stock.[228]

In 1997, Congress amended the extraordinary dividend rules in connection with redemptions between related corporations.[229] In the case of any stock redemption that would not have been treated (in whole or in part) as a dividend if the related corporate redemption rules had not applied, then any amount treated as a dividend with respect to such redemption is treated as an extraordinary dividend without regard to the holding period.[230] In other words, such dividends are per se extraordinary dividends. In addition, only the basis in the stock redeemed in the related corporate redemption transaction (i.e., the hypothetically issued acquiring corporation stock) is subject to the general basis reduction rule.[231]

The Treasury Department has applied the extraordinary dividend rules in the partnership setting pursuant to a Congressional grant of authority.[232]

Earnings and profits in a consolidated group

A corporation that is a member of a consolidated group must compute its earnings and profits so as to reflect the earnings and profits of any subsidiary of that particular member.[233]

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[226] Sec. 1059(a)(1). If the non-taxed portion of the dividends exceeds the corporation's basis in the stock, then the excess is treated as gain for the taxable year in which the extraordinary dividend is received. Sec. 1059(a)(2).

[227] Sec. 1059(b).

[228] Sec. 1059(c).

[229] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1013(b) (August 5, 1997) (effective for distributions and acquisitions after June 8, 1997).

[230] Sec. 1059(e)(1)(A)(iii)(II).

[231] Sec. 1059(e)(1)(A) (last sentence).

[232] Sec. 1059(g); Treas. Reg. sec. 1.701-2(f) example 2. In the example, a partnership composed of two corporate partners received an extraordinary dividend. The partnership was treated as an aggregate of its partners for purposes of section 1059. As a result, the partnership had to make appropriate adjustments to the basis of the stock it owned, and the corporate partners had to make appropriate adjustments to the basis in their partnership interests.

This rule is designed to treat the two entities as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the consolidated group's earnings and profits in the common parent.[234] If the location of a member within a consolidated group changes, then appropriate adjustments must be made to the members to prevent earnings and profits from being eliminated.[235]

Real estate mortgage investment conduits[236]

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating vehicle that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.[237] In order to qualify as a REMIC, all of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A regular interest is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or to the extent provided in regulations, at a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. The holder of a regular interest generally recognizes income in an amount equal to the taxable income that would be recognized by an accrual method holder of a debt instrument that has the same terms as the regular interest.

In general, a residual interest is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders. Specifically, the holder of a residual interest takes into account the holder's daily portion of the taxable income or net loss of the REMIC for each day during the holder's taxable year in which such holder held such interest. The amount so taken

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[233] Treas. Reg. sec. 1.1502-33.

[234] Treas. Reg. sec. 1.1502-33(a)(1).

[235] Treas. Reg. sec. 1.1502-33(f)(2). For example, if P transfers all of S's stock to another member in a section 351 transaction (and Treas. Reg. sec. 1.1502-13 applies), the transferee's earnings and profits are adjusted immediately after the transfer to reflect S's earnings and profits immediately before the transfer from consolidated return years. Also, if the transferee purchases S's stock from P, then the transferee's earnings and profits are not adjusted. The regulation also provides for an anti-avoidance rule warning that adjustments must be made as necessary to carry out the purpose of the section.

[236] Although unrelated to the general corporate tax laws, a general discussion of the rules relating to REMICs has been included in this section because REMICs were used in connection with Projects Steele and Cochise.

[237] See sections 860A through 860G.

into account is treated as ordinary income or loss. The daily portion is determined by allocating to each day in any calendar quarter, a ratable portion of the taxable income or net loss of the REMIC for such quarter, and by allocating the amount so allocated to any day among the holders (on such day) of residual interests in proportion to their respective holdings on such day.

A holder's basis in a residual interest is increased by the amount of taxable income of the REMIC that is taken into account by the holder. The basis of such an interest is decreased (but not below zero) by the amount of any distributions received from the REMIC and by the amount of any net loss of the REMIC that is taken into account by the holder.

Because of the interest income and deduction accrual rules pertaining to REMIC residual interests, such interests typically produce non-cash "phantom" interest income accruals that cannot be offset by net operating losses or negated by the tax-exempt status of a REMIC residual interest holder.[238] Unlike non-statutory securitization structures, the holder of the residual interest in a REMIC is not required to demonstrate any degree of equity substantiality through a minimum threshold of cash return entitlement, which makes the REMIC a highly efficient securitization structure. Therefore, REMIC residual interests typically have little or no fair market value because they have nominal (if any) entitlement to cash distributions from the REMIC. In fact, REMIC residual interests often have a negative fair market value because, although the non-cash "phantom" interest income accruals are reversed by non-cash "phantom" interest deductions, such deductions may accrue only years after the income inclusions, and REMIC residual interest values reflect the time value of money relating to this timing mismatch. The magnitude of these timing differences depends (among other things) upon the structure of the REMIC regular interest tranches and, in particular, their interest rates and terms to maturity in relation to each other and to the REMIC assets.[239]

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[238] Primarily because of the REMIC excess inclusion rules that require this result, REMIC residual interests have been described as "intensely regulated by arcane and complicated tax rules that are designed principally to maximize a holder's tax liability." Kirk Van Brunt, *Tax Aspects of REMIC Residual Interests,* 2 Fla. Tax Rev. 149, 152 (1994). However, others point out that the excess inclusion rules "tend to reduce the excessive differences in after-tax yields for high and low marginal rate taxpayers," in part because excess inclusion income may not be offset by net operating losses or negated by the tax-exempt status of the holder of a REMIC residual interest. Bruce Kayle, *Where Has All the Income Gone? The Mysterious Relocation of Interest and Principal in Coupon Stripping and Related Transactions,* 7 Va. Tax Rev. 303, 351 (1987).

[239] "Income and deductions created by timing differences will ultimately offset each other and net to zero. However, timing is everything and the pain of a substantial tax liability on phantom income in one year is only partially eased by the prospect of offsetting phantom losses in a later year." Kirk Van Brunt, *Tax Aspects of REMIC Residual Interests,* 2 Fla. Tax Rev. 149, 156 (1994).

Lease versus financing[240]

The IRS has issued a number of revenue rulings and revenue procedures addressing the issue of whether an agreement is a lease or a conditional sales contract (i.e., a financing arrangement).[241] A synthetic lease transaction is a transaction that is structured as an operating

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[240] Although unrelated to corporate tax laws, a general discussion of synthetic lease arrangements is included in this section because Project Teresa involved such an arrangement (though this Report does not focus on issues raised by the synthetic lease arrangement).

[241] In Rev. Rul. 55-540, 1955-2 C.B. 39, the IRS stated that whether an agreement, which is in form a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the terms of the agreement and the facts and circumstances existing at the time of the execution of the agreement. The IRS subsequently issued a number of rulings in distinguishing a lease from a conditional sales contract. *See, e.g.,* Rev. Rul. 55-541, 1955-2 C.B. 19 (sale rather than a lease), Rev. Rul. 55-542, 1955-2 C.B. 59 (sale rather than a lease), Rev. Rul. 60-122, 1960-1 C.B. 56 (two transactions, one considered a lease and the other considered a sale), and Rev. Rul. 72-408, 1972-2 C.B. 86 (sale rather than a lease).

In Rev. Proc. 75-21, 1975-1 C.B. 715, the IRS set forth guidelines that it would use for ruling purposes in determining whether certain transactions purporting to be leases are, in fact, leases for Federal income tax purposes. On May 7, 2001, the IRS published Rev. Proc. 2001-28, 2001-19 I.R.B. 1156, which modifies and supersedes Rev. Proc. 75-21. The new revenue procedure, like its predecessor, applies to leveraged lease transactions.

The leading case in determining the tax ownership of leased property in a sale-leaseback transaction is *Frank Lyon Co. v. United States,* 435 U.S. 561 (1978). In *Lyon,* Worthen Bank & Trust Company ("Worthen") constructed a bank building and sold it to Frank Lyon Company ("Lyon") for approximately $7.64 million. Lyon invested $500,000 of its own funds and financed the remaining purchase price with a mortgage from New York Life Insurance Company payable over 25 years. Lyon then leased the bank building to Worthen for 25 years (equal to the term of the mortgage). The rental payments under the lease also matched in time and amounts the payments due under the mortgage. Under the lease, Worthen had the option after 11 years, 15 years, 20 years, and 25 years, to repurchase the building at a price equal to: (1) the outstanding balance on the mortgage and (2) $500,000 plus six percent compound interest over the lease term. If Worthen did not exercise its option to repurchase the building, it could renew the lease for eight additional five-year terms. The rents under the renewal were calculated to return Lyon's investment plus six percent compound interest. Worthen was responsible for all expenses associated with the maintenance of the building (a "net lease" arrangement).

The Supreme Court respected the form of the transaction and held for the taxpayer. The Court wrote:

> In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-

lease for financial accounting purposes but a financing arrangement for tax purposes. The primary benefit is that the lessee does not record the debt incurred to finance the property acquisition or the rent obligation to the lessor as a liability on its balance sheet. For income tax purposes, the transaction is structured so that the lessee (and not the lessor) is treated as the owner of the property. As a result, for tax purposes, the lessee is entitled to the depreciation and interest deductions.[242]

2. Projects Tanya and Valor

Brief overview

Projects Tanya and Valor were structured to accelerate and duplicate certain deductions within the Enron consolidated group. Each transaction involved a tax-free transfer of assets and unrelated contingent liabilities by Enron to an Enron subsidiary in exchange for stock in the subsidiary. The transferred assets had a value that only slightly exceeded the projected amount of the contingent liabilities.[243] The transferred assets had a tax basis that significantly exceeded the net value of the stock received in the exchange. Therefore, a sale by Enron of the subsidiary stock would result in a significant capital loss (i.e., an acceleration of a future loss). In addition, the contingent liabilities would give rise to a future tax deduction when paid by the subsidiary (resulting in a duplication of the loss).

Project Tanya – background[244]

Reported tax and financial statement effects

In connection with Project Tanya, Enron reported a short-term capital loss of $188.515 million on its 1995 return. Enron also deducted a total of $76.68 million in connection with the assumed liabilities in its 1996 through 2000 tax returns.

The $188.515 million loss that Enron reported on its tax return did not result in a corresponding loss for financial statement purposes. Thus, the tax savings associated with the

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avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. *Id.* at 583-84.

[242] The IRS has issued agency decisions addressing synthetic lease arrangements. For example, in 1998 FSA LEXIS 413 (February 26, 1998), the IRS concluded that a transaction structured as a synthetic lease was a lease for Federal income tax purposes and not a financing arrangement. The IRS reached a contrary result in FSA 19992003 (January 12, 1999).

[243] Project Tanya involved the assumption of liabilities relating to deferred compensation and post-retirement medical, life insurance, and executive death benefit obligations. Project Valor involved the assumption of certain risks associated with third-party commodity contracts.

[244] The information regarding Project Tanya was obtained from Joint Committee staff interviews of Robert J. Hermann, Robert D. Maxey, Greek L. Rice, and Mary K. Joyce, as well as from documents and information provided by Enron and the IRS.

loss resulted in an increase in financial statement earnings (i.e., earnings through a reduction in the provision for income tax expense) of $65.8 million.[245] Enron reported $46.5 million of the earnings in 1995 and the remaining $19.3 million in 1999 (upon the IRS's completion of its review of the stock sale that generated the capital loss).[246]

Development of Project Tanya

Arthur Andersen, Enron's outside auditor, brought the idea for Project Tanya to Enron in August 1995.[247] Robert J. Hermann, Managing Director and General Tax Counsel of Enron Corp., named the transaction after a hurricane.[248] Arthur Andersen, aware that Enron had significant capital gain in 1995 from the sale of stock in Enron Oil & Gas, proposed the transaction as a means to offset a portion of the capital gain. Originally, the transaction contemplated the assumption of potential environmental liabilities; however, Enron did not have such liabilities. So the transaction was customized to involve the assumption of deferred compensation and post-retirement benefit obligations. The transaction had to be completed in December 1995 (presumably to offset the capital gain that was recognized in the same year).

The Finance Committee of Enron Corp.'s Board of Directors approved the transaction on December 11, 1995.[249] The next day, Richard D. Kinder, a member of the Enron Corp. Board of Directors, presented the details of the transaction at a meeting of the Board of Directors. At that meeting, the Board of Directors approved and ratified the transaction.[250]

Implementing the transaction was a time-consuming process, but the Enron tax group received help from different parts of the company for document production. The Enron tax group also depended heavily on Arthur Andersen in implementing the transaction. Enron's Human Resources Department did the modeling for the transaction.

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[245] The calculation is 35 percent (i.e., the statutory Federal corporate income tax rate) of $188.515 million.

[246] The General Background Materials in Appendix B contain the Structured Transactions Group, Summary of Project Earnings & Cash Flows, November 2001. The IRS review of Project Tanya is discussed in greater detail below.

[247] ERMI Structure Presentation by Arthur Andersen, dated August 14, 1995, EC2 000037817-37827.

[248] This tax Project was named for the Atlantic tropical storm, as listed by the World Meteorological Organization, that began with the letter "T" in the year the project was commenced. Projects Teresa, Tomas, and Tammy I and II were also named using this convention.

[249] Agenda item #3 of the Meeting of the Finance Committee of the Enron Corp. Board of Directors, December 11, 1995, EC2 000037848.

[250] Minutes of the Meeting of the Board of Directors of Enron Corp., December 12, 1995, EC2 000037855-56.

The purported business purpose of the transaction was to provide an incentive for human resource personnel to manage the deferred compensation and post-retirement benefit obligations by allowing the employees to share in the successes that may result from their management efforts. According to an Arthur Andersen memo, "the biggest issue to be resolved [is the] business purpose for [the subsidiary's] managing these items."[251]

Implementation of Project Tanya

In December 1995, Enron Corp. transferred two intercompany promissory notes to Enron Management, Inc:[252] (1) a 20-year promissory note with a tax basis of $120.84 million, and (2) a 10-year promissory note with a tax basis of $67.7 million. As part of the transfer, Enron Management, Inc. also assumed certain contingent liabilities of Enron Corp. -- a contractual assumption of Enron Corp.'s deferred compensation obligations of approximately $67.7 million, and a contractual assumption of post-retirement medical, life insurance, and executive death benefit obligations of approximately $120.8 million. Enron Management, Inc. also assumed responsibility for administering Enron Corp.'s other compensation and benefit plans. These employee benefit liabilities were segregated from the employee benefit liabilities that were not involved in the transfer.

In exchange for the two promissory notes (and the assumption of the contingent liabilities), Enron Corp. received 20 shares (i.e., all of the issued shares) of a newly created class of voting preferred stock in Enron Management, Inc. The preferred stock had a reported tax basis of $188.555 million.[253] The preferred stock provided for a nine percent annual dividend and represented $40,000 of Enron Management, Inc.'s existing net equity. In addition, the class of preferred stock was entitled to three percent of any increase in Enron Management, Inc.'s net equity up to a maximum redemption value of $340,000.

On December 28, 1995, Enron Corp. sold the 20 shares of Enron Management preferred stock to Patricia L. Edwards and Mary K. Joyce (10 shares to each), both of whom were officers in Enron Corp.'s Human Resources Department and were involved in the management of deferred compensation and post-retirement benefit obligations.[254] The sales price of the stock

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[251] The Project Tanya materials in Appendix B contain a Memo from Robert P. Palmquist of Arthur Andersen to Robert J. Hermann dated October 27, 1995, item # 4, EC2 000037798.

[252] Enron Management, Inc. was a wholly-owned subsidiary of Enron Corp. and a member of the Enron consolidated group.

[253] The tax basis equaled the tax basis of the promissory notes Enron Corp. contributed to Enron Management, Inc.

[254] According to current Enron management, the shares were offered to Ms. Joyce and Ms. Edwards because of their cost-management knowledge and expertise regarding the various pension and deferred compensation liabilities contributed to Enron Management, Inc. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, dated January 13, 2003, answer 5.

was $40,000,[255] and Enron Corp. reported a capital loss from the stock sale of $188.515 million ($40,000 amount realized less a tax basis of $188.555 million).

The terms of the Enron Management preferred stock, as contained in a Stock Sale and Purchase Agreement, included a put option after five years for the shareholders and a call option after six years. The holders of the preferred stock had the right to elect one of the six directors of Enron Management, Inc.[256]

It was anticipated that in 2002, Enron Management, Inc. would be liquidated into Enron Corp., and Enron Corp. would assume the deferred compensation and post-retirement benefit obligations that Enron Management, Inc. had assumed from Enron Corp. in 1995.[257]

The diagram on the next page depicts the general structure of Project Tanya.

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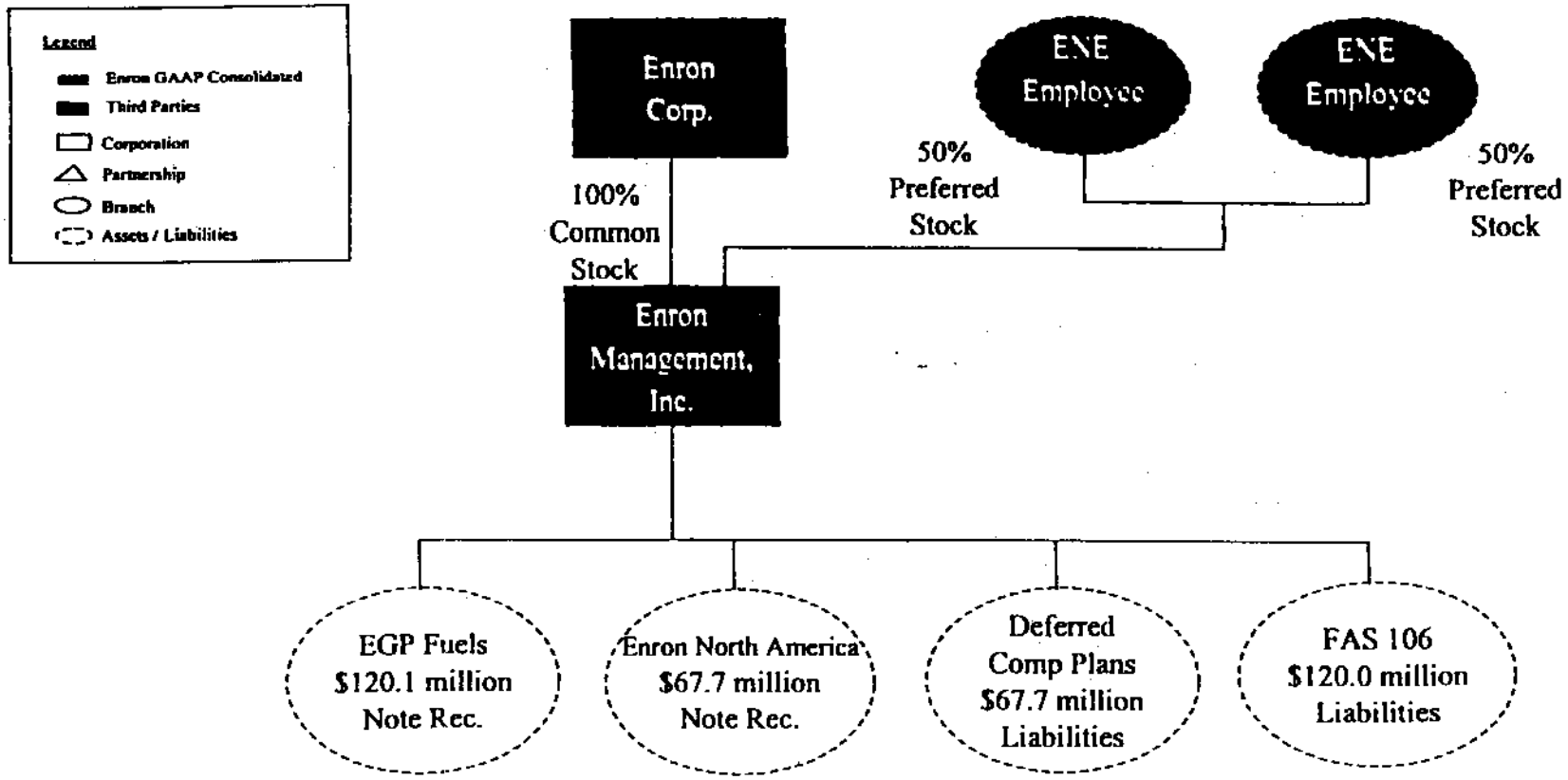
[255] Current Enron management is not aware of any investment information or advice provided to either Ms. Joyce or Ms. Edwards in connection with the investment. In addition, current Enron management is not aware of any payments that were made to Ms. Joyce or Ms. Edwards regarding the economic outlay for the Enron Management, Inc. preferred stock. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, dated January 13, 2003, answers 6 and 8.

[256] Current Enron management is not aware of any promises or commitments made by Enron to Ms. Joyce or Ms. Edwards regarding a return of their investments. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, dated January 13, 2003, answer 9.

[257] Project Tanya Structure Overview, EC2 000038324.

Transaction Structure



Time to execute	2 months
Closing date	December 1995
Total earnings	$66 million

Role of outside advisors

Arthur Andersen promoted the transaction to Enron. In connection with Project Tanya, Arthur Andersen provided a tax opinion which concluded that the overall tax result of the transaction, "more likely than not," is the recognition of a capital loss by Enron on the sale of the Enron Management, Inc. preferred stock. The specific tax issues discussed in the opinion were: (1) the qualification of the transfer of the intercompany promissory notes to Enron Management, Inc., subject to the contractual assumption of the contingent liabilities, as a tax-free contribution; (2) Enron Corp.'s tax basis in the Enron Management, Inc. preferred stock not being reduced by the deferred compensation and post-retirement benefit liabilities; (3) Enron Corp.'s loss on the sale of the Enron Management, Inc. preferred stock not being a duplicated loss (and thus a disallowed loss) under the Treasury consolidated return regulations; and (4) the contribution of the assets in exchange for the Enron Management, Inc. preferred stock not being considered an acquisition made to evade or avoid income taxes.

Arthur Andersen's fee in connection with Project Tanya was approximately $500,000.[258]

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

Subsequent developments

In the years following the transaction, Enron Management, Inc. claimed the following deductions in connection with the assumed employee benefit obligations: $16.977 million on its 1996 return; $16.217 million on its 1997 return; $13.682 million on its 1998 return; $14.7 million on its 1999 return; and $15.103 million on its 2000 return.

In July 1998, Ms. Edwards left Enron and sold her 10 shares to Ms. Joyce for $85,000. In 2001, Enron notified Ms. Joyce that it intended to exercise the call option pursuant to the Stock Sale and Purchase Agreement and purchase the 20 shares of Enron Management, Inc. preferred stock. The purchase price was $440,000 (i.e., $22,000 per share).[259] The stock purchase occurred in year 2000.

The IRS reviewed the transaction and ultimately allowed the $188.515 million short-term capital loss to Enron in its audit of Enron's 1995 consolidated tax return.[260] The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001.

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[258] Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 7; confirmed by information obtained from interviews.

[259] According to current Enron management, the price was the result of negotiations between Ms. Joyce, Mr. Richard A. Causey and other personnel who are no longer at Enron. Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 1.

[260] There were disagreements within the IRS regarding the proper tax treatment of the transaction. The IRS Houston field office (including the audit team responsible for the Enron

Project Valor – background[261]

Reported tax and financial statement effects

In connection with Project Valor, Enron reported a short-term capital loss of $235.327 million on its 1996 tax return. Enron also deducted $181.73 million in connection with the assumed liabilities in its 1997 tax return, and a total of $88.56 million in connection with the assumed liabilities in its 1998 through 2001 tax returns.

The $235.327 million loss Enron reported on its tax return resulted in an increase in financial statement earnings (i.e., earnings through a reduction in the provision for income tax expense) of $82.38 million.[262] However, it appears that Enron never recorded any benefits from Project Valor in its financial statements.[263]

Development of Project Valor

Project Valor was patterned after Project Tanya, though Project Valor involved different types of contingent liabilities. Project Valor was designed to generate a capital loss that could be used to offset capital gain realized by Enron from the sale of additional stock in Enron Oil & Gas.

It appears that Ben F. Glisan, Jr., recruited from Arthur Andersen in 1996 to be a Director at Enron Capital Trade & Resources Corp. ("Enron Capital Trade"),[264] led the effort to

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audit) believed that the capital loss should be disallowed. The IRS Houston field office forwarded to IRS District Counsel Office a proposed notice of deficiency that would have disallowed the loss on the grounds that the transaction lacked economic substance, or alternatively, that it lacked business purpose. The IRS District Counsel Office, in consultation with the Corporate Division of the Office of Chief Counsel, declined to support the audit team's position. As a result, the issue was not included in the Revenue Agent Report for Enron's 1995 tax year. The Project Tanya materials in Appendix B contain a Memo dated August 16, 1999, from IRS District Counsel, Houston District to Chief, Quality Measurement Staff, Houston District, regarding this matter.

[261] The information regarding Project Valor was obtained from Joint Committee staff interviews of Robert J. Hermann, Jordan H. Mintz, Robert D. Maxey, and Greek L. Rice, as well as from documents and information provided by Enron and the IRS.

[262] The calculation is 35 percent (i.e., the statutory Federal income tax rate) of $235.327 million.

[263] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 12; confirmed by information obtained from interviews.

[264] Enron Capital Trade is a wholly-owned subsidiary of Enron Corp. and a member of the Enron consolidated group.

implement Project Valor. Sometime in September 1996, Mr. Glisan began assembling a team to restructure certain commodity contracts used by Enron in its commodity business. Mr. Glisan was considered the team leader of Project Valor, and he reported to Andrew Fastow (who was Managing Director of Enron Capital Trade). In early December 1996, Mr. Hermann asked Jordan H. Mintz (who had recently been hired by Enron Capital Trade as its Vice President of Taxes) to assist in the project, which Mr. Hermann wanted completed before December 31, 1996. Mr. Mintz became the tax representative of the team.[265] Other significant participants in Project Valor included Richard Kieval (who was selected to manage the risk management liabilities), Bill Bradford (who was selected to manage the credit risk liabilities), Debra Culver (internal counsel representative on the team), and Paige Grumulaitis (Assistant Business Unit Coordinator).[266]

Unlike Project Tanya, Project Valor apparently was not presented to Enron Corp. management for formal approval.[267] Rather, Mr. Glisan informally presented an overview of the concept to Mr. Fastow, and Mr. Fastow gave Mr. Glisan an informal approval to proceed. To account for control policies, Ms. Culver (from internal counsel) was included on the team.[268]

The purported business purpose of the transaction was to provide an incentive for employees responsible for managing Enron's potential credit risk obligations and fixed price and risk management contract liabilities to manage effectively such liabilities by allowing the employees to share in the successes that may result from their management efforts.

Implementation of Project Valor

Enron Capital Trade was a purchaser and marketer of natural gas and wholesale electricity. In addition, it managed a portfolio of contracts offering physical and financial energy products and services. In support of its business activities, Enron Capital Trade would enter into various swaps, options, and forward contracts with unrelated parties, including numerous fixed price and risk management contracts ("FPRM contracts"). Due to changes in commodity prices and interest rates, some FPRM contracts were liabilities to Enron Capital Trade (because it would owe a payment to the counterparty pursuant to the contract). Enron Capital Trade also had certain credit risks that were characterized as liabilities in its financial records.

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[265] The project was approximately 25 to 50 percent complete when Mr. Mintz became involved.

[266] IRS compilation of interviews with Ben Glisan, Paige Grumulaitis, Bill Bradford, Jordan Mintz, Richard Kieval, and Debra Culver.

[267] However, current Enron management understands that Project Valor was presented to and approved by the Board of Directors of Enron Capital Trade. Letter from Enron's counsel (Skadden, Arps), to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 17.

[268] IRS compilation of interview with Mr. Glisan.

On December 20, 1996, Enron Capital Trade transferred to Enron Capital Trade Strategic Value Corp. ("ECT Strategic")[269] two intercompany promissory notes: (1) a 10-year promissory note with a tax basis of $217 million, and (2) a 10-year promissory note with a tax basis of $50.32 million. As part of the transfer, ECT Strategic assumed certain contingent liabilities of Enron Capital Trade -- a contractual assumption of $5.01 million of Enron Capital Trade's credit reserve obligations and a deemed assumption of $262.27 million of Enron Capital Trade's FPRM contract liabilities.[270] Pursuant to a Liability Management Agreement between Enron Capital Trade and ECT Strategic dated December 20, 1996, ECT Strategic assumed responsibility for managing the FPRM contract liabilities and the credit reserves, but any restructuring of the FPRM contracts or the credit reserves required prior approval by Enron Capital Trade. Employees who were responsible for the management of these liabilities, including Richard Kieval and Bill Bradford, were transferred to ECT Strategic.

In exchange for the promissory notes (and the assumption of the contingent liabilities), Enron Capital Trade received 40 shares (i.e., all of the issued shares) of a new class of ECT Strategic voting participating preferred stock. The preferred stock had a reported tax basis of $235.367 million.[271] The preferred stock paid a nine percent annual dividend and represented in the aggregate, $40,000 of ECT Strategic's net equity. In addition, the class of preferred stock was entitled to four percent of any increase in ECT Strategic's net equity up to a maximum redemption value of $2 million.

On December 27, 1996, Enron Capital Trade sold the 40 shares of ECT Strategic preferred stock to three employees involved in the monitoring of the commodity trading activities – Mr. Kieval (who purchased 30 shares for $30,000), Mr. Bradford (who purchased five shares for $5,000) and Mr. Glisan (who purchased five shares for $5,000).[272] Thus, the aggregate sales price of the stock was $40,000, and Enron reported a capital loss from the stock sale of $235.327 million ($40,000 amount realized less a tax basis of $235.367 million).

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[269] ECT Strategic, formerly known as Enron Gas Gathering Inc., was formed in March 1985, to manage various gathering assets of Enron. In connection with Project Valor, its name was changed to ECT Strategic, and its purpose was altered to undertake responsibilities associated with credit reserve obligations and FPRM contract liabilities.

[270] In order to avoid a breach of the terms of the FPRM contracts (which required consent for any assignment), Enron Capital Trade and ECT Strategic entered into a Master Swap Agreement and a Liability Management Agreement. These agreements replicated the economics that would have resulted from an actual transfer of the FPRM contracts to ECT Strategic.

[271] This amount equals the aggregate basis in the promissory notes of $267.37 million less approximately $32 million of premiums on unrealized liabilities that were assumed by ECT Strategic in connection with the transfer.

[272] Current Enron management is not aware of any payments that were made to Messrs. Kieval, Bradford, or Glisan specifically to cover the economic outlay for the ECT Strategic preferred stock. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 15.

The terms of the ECT Strategic preferred stock included a put option exercisable by the shareholders (requiring ECT Strategic to redeem its shares) after five years[273] and a call option exercisable by ECT Strategic (requiring the preferred shareholder to sell the stock to ECT Strategic) after six years.[274] The holders of the ECT Strategic preferred stock had the right to elect one of the six directors of ECT Strategic.

Role of outside advisors

In connection with Project Valor, Arthur Andersen provided a tax opinion, dated December 27, 1996, which concluded that the overall tax result of the transaction, "more likely than not," is the recognition of a capital loss by Enron Capital Trade on the sale of the voting participating preferred stock of ECT Strategic. The specific tax issues discussed in the opinion were: (1) the qualification of the transfer of the intercompany promissory notes to ECT Strategic, subject to the contractual assumption of the contingent liabilities, as a tax-free contribution; (2) Enron Capital Trade's tax basis in the ECT Strategic preferred stock not being reduced by the amount of the credit reserve obligations and FPRM contract liabilities assumed by ECT Strategic; (3) Enron Capital Trade's loss on the sale of the ECT Strategic preferred stock not being a duplicated loss (and thus a disallowed loss) under the Treasury consolidated return regulations; and (4) the contribution of the assets for ECT Strategic stock not being considered an acquisition made to evade or avoid income taxes.

Arthur Andersen's fee in connection with Project Valor was approximately $100,000.[275]

Appendix C, Part II to this Report contains the tax opinion Enron received in connection with Project Valor.

Subsequent developments

In the years following the transaction, ECT Strategic claimed the following deductions in connection with the assumed credit risk and risk management liabilities; $181.729 million on its 1997 return; $49.099 million on its 1998 return; $26.064 million on its 1999 return; $10.317 million on its 2000 return; and $3.085 million on its 2001 return.[276]

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[273] The price at which the preferred stock could be put to the company would be equal to four percent of any increase in ECT Strategic's net equity up to a maximum redemption value of $2 million.

[274] The right to call the preferred stock had a maximum redemption value of $2 million.

[275] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 22.

[276] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 18. The total of these losses exceeds the amount of the loss reported in 1996 in connection with the sale of the ECT Strategic preferred stock.

Around March 30, 1999, Mr. Kieval left Enron. Immediately prior to his departure, ECT Strategic redeemed the 30 shares of preferred stock owned by Mr. Kieval for $30,000 (i.e., the initial investment). The 30 shares were resold to Messrs. Bradford and Glisan, effective March 30, 1999, in the amount of $15,000 per each investor. According to current Enron management, Enron included amounts equal to the purchase price of the additional 15 shares each of the ECT Strategic preferred stock in Messrs. Bradford's and Glisan's 1999 bonuses (paid in February 2000).[277] Messrs. Bradford and Glisan apparently continue to hold their ECT Strategic preferred stock.

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

Discussion

In Projects Tanya and Valor, Enron sought to both duplicate and accelerate certain deductions with respect to contingent liabilities assumed by the respective Enron subsidiaries. Enron claimed a loss with respect to the contingent liabilities when Enron sold the preferred stock, and a second deduction in subsequent years as the liabilities were paid.[278]

A determination of whether Enron should be entitled to a capital loss on the sale of the preferred stock and on the subsequent accrual of the contingent liabilities necessarily involves an analysis regarding Enron's satisfaction of the literal requirements of the corporate 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-motivated transactions.[279]

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[277] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 15.

[278] The transfer of swap liabilities raises an issue that is unique to Project Valor. By independent operation of the Treasury regulations concerning the tax treatment of notional principal contracts with significant nonperiodic payments, Treas. Reg. sec. 1.446-3(g)(4), the manner in which the promissory notes and swap liabilities were transferred to ECT Strategic could have caused the transfer (at least to the extent of the swap liabilities and a corresponding amount of the promissory notes) to be recharacterized instead as a deemed contribution of on-market swaps and a loan by Enron Capital Trade to ECT Strategic (with the amount of the deemed loan being equal to the actual liabilities associated with the individual swaps). In such a case, the basis in the ECT Strategic preferred stock received by Enron Capital Trade in the exchange would be reduced by the amount of the deemed loan to ECT Strategic.

[279] 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 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

From a policy perspective, there is little question that, assuming Enron remains responsible for the liabilities, Enron should be entitled to a deduction when the liabilities are paid or accrued. Had Enron not engaged in Projects Tanya and Valor, it would have been entitled to a deduction with respect to the liabilities when the liabilities are taken into account under Enron's method of accounting. By the same token, however, there is no policy justification for allowing a single taxpayer multiple deductions with respect to the same liabilities.[280]

In Projects Tanya and Valor, Enron remained accountable for the liabilities both before and after the transactions. Also in each project, the same employees remained responsible for monitoring and managing the liabilities both before and after the transactions. Thus, apart from the tax benefits, there appeared to be little justification for participating in Projects Tanya and Valor. The purported rationale -- to provide an incentive for employees responsible for managing these liabilities to share in the success of their efforts -- is dubious. The maximum value of the preferred stock (whose value was dependent upon the successful management of the liabilities) was capped and subject to a call option, which had the effect of limiting the employee incentives. Enron could have provided similar incentives (without engaging in a complex and costly restructuring of its liabilities) through employment contracts. Indeed, Arthur Andersen noted that "the biggest issue to be resolved [is the] business purpose for [the subsidiary's] managing these items."[281]

If the non-tax business purpose of a transaction is not self-evident -- or stated another way, if a taxpayer and its tax advisor have to develop or devise a justification for the taxpayer's involvement in a particular transaction -- then the transaction in all likelihood lacks a non-tax

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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).

[280] *Cf. Rite Aid Corp. v. United States,* 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied,* 2001 U.S. App. LEXIS 23207 (Oct. 3, 2001), where the Circuit Court of Appeals for the Federal Circuit invalidated a provision in the consolidated return regulations that prevented the taxpayer from claiming a loss on the sale of stock of a subsidiary to the extent the subsidiary had assets that had a built-in loss, or had a net operating loss, that could be recognized or used by another taxpayer. Subsequent to the *Rite Aid* decision, the IRS issued Notice 2002-18, 2002 I.R.B. 644, in which the Treasury Department reiterated its belief that "a consolidated group should not be able to benefit more than once from one economic loss," and indicated its intent to issue regulations that will prevent a consolidated group from claiming multiple losses with respect to one economic loss. In October 2002, the Treasury Department proposed regulations under section 1502 that redetermine the basis of the stock of a subsidiary member of a consolidated group immediately prior to dispositions and deconsolidations of the stock. The proposed regulations also suspend certain losses recognized on the disposition of such stock. *See* REG-131478-02, 67 FR 65060 (Oct. 23, 2002).

[281] The Project Tanya materials in Appendix B contain a Memo from Robert P. Palmquist of Arthur Andersen to Robert J. Hermann dated October 27, 1995, item # 4, EC2 000037798.

business purpose and should be challenged accordingly. In Project Tanya, Enron and Arthur Andersen shared the responsibility of developing a business purpose for the transaction.[282] The fact that Enron's tax advisor, who promoted the transaction and assisted in its implementation, actually shared in the responsibility for developing the business purpose for Project Tanya should be *prima facie* evidence that Enron lacked a non-tax business purpose for the transaction.

Related to the concept of a non-tax business purpose is section 269. This provision grants the IRS the authority to disallow benefits if a taxpayer acquires control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax.[283] In Projects Tanya and Valor, the Arthur Andersen tax opinions concluded that section 269 was not implicated because Enron Management, Inc. and ECT Strategic were preexisting entities (and the acquisition occurred when Enron acquired the common stock, not the preferred stock, of these subsidiaries). Furthermore, even if control were measured at the time the preferred stock was acquired, the opinion letters rely on Enron's representations regarding its business purpose to conclude that the principal purpose was not the evasion or avoidance of income tax.[284] Given that Arthur Andersen shared in the responsibility for devising a business purpose for the transactions, its reliance on Enron's representations is difficult to justify. Similarly, if called upon, Enron should have a difficult time asserting that its reliance on the tax opinion constitutes reasonable cause and good faith.[285]

As to the economic substance of the transactions, even the most optimistic projections regarding the expected additional savings resulting from the transaction would be miniscule

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[282] The Project Tanya materials in Appendix B contain a facsimile that Enron Corp. received from Arthur Andersen of a "To Do List" dated November 9, 1995, EC2 000037845-37847, which states (action step #7) that Arthur Andersen and Enron shared the responsibility of developing a business purpose for Project Tanya.

[283] Sec. 269(a)(1).

[284] Appendix C, Part I to this Report contains the tax opinion Enron received in connection with Project Tanya (with the section 269 analysis in appendix E of the tax opinion). Appendix C, Part II to this Report contains the tax opinion Enron received in connection with Project Valor (with the section 269 analysis in appendix E of the tax opinion).

[285] 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. Section 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. This standard is not satisfied if the advice or opinion is based on unreasonable factual or legal assumptions. "For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner." Treas. Reg. sec. 1.6664-4(c)(1)(ii).

when compared to the $423.8 million in additional tax deductions claimed by Enron (i.e., the aggregate loss from the sale of the Enron Management preferred stock and ECT Strategic preferred stock).

Another troubling aspect of Projects Tanya and Valor was Enron's use of an accommodation party -- its employees. While these shareholders were not "related" to Enron as the term is generally used under the tax laws, their interests were aligned with Enron and they shared the same objectives as Enron for purposes of the transactions. In these situations, the tax rules oftentimes do not function as intended and may produce undesirable results.

Subsequent legislation

Congress enacted legislation in 2000 out of concern that taxpayers were accelerating and potentially duplicating deductions involving contingent liabilities -- precisely what Projects Tanya and Valor were designed to accomplish.[286] The provision applies if, after application of the other transferor basis rules, the basis of property permitted to be received without the recognition of gain or loss exceeds its fair market value. In such a case, the basis of the property is reduced (but not below its fair market value) by the amount of any liability that is assumed in exchange for such property if the liability was not treated as money received by the taxpayer in the exchange.[287] Had section 358(h) been in effect at the time that Projects Tanya and Valor were undertaken, the provision would have reduced Enron's aggregate tax basis in its Enron Management and ECT Strategic preferred stock from $423.8 million to $80,000.

Administrative guidance

The IRS also has made several administrative pronouncements with respect to contingent liability transactions. On February 26, 2001, the IRS released a notice on the contingent liability tax shelter.[288] The notice describes the transaction and states that the IRS was "not aware of any case in which a taxpayer has shown a legitimate non-tax business reason to carry out the combination of steps... ." In addition, "any business purposes taxpayers may assert for certain aspects of these transactions are outweighed by the purposes to generate deductible losses... ." The notice states that the IRS will disallow any loss from the sale of the stock.[289] The IRS also

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[286] The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000). *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 106th Congress* (JCS-2-01), April 19, 2001, at 154.

[287] Sec. 358(h)(1).

[288] Notice 2001-17, 2001-09 I.R.B. 730. The notice identifies the contingent liability tax shelter (and transactions similar to it) as a "listed transaction."

[289] For transfers after October 18, 1999, the losses are disallowed by reason of section 358(h). For transfers on or before October 18, 1999 (and for transfers not subject to section 358(h)), the IRS stated that it would disallow such losses under several different legal theories, including: (1) the purported section 351 exchange lacks a sufficient business purpose; (2) the transfer of the asset to the transferee corporation is in substance an agency arrangement or a payment to the transferee corporation for its assumption of a liability; (3) the purported section

noted that any deduction claimed by the transferee corporation for payments on the assumed liability may be subject to disallowance on one or more of several possible grounds, including that the payments are not for ordinary and necessary business expenses of the transferee corporation.[290] The IRS also has issued notices to assist Chief Counsel attorneys in advising field personnel in the development of cases involving these (or similar) transactions.[291]

Tax shelter resolution initiative program

On October 4, 2002, the government announced a tax shelter resolution initiative[292] under which it will agree to enter into settlement agreements with taxpayers involved in three abusive tax-avoidance transactions (including the contingent liability transactions). With respect to the contingent liability transaction, the settlement initiative provides for two resolution methodologies that an eligible taxpayer can elect.[293] A taxpayer that wishes to participate in the program must notify the IRS by a written application before March 5, 2003.[294]

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351 exchange is disallowed under section 269(a); (4) the principal purpose of the transferee's assumption of the liability was to avoid federal income tax or was not a bona fide business purpose under section 357(b)(1) and therefore the assumption of the liability should be treated as money received by the transferor; (5) the purported loss on the sale of stock of the transferee corporation is disallowed or limited by the loss disallowance rules of Treas. Reg. sec. 1.1502-20; (6) the purported loss on the sale of stock of the transferee corporation is not a bona fide loss under section 165; and (7) the transaction lacks sufficient economic substance.

[290] The IRS distinguished Rev. Rul. 95-74 by noting that in the ruling, the transferee corporation assumed the liabilities in connection with the transfer of substantially all the assets associated with the operation of a manufacturing business.

[291] *See,* CC-2001-033 (June 22, 2001) and CC-2001-033a (revised) (June 28, 2001). The IRS has released a number of agency decisions in which it has cited Notice 2001-17. *See, e.g.*, FSA 200121013 (February 12, 2001) (transaction involving nonqualified deferred compensation liabilities in a consolidated return context); FSA 200122022 (February 23, 2001) (transaction involving swap liabilities and credit reserves in a consolidated return context); CCA (chief counsel advice) 200117039 (March 13, 2001) (transaction involving an obligation to pay rent under a leasehold position following a lease stripping transaction); FSA 200134008 (May 15, 2001) (transaction involving employee benefits); and FSA 200146025 (August 2, 2001) (in determining whether a loss is a bona fide loss in an equity stripping transaction).

[292] IR-2002-105 (Oct. 4, 2002).

[293] Under one methodology -- the "fixed concession procedure" -- an eligible taxpayer is permitted a capital loss deduction equal to 25 percent of the amount of the capital loss reported for the sale of the transferee stock received in the contingent liability transaction. To prevent a duplication of the tax benefits, the taxpayer must include an amount equal to the permitted capital loss as income in equal annual amounts over a 15-year period. Under the second methodology -- the "fast track dispute resolution procedure" -- the taxpayer must concede between 50 and 90 percent of the amount of the capital loss reported for the sale of stock (with a

Recommendations

The legislation enacted in 2000 makes it more difficult for taxpayers to achieve the duplication of losses sought by Enron in Projects Tanya and Valor. The IRS and Treasury Department also have taken measures to address the specific transaction. Therefore, with respect to the specific transaction, a recommendation is not necessary at this time.

The linchpin to the contingent liability transaction is the interactive effect of the corporate tax-free transfer rules and the tax basis rules,[295] which results in a duplication of losses for the transferor and transferee. Equally as important to the transaction is the use of a liability that is not taken into account for Federal income tax purposes.[296] While section 358(h) was an appropriate response to the transaction at issue, there are instances in which it falls short of addressing other transactions that raise similar concerns. For example, the provision does not apply to situations in which the duplication of loss is achieved via a transfer of built-in loss assets without an assumption of liabilities.[297]

The duplication of gains and losses is one of the fundamental underpinnings of subchapter C. Some commentators have said that duplication of gain and loss is the price a transferor pays in order to achieve deferral of gain and loss.[298] Such a rationale, however, does

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binding arbitration procedure if the taxpayer and IRS cannot agree on the amount of the disallowed loss). The details of the settlement offer in connection with the contingent liability transaction are described in Rev. Proc. 2002-67, 2002-43 I.R.B. 733 (Oct. 28, 2002).

[294] In Announcement 2002-110, 2002-50 I.R.B. 1, the IRS announced it was extending the deadline for participating in the resolution program from January 2 to March 5.

[295] Secs. 351, 358 and 362.

[296] For a general discussion of the treatment of liabilities, *see generally,* Lee Sheppard, *What is a Liability,* 89 Tax Notes 1513 (2000).

[297] Bank of America used a similar section 351 loss duplication strategy in connection with certain problem loans to increase its 2001 fourth-quarter earnings by $418 million (i.e., earnings through a permanent reduction in its income tax liability). *See* Bank of America News Release dated January 22, 2002 ("During the year, the company realigned operations that manage distressed assets to make them more effective. The establishment of this new unit and the disposal of distressed assets generated a $418 million tax benefit which resulted in a 17 percent [effective] tax rate for the company."). *See also,* Carry Mollenkamp, *Rare Use of Tax Law Helps Lift Bank of America to Hefty Profit,* Wall St. Journal, p. A-2 (Jan. 24, 2002); Lee Sheppard, *Bank of America's Tax Plan for Bad Loans,* Tax Notes Today, 2002 TNT 38-5 (Feb. 26, 2002). *See also,* the following discussions of Projects Steele and Cochise in this Report.

[298] *See, e.g.,* Boris Bittker & James Eustice, *Federal Income Taxation of Corporations and Shareholders,* par. 3.01 at 3-8 (7th ed. 2002) ("In short, the cost of deferral under sec. 351 is that gain or loss accruing during the individual transferor's ownership is escalated from the one-tier tax treatment of individual to the two-tier corporate regime. This is one of the features

not justify permitting a transaction whose primary purpose is to duplicate losses, particularly in light of the degree of tax planning flexibility that taxpayers enjoy with respect to tax-free transfers.

A single economic loss should not be deducted more than once. If the loss duplication issue is to be addressed, a question arises as to which party should be entitled to the deduction. One theory is that the transferor bore the economic consequences of the loss and therefore should be entitled to the deduction. If this theory is followed, the Joint Committee staff recommends limiting a corporation's basis in property acquired in a tax-free transfer (or reorganization) to its fair market value.[299] An alternative view is that the loss is a tax attribute that is inherent in the property, and therefore it should remain with the property. The depreciation recapture rules reflect this concept -- if depreciable property is transferred to a corporation in a tax-free transaction, the recharacterized gain element remains with the asset (as opposed to tainting the stock received in the exchange).[300] If this theory is followed, the Joint Committee staff recommends expanding the sec. 358(h) basis reduction rule.

In addition to the above specific recommendations, Projects Tanya and Valor highlight the need for stronger measures to discourage transactions that lack a non-tax business purpose or economic substance. Such measures, however designed, must significantly increase the economic risk to taxpayers of entering into tax-motivated transactions. Under the present system, the expected tax benefits from these transactions typically far outweigh the associated costs. Taxpayers will continue to engage in tax-motivated transactions unless and until there is a meaningful change in this cost-benefit analysis. At a minimum, taxpayers that engage in tax-motivated transactions should be subject to substantial penalties. A number of recommendations and proposals have been made in recent years to curtail the use of tax-motivated transactions (including by the Joint Committee staff).[301]

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making life in the subchapter C lobster pot confining, complicated, and costly, even though entry, thanks to sec. 351, is usually simple and painless.") (citations omitted).

[299] For example, section 301 of H.R. 2520, the "Abusive Tax Shelter Shutdown Act of 2001," would reduce a transferee corporation's basis under section 362 with respect to loss property the corporation receives from a foreign transferor in a tax-free transaction. Such a proposal would raise several related issues, most notably whether the basis limitation rule should apply to aggregate asset transfers or to individual assets.

[300] Sec. 1245(b)(3).

[301] 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 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

The Joint Committee staff recommendations regarding Project Cochise[302] include recommendations to expand section 269. These recommendations also are appropriate for consideration with respect to Projects Tanya and Valor.

3. Project Steele

Brief overview

Project Steele was structured to generate approximately $130 million of pre-tax financial statement operating income[303] while, conversely, generating significant Federal income tax deductions for Enron. Project Steele involved a tax-free transfer of (1) cash and leased assets by Enron, and (2) cash and assets[304] with tax basis significantly in excess of their fair market value by Bankers Trust Company, a New York banking corporation ("Bankers Trust"),[305] to a newly formed corporation in return for common and preferred stock. Because Enron received more than 80 percent of the vote and value of the corporation, the corporation's income and loss was included in Enron's consolidated tax return. Therefore, the ensuing tax losses from the built-in loss assets contributed by Bankers Trust are generally available to offset taxable income of Enron.

Additionally, because Bankers Trust's tax basis in the stock received is determined by reference to the built-in loss assets contributed, Bankers Trust's tax basis in the stock significantly exceeds its fair market value. Thus, the transaction effectively duplicates the built-in loss in the contributed assets (i.e., Bankers Trust and Enron both seek to shelter taxable income as a result of the built-in-loss on the contributed assets). In order to provide substance to the transaction, Bankers Trust anticipated holding the stock received until at least 2002. In order to compensate Bankers Trust for delaying the realization of its tax loss for a number of years, Bankers Trust requested Enron pay Bankers Trust the present value cost of delaying such losses.

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).

[302] Project Cochise is discussed in this corporate section of the Report (following Project Steele).

[303] This amount was obtained from an Enron presentation material titled "Show Me the Money! Project Steele Earnings Benefits." The after-tax amount was anticipated to be approximately $83.5 million. The Project Steele materials in Appendix B contain the document. EC2 000038546.

[304] The assets contributed by Bankers Trust entities were Real Estate Mortgage Investment Conduit residual interests (hereinafter "REMIC residual interests").

[305] The assets were contributed by Bankers Trust (Delaware) and Bankers Trust. On or about June 4, 1999, all of the outstanding stock of Bankers Trust Corp., a New York corporation and the holding company parent of Bankers Trust, was acquired by Deutsche Bank.

This was described in correspondence between Bankers Trust and Enron that quantified the present value cost to Bankers Trust of entering into Project Steele.[306]

Background[307]

Reported tax and financial statement effects

Project Steele generated approximately $112 million of net Federal income tax deductions from 1997 through 2001.[308] In addition, Project Steele generated approximately $65 million in net earnings for financial reporting purposes from 1997 through 2001.[309]

Development of Project Steele

Bankers Trust promoted the concept of Project Steele to Enron in April of 1997.[310] The transaction was presented to Enron as a mechanism to generate financial statement income while providing significant Federal income tax deductions. A memorandum prepared by Bankers Trust provided an analysis of the financial accounting and Federal income tax treatment of three alternative structures that could be used to undertake the proposed transaction.[311] The memorandum states that in Bankers Trust's professional opinion that it would not receive much, if any, fee solely for the tax benefits (alternative structure one), but if the transaction were

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[306] Letter from Thomas Finley of Bankers Trust to Mr. Maxey dated August 11, 1997. The Project Steele materials in Appendix B contain the letter. EC00003795-96.

[307] The information regarding Project Steele was obtained from Joint Committee staff interviews of Robert J. Hermann and R. Davis Maxey, as well as from documents and information provided by Enron Corp. and the Internal Revenue Service.

[308] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 4.

[309] Enron stated that no opinion or memoranda was obtained from Arthur Andersen regarding the financial accounting treatment of Project Steele. However, Enron provided documentation from Bankers Trust regarding the accounting treatment of Project Steele. The Project Steele materials in Appendix B contain the letter. EC2 000037573 - EC2 000037592. The financial statement net earnings source documentation is a letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13 and January 31, 2003, answers 32 and 4, respectively.

[310] Project Steele Overview contained in a document titled Enron Structured Transactions Group Summaries of Project Earnings and Cash Flows dated November 2001. See also letter from Mr. Finley of Bankers Trust to Mr. Maxey dated June 17, 1997. The Project Steele materials in Appendix B contain the letter. EC2 00037571 - EC2 000037572.

[311] Letter and attachment from William B. Boyle of Bankers Trust to William McKee of King & Spalding, dated June 2, 1997. The Project Steele materials in Appendix B contain the letter and attachment. EC2 000037574- EC2 000037592.

redesigned to provide for financial accounting benefits, as well, then corporate clients would be extremely interested and would pay a substantial fee (alternative structures two and three).[312]

On June 17, 1997, Bankers Trust provided an engagement letter to Enron indicating that Bankers Trust agreed to provide Enron with all information regarding the proposed transaction, including all analyses and documents prepared by Bankers Trust or any of its advisors, and, in consideration thereof, Enron agreed to employ Bankers Trust as its exclusive financial advisor in connection with the consummation of one of the alternative structures.[313]

During the summer and early fall of 1997, the alternatives were evaluated and various details of the transaction were agreed to by Enron and Bankers Trust. On October 28, 1997, Enron and Bankers Trust entered into an agreement: (1) providing that Enron would enter into the proposed transaction with Bankers Trust; (2) providing that Enron would engage Bankers Trust to act as its financial advisor in connection with such transaction; and (3) detailing the compensation to be paid by Enron to Bankers Trust and to Akin, Gump, Stauss, Hauer & Feld, LLP (hereinafter "Akin, Gump") by Enron.[314] The transaction was subsequently completed on October 31, 1997.

It is unclear from the documents which corporate officers, other than Mr. Causey, approved the transaction prior to its completion. However, on March 4, 1998, Kenneth L. Lay, Chairman and Chief Executive Officer of Enron Corp. thanked Mr. Hermann and Mr. Maxey for their good job on the transaction.[315] In addition, Enron's Board of Directors was made aware of the completion of Project Steele at the December 9, 1997 meeting.[316]

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[312] *Id.* at EC2 0000375092. The letter also states that "other less expensive alternatives exist to generate equivalent tax benefits." EC2 000037592 and EC2 000037573.

[313] Letter from Mr. Finley of Bankers Trust to Mr. Maxey, dated June 17, 1997. Although the letter limits disclosure of the information, it does not explicitly require confidentiality; however, it states "[i]f any law enacted after the date of this letter shall require that the Transaction be registered as a 'tax shelter'... then this letter shall be null and void...including without limitation any payment obligations or any requirements of confidentiality or exclusivity." The Project Steele materials in Appendix B contain the letter. EC2 00037571 - EC2 000037572.

[314] Letter from Mr. Finley of Bankers Trust to Richard A. Causey, dated October 28, 1997. Although Akin, Gump was not a party to the agreement, the agreement specifically references fees to be paid to Akin, Gump, an unrelated and otherwise unnamed third party. Enron stated it was not aware why Akin, Gump was included in the agreement.

[315] Mr. Lay relayed his comments to Mr. Hermann and Mr. Maxey by forwarding a letter from Frank N. Newman, Chairman of the Board and Chief Executive Officer of Bankers Trust, in which Mr. Newman congratulates Mr. Lay on the successful completion of Project Steele. Mr. Newman wrote that Bankers Trust " is extremely pleased to have worked with your company as both financial advisor and principal on this transaction to collaboratively meet Enron's financial objectives. Moreover, we view this transaction as a solid platform for

Enron's purported principal business purpose for the transaction was to generate financial accounting income. Other business purposes stated were (1) that the transaction is expected to reduce Federal income taxes owed by Enron, (2) that the transaction is expected to generate investment profits, and (3) that the transaction provides access to Bankers Trust investment expertise.[317]

Implementation of Project Steele

On October 27, 1997, Enron Corp., indirectly through three wholly owned subsidiaries ("the Enron Subsidiaries"), formed ECT Investing Partners, LP ("ECT Partners").[318] Although legally a limited partnership, ECT Partners elected under the "check the box" regulations to be treated as a corporation for Federal income tax purposes.[319]

On October 29, 1997, ECT Partners borrowed on a short-term basis $51.2 million from Enron North America, Inc.[320] The next day, ECT Partners used the entire proceeds to purchase corporate bonds from Bankers Trust.[321] The purchased bonds were high-grade corporate bonds

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continuing to explore innovative solutions that are tailored to your needs." It is unclear if Mr. Newman's reference to "financial objectives" was to the stated business purpose of generating financial accounting income. The Project Steele materials in Appendix B contain the letter. EC2 000037643. In addition, subsequent to the completion of Project Steele, Bankers Trust invited Mr. Maxey to the Potomac Capital Investment Corporation Conference on Februrary 8, 1998 through February 11, 1998. The Project Steele materials in Appendix B contain the letter. EC2 000037639-EC2 000037642.

[316] Enron 1998 - 2000 Operating & Strategic Plan for Enron mentioned that Project Steele, a tax strategy, will contribute pre-tax earnings of about $20 million per year in 1998-2000. EC 000046108 and EC 000046154.

[317] Federal tax opinion letter from Akin, Gump to Mr. Maxey dated December 16, 1997 at EC2 000033872. Appendix C, Part III to this Report contains the tax opinion letter.

[318] The Enron Subsidiaries received general and limited partnership interests in return for their contributions. The contributing subsidiaries were ECT Investing Corp., ECT Investments Holding Corp., and Enron Pipeline Company.

[319] Treas. Reg. sec. 301.7701-3.

[320] At the time of the loan, Enron North America, Inc. was known as Enron Capital & Trade Resources Corp. Enron North America, Inc. (a wholly owned subsidiary of Enron) is an parent corporation of two of the ECT Partners.

[321] The bonds were subsequently transferred to ECT Diversified Investments, LLC, a wholly owned subsidiary of ECT Partners. ECT Diversified Investments, LLC elected to be treated as a disregarded entity for Federal income tax purposes.

of various energy companies.[322] On October 30, 1997, and October 31, 1997, the three Enron owners contributed approximately $48 million of cash, $93.5 million of preferred stock of Enron Liquids Holding Corporation,[323] and a beneficial interest in certain leased aircraft with a fair market value of $42.6 million and a tax basis of zero to ECT Partners. The leased aircraft interest was contributed subject to $42.6 million of debt. In exchange for such property, Enron received approximately 95 percent ownership in ECT Partners. Also on October 31, 1997, ECT Partners repaid $50.5 million to Enron North America, Inc. in satisfaction of all but $700,000 of ECT Partner's borrowing from Enron North America, Inc.

On October 31, 1997, Bankers Trust, through two entities, contributed to ECT Partners $4.4 million of cash and REMIC residual interests with an approximate fair market value of $7.6 million and a tax basis of $233.8 million. In return, the Bankers Trust entities received approximately a five percent preferred ownership interest in ECT Partners and $4.5 million of ECT Partners debt securities. Bankers Trust also purchased from Enron Corp. two puts for $1,000 ($500 per option). The puts permits Bankers Trust to put its interest in ECT Partners to Enron at specified times (2 years and 6 ½ years after a recapitalization of ECT Partners).[324]

As a result of these steps, the Enron Subsidiaries received common and preferred shares in ECT Partners representing approximately 95 percent of the total vote and value of ECT Partners's shares. Bankers Trust's received preferred shares representing approximately 5 percent of the total vote and value of ECT Partners and $4.5 million of ECT Partners debt securities. After the contribution of property, ECT Partners owned REMIC residual interests with a fair market value of approximately $7.5 million and a tax basis of $234 million. The partnership also owned $51.2 million of corporate bonds, $2 million cash, and $42.6 million in leased assets (with a zero tax basis) subject to debt in an equal amount, and 100 percent of the

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[322] The companies included Mobil Oil, Texaco Capital, Pacificorp, Alabama Power, Florida Power and Light, Imperial Oil, and Northern States Power. Ecx000003222.

[323] ECT Partners subsequently contributed the Enron Liquids Holding Corporation preferred stock to Enron Equity Corporation in return for a preferred interest in such entity. Enron North America contributed a $110 million intercompany note receivable from Enron Reserve Acquisition Corporation for the common interest in Enron Equity Corporation. Enron Equity Corporation immediately sold the Enron Liquids Holding Corporation preferred stock to Enron Corp. in exchange for a $93.5 million intercompany note receivable from Houston Pipeline Company, another wholly owned subsidiary of Enron Corp. Enron stated that it is not aware of any non-tax business reasons for the issuance of the $110 million intercompany note receivable from Enron Reserve Acquisition Corporation or the $93.5 million of Enron Liquids Holding Corporation preferred stock.

[324] At any time after five years, any equity owner of ECT Partners could cause a recapitalization of ECT Partners pursuant to which preferred shares and debt securities held by Bankers Trust would be exchanged for new debt securities of ECT Partners with a current cash pay London Interbank Offering Rate based rate of return.

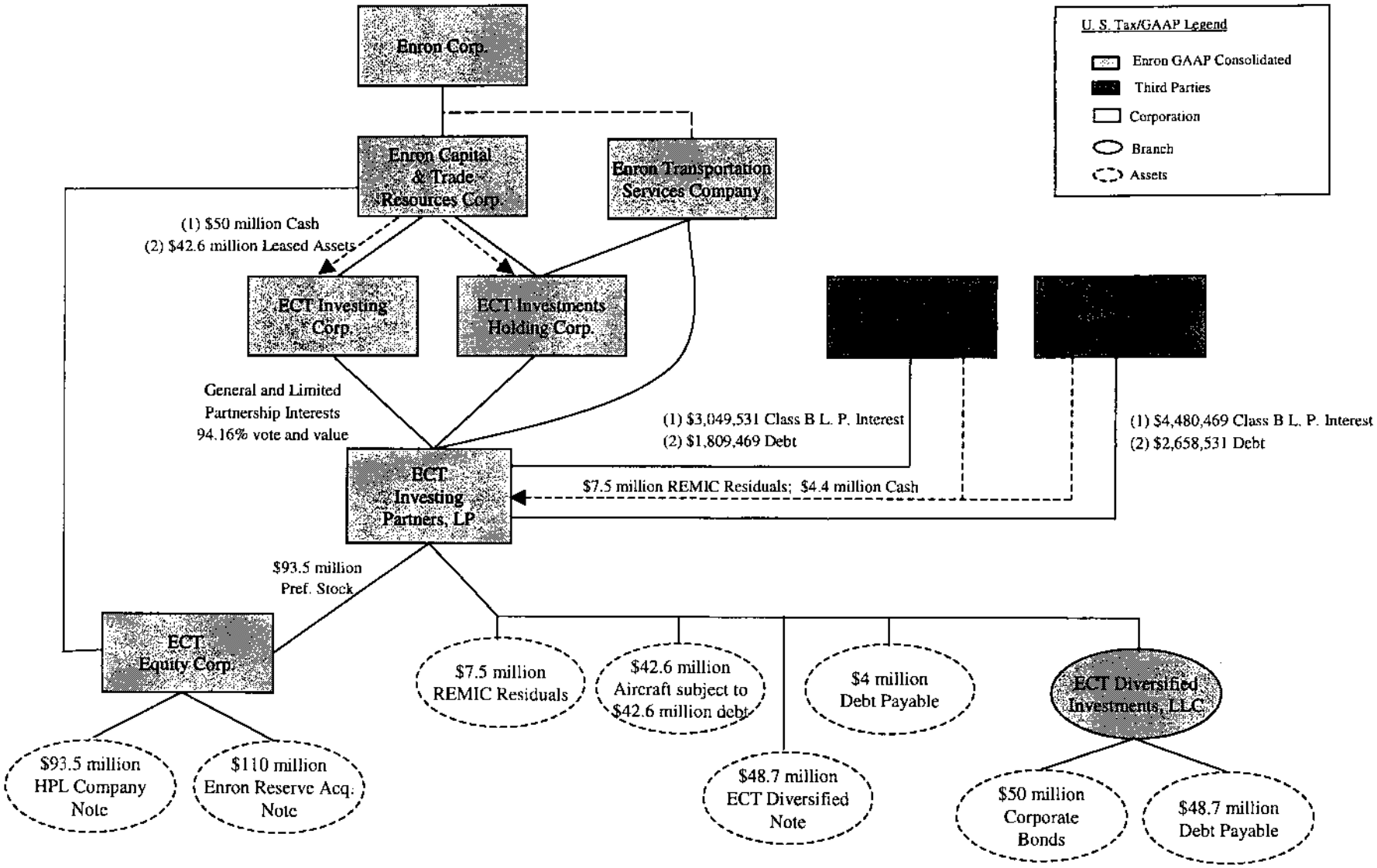
preferred stock of ECT Equity Corp. which owned $203.5 million of intercompany notes of Enron affiliates.[325]

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

[325] ECT Equity Corp. held a $93.5 million note receivable from Houston Pipeline Company and a $110 million note receivable from Enron Acquisition Corporation. Enron North America, Inc. owned 100 percent of the common shares of ECT Equity Corp.

Confidential

Project Steele
Structure as of October 31, 1997



Role of outside advisors

As noted above, Bankers Trust promoted and was the exclusive financial advisor on the transaction to Enron; in addition, Bankers Trust was the only legally unrelated counterparty to the transaction. Enron's outside counsel for Project Steele was Akin, Gump. In connection with Project Steele, Akin, Gump provided two tax opinion letters. The first opinion analyzed the tax implications of the transaction and concluded that (1) the contribution of property and assets by the Enron Subsidiaries and Bankers Trust should constitute nontaxable transfers of property under section 351; (2) the tax basis of the contributed property to the corporation should equal the tax basis of such assets in the hands of the contributor; (3) the losses attributable to the REMIC residual interests should not be disallowed, whether by the business purpose doctrine, section 269, the step transaction doctrine, or Treas. Reg. sec. 1.1502-13(h); (4) losses attributable to the REMIC residual interests recognized during the five-year period after the closing of the transaction more likely than not will be subject to limitation under the SRLY rules of the consolidated return regulations; and (5) ECT Partners should be eligible to join the consolidated group of Enron.[326] The second tax opinion analyzed the potential accuracy-related penalties (under section 6662) and tax shelter disclosure requirements (under section 6111). The opinion concluded that (1) the accuracy-related penalty should not apply in the event the deductions attributable to the REMIC residual interests are disallowed, and (2) no person principally responsible for, or participating in, the organization and management of ECT Partners should be required to register ECT Partners as a tax-shelter.[327] In addition, Arthur Andersen was engaged to do a tax basis study on the REMIC residual interests contributed by Bankers Trust.

Bankers Trust was paid $8.65 million for its services.[328] Akin, Gump was paid $1 million for the tax opinion letters and Arthur Andersen was paid $49,600 for its services.[329]

Discussion

Project Steele was designed to provide Enron with the tax benefits associated with built-in losses in the REMIC residual assets at a cost significantly less than the amount of the tax benefit. A determination of whether Enron should be entitled to deduct the built-in losses in the REMIC residual assets necessarily involves an analysis regarding Enron's satisfaction of the

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[326] Federal tax opinion letter from Akin, Gump to Mr. Maxey dated December 16, 1997. Appendix C, Part III to this Report contains the tax opinion letter Enron received in connection with Project Steele. EC 000033867-EC 000033903.

[327] Akin, Gump tax opinion letter to Mr. Maxey dated December 16, 1997. EC 000033905-EC 000033916. Appendix C, Part III to this Report contains the tax opinion letter Enron received in connection with Project Steele.

[328] The contractual fee was $10 million. Enron is still obligated on the final three installments of $450,000.

[329] The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/01). The fees were determined from a table summarizing fees paid on structured transactions. EC2 000036379.

literal requirements of the applicable statutory requirements as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate the purported tax benefits in tax-avoidance transactions.[330]

The Code and Treasury regulations recognize the potential for abusive activity and contain provisions intended to limit the benefits of arrangements that, although satisfying the literal requirements of a provision, are used to distort, pervert, and defeat the basic purpose of the underlying statute.[331] These provisions address such policy concerns by limiting the benefit of the underlying statute through the use of general disallowance if (1) specific factual tests are met or (2) if the principal purpose of the transaction is to evade or avoid income tax.

Acquisitions made to evade or avoid income tax

If a taxpayer acquires control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax, the deductions or other tax benefits may be disallowed.[332] In Project Steele, the formation of ECT Partners by the Enron Subsidiaries and Bankers Trust was the acquisition of control. Thus, in order to avoid the disallowance of the tax benefits from Project Steele, Enron had to have a principal purpose other than the avoidance or evasion of Federal income tax.

In determining Enron's motives for engaging in Project Steele, Akin, Gump relied heavily upon Enron's representation that its principal purpose for entering into the transaction

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[330] 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).

[331] *See, e.g.*, sec. 269 (acquisitions made to evade or avoid income tax), sec. 362(d) (limitation on basis increase attributable to assumption of liability), sec. 358(h) (reduction to basis of assets in connection with transfers of liabilities that give rise to a deduction), Treas. Reg. sec. 1.701-2 (partnerships formed or availed of in connection with a transaction with a principal purpose of reducing tax), and sec. 732(f) (adjustment to basis of assets of a distributed corporation controlled by a corporate partner). *See also* proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

[332] Sec. 269(a)(1).

was to generate financial accounting benefits and that it would not have entered into the transaction in the absence of the accounting benefits. In addition, Akin, Gump relied on Enron's representation that it would have entered into the transaction even if no net cash benefit was anticipated to arise as a result of an excess of net present value tax savings over the transaction costs. Based on these representations, Akin, Gump concluded that section 269 would not disallow the benefits obtained from Project Steele.[333]

Akin, Gump's conclusion is disturbing in two respects. First, concluding that a non-tax business purpose exists based on the accounting benefits of Project Steele fails to consider the origin of the accounting benefit (i.e., solely reduction of taxes). Such an analysis significantly diminishes the purpose for having a substantial non-tax business purpose.[334] Second, Akin, Gump's reliance on Enron's representation that Enron would have engaged in the transaction even if there were no present value tax benefits after transaction costs fails to recognize that Project Steele under all circumstances, absent an extraordinary fee to the promoter, would have significant present value tax benefits. Reliance on answers given to unimaginable hypothetical transactions, especially when evaluating a taxpayer's non-tax business purposes, may call into question the reasonableness and objectivity of the advice given, especially for purposes of the accuracy related penalty.[335]

Section 351

The Code and Treasury regulations also contain specific provisions intended to limit a taxpayer's ability to transfer tax attributes, such as net operating losses, built-in-losses, and

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[333] Appendix C, Part III to this Report contains the Akin, Gump tax opinion.

[334] *See, e.g., American Electric Power, Inc. v. U.S.,* 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner,* 113 T.C. 254, 287 (1999)).

[335] 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. This standard is not satisfied if the advice or opinion is based on unreasonable factual or legal assumptions. "For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner." Treas. Reg. sec. 1.6664-4(c)(1)(ii).

various credit items.[336] The general purpose of these provisions is to limit the ability of such tax benefits by a taxpayer who did not suffer the economic loss that gave rise to the tax benefit.

Project Steele purported to use the tax-free incorporation rules and resulting carryover basis rules to transfer losses and duplicate a single economic loss. The ability to transfer losses and duplicate a single economic loss through section 351 has been, and continues to be, a concern in the administration of tax policy.[337] In order for Project Steele to achieve the desired tax results (and the corresponding financial accounting benefits), the transfer of the REMIC residual interests by Bankers Trust had to occur in a tax-free incorporation such that the REMIC residual interests tax basis would carry over to ECT Partners.

It may be argued that the application of section 351(a) is predicated upon a valid non-tax business purpose and that the transfer by Bankers Trust did not have the requisite business purpose.[338] Documents exchanged between Bankers Trust and Enron clearly reflect that one of the considerations in the transaction was the fee paid to Bankers Trust for the delay the structure imposed on Bankers Trust's ability to deduct the losses. Bankers Trust provided schedules to Enron detailing the net present value cost of delaying their tax benefits until the recapitalization was permitted.[339] The documentation reviewed by the Joint Committee staff demonstrated no

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[336] *See, e.g.*, sec. 382 (limitation on net operating loss carryforwards and certain built-in-losses following ownership changes, sec. 383 (special limitations on certain excess credits, etc.), and Treas. Reg. sec. 1.1502-15 (SRLY limitation on built-in-losses).

[337] For example, in the year 2000, Congress enacted rules requiring a reduction in basis of assets in connection with transfers of certain liabilities in order to stop transactions that duplicated a single economic loss. *See*, the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000). *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Enacted in the 106th Congress* (JCS-2-01), April 19, 2001, at 154. In addition, President Clinton's Fiscal Year 2001 Budget Proposals contained a proposal that was aimed at limiting the ability of taxpayers to transfer built-in losses into the U.S. tax system by requiring marking to fair market value such assets when such assets become "relevant" for U.S. tax purposes (See Office of Management and Budget, *Budget of the United States Government, Fiscal 2001: Analytical Perspectives* (H.Doc. 106-162, Vol. III). See also Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000.) Most recently, the Treasury Department issued proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

[338] An analysis of the non-tax business purpose is also relevant for the application of the judicial doctrines referred to above.

[339] Letter from Mr. Finley of Bankers Trust to Mr. Maxey dated August 11, 1997. The Project Steele materials in Appendix B contain the letter. EC2 000037595 - EC2 000037596. King & Spalding was counsel to Bankers Trust on Project Steele.

purpose for the transaction other than to facilitate the transfer of Federal income tax benefits, and the resulting financial accounting benefits to Enron.

Bankers Trust's reason for engaging in the transaction can be gleaned from a letter to King & Spalding.[340] Bankers Trust provided a detailed analysis of how the "base case" duplication of losses from the REMIC residual interests could be enhanced by inserting a recapitalization feature and having a corporation (in this case Enron) transfer additional unrelated assets into the structure.[341] By inserting these features, Bankers Trust concluded that significant financial accounting benefits inure to a participant, including reflecting the tax benefits in operating income rather than as reduction to tax expense.[342] Most importantly to Bankers Trust, though, was its conclusion that by inserting the recapitalization feature into the structure, it could earn a modest fee, but with both features inserted, it could obtain a substantial fee from its corporate clients.

Recommendations

The Joint Committee staff recommendations regarding Projects Tanya and Valor[343] include recommendations to limit the duplication of a single economic loss. These recommendations also are appropriate for consideration with respect to Project Steele.

Irrespective of whether an overall change is made to limit the duplication of a single economic loss under subchapter C generally, the Joint Committee staff believes it is appropriate to limit the ability to transfer REMIC residual interests in a carryover basis transaction. Under the statutory rules regarding the taxation of REMICS, phantom income is allocated to REMIC residual interest holders. The phantom income allocation inevitably creates built-in losses to the holders of the REMIC residual interests, thus making such interests a natural component for transactions designed to duplicate a single economic loss. As such, the Joint Committee staff recommends that either a corporation's basis in REMIC residual interests acquired in a tax-free transfer (or reorganization) be limited to its fair market value or that a transferor's basis in the stock received in exchange for REMIC residual interests be limited to the fair market value of the REMIC residual interests.[344]

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[340] *See* letter and attachment from William B. Boyle of Bankers Trust to William McKee of King & Spalding dated June 2, 1997. The Project Steele materials in Appendix B contain the letter. EC2 000037574 - EC2 000037592.

[341] Both of these features were included in Project Steele.

[342] A short explanation of why operating earnings are considered more beneficial than a reduction in income tax expense is contained in Background and Rationale of this Part of the Report.

[343] Projects Tanya and Valor are discussed in this section of the Report immediately preceding Project Steele.

[344] *See* recommendations for Projects Tanya and Valor for a discussion of general issues with respect to this type of proposal.

4. Project Cochise

Brief overview

Project Cochise was a variation on Project Steele and, like Project Steele, was designed to produce operating income on Enron's financial statements, while also providing Enron with significant Federal income tax deductions. Thus, the prearranged transaction was intended to yield Enron a combination of both income for financial statement purposes and deductions for Federal income tax purposes.

In general, Project Cochise involved tax-free transfers by Enron of assets with a steady income stream (i.e., REMIC regular interests)--along with tax-free transfers by the London branch of Bankers Trust of assets with a tax basis significantly in excess of fair market value (i.e., residual interests in the same portfolio of REMICs)--to an existing wholly-owned subsidiary of Enron. The subsidiary subsequently elected to be treated as a real estate investment trust ("REIT") for Federal income tax purposes. Based upon the differences between the financial accounting and Federal income tax treatment of the REMIC residual interests that were transferred to the subsidiary by Bankers Trust, Project Cochise produced for Enron a substantial amount of financial accounting income through the immediate creation of a deferred but undiscounted tax asset.[345]

Because the subsidiary would no longer be part of Enron's consolidated group (as a result of its REIT status election) and Bankers Trust would own all of the common stock of the subsidiary following the transfers, all of the remaining so-called "phantom" (i.e., non-cash) income from the REMIC residual interests would be distributed to Bankers Trust through the declaration of consent dividends on the common stock in the subsidiary held by Bankers Trust. Furthermore, it was anticipated that Enron would recognize in later years the tax deductions resulting from the reversal of the earlier REMIC non-cash "phantom" income, after the subsidiary was recapitalized and rejoined the Enron consolidated group in 2004. Based upon the special deconsolidated treatment of the subsidiary as a REIT and the anticipated future reconsolidation of the subsidiary with the Enron consolidated group, Project Cochise was intended to redirect the REMIC non-cash "phantom" income and the subsequent offsetting deductions so that Enron could claim the deductions on its Federal income tax return after 2003 without having recognized the associated income in earlier tax years.

As with Project Steele, Project Cochise also produced a duplication of the loss that was built into the REMIC residual interests transferred by Bankers Trust to the subsidiary. Specifically, the tax basis of the subsidiary stock received by Bankers Trust in exchange for the REMIC residual interests significantly exceeded its fair market value because the tax basis in the stock was determined by reference to the built-in loss assets (i.e., the REMIC residual interests) contributed by Bankers Trust to the subsidiary. Consequently, Project Cochise enabled both Enron and Bankers Trust to shelter other taxable income with the losses that were built into the

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[345] The financial accounting benefits of Project Cochise also were facilitated by the acquisition by Enron from Bankers Trust of two leased aircraft and the associated leases.

REMIC residual interests, either directly with future deductions generated by the REMIC residual interests (in the case of Enron) or indirectly through the disposition of stock in the subsidiary that mirrored the built-in loss in the interests (in the case of Bankers Trust).

Background[346]

Reported tax and financial statement effects

Although Project Cochise did not (and was not intended to) generate any material net tax deductions during the period 1999 through 2001 (out of a projected total of approximately $388 million beginning after 2004), it did generate approximately $100 million (out of a projected total of approximately $140 million) in reported net earnings for financial reporting purposes through the third quarter of 2001.[347]

Development of Project Cochise

The development of Project Cochise began as early as July of 1998 and, on December 18, 1998, the executive committee of Enron's Board of Directors approved for recommendation to the full Board a resolution authorizing Enron to undertake the transactions involved in Project Cochise.

On January 28, 1999, Bankers Trust provided an engagement letter to Enron indicating that Bankers Trust agreed to act as the exclusive financial advisor to Enron in connection with assisting in the implementation of Project Cochise. The engagement letter provided that Enron would pay Bankers Trust $15 million in consideration of the services provided by Bankers Trust pursuant to the engagement letter, with an initial payment of $5,250,000 on September 1, 1999 and quarterly installments of $750,000 beginning on December 1, 1999 and ending on December 1, 2002.[348]

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[346] The information regarding Project Cochise was obtained from Joint Committee staff interviews of Robert J. Hermann, Robert Davis Maxey, David Williams, and Alicia Goodrow, as well as from documents and information provided by Enron Corp. and the IRS.

[347] The General Background materials in Appendix B contain the Structured Transactions Group Summary of Project Earnings & Cash Flows (Nov. 2001). In response to questions from the Joint Committee staff, Enron has indicated that it recorded financial statement benefits from Project Cochise as follows: (1) $27.7 million in 1999; (2) $50.3 million in 2000; and (3) $23.2 million in 2001. However, Enron also has indicated that it recorded a financial statement valuation reserve in December 2001 with regard to Project Cochise in the amount of $73.5 million. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003.

[348] Bankers Trust letter from Brian J. McGuire to Richard A. Causey, dated January 28, 1999. EC2 000037417 through EC2 000037421. The Project Cochise materials in Appendix B contain this letter. Although the contractual fee was $15 million, it appears that Enron has not paid the final five installments of $750,000. Thus, the fees paid to date by Enron to Bankers

On January 28, 1999, the primary initial transactions involved in Project Cochise (e.g., transfers of assets to Enron subsidiary) were executed, as described below.

On January 28, 1999, Potter Anderson & Corroon LLP provided an opinion to Enron relating to the application of Delaware law to the transactions involved in Project Cochise.

On February 8, 1999, the Enron Board of Directors approved the board resolution relating to Project Cochise.[349]

On May 26, 1999, Arthur Andersen provided a SAS 50 opinion to Bankers Trust relating to the appropriate financial accounting treatment of the transactions involved in Project Cochise.[350]

On March 21, 2001, McKee Nelson, Ernst & Young LLP provided an opinion to Enron relating to the Federal income tax consequences of the transactions involved in Project Cochise.[351]

On May 14, 2001, King & Spalding provided an opinion to Enron relating to the REIT qualification of the Enron subsidiary involved in Project Cochise for Federal income tax purposes.[352]

The principal tax personnel involved in executing the transaction for Enron were Mr. Hermann and Mr. Maxey.

Enron's purported principal business purposes for the transaction were to: (1) invest in REMIC regular and residual interests; (2) invest in leased aircraft; and (3) increase the pre-tax financial accounting income and net earnings of Enron.[353]

Trust with regard to Project Cochise equal $11,250,000. The General Background materials in Appendix B contain the Estimated Project Fees schedule (June 4, 2001).

[349] The Project Cochise materials in Appendix B contain the minutes of the February 8, 1999 meeting of the Enron Board of Directors at which the Board discussed and approved Project Cochise and the associated resolution.

[350] Arthur Andersen letter to Bankers Trust Company, dated May 26, 1999. EC2 000037349 through EC2 000037367. The Project Cochise materials in Appendix B contain this letter.

[351] McKee Nelson, Ernst & Young LLP letter from William S. McKee and James D. Bridgeman to R. Davis Maxey, dated March 21, 2001. EC2 000033988 through EC2 000034072. Appendix C, Part IV of this Report contains the tax opinion letter Enron received from McKee Nelson, Ernst & Young LLP in connection with Project Cochise.

[352] King & Spalding letter to Enron, dated May 14, 2001. EC2 000033980 through EC2 000033983. Appendix C, Part IV of this Report contains the tax opinion letter Enron received from King & Spalding in connection with Project Cochise.

Implementation of Project Cochise

Prior to the execution of Project Cochise, Enron owned all of the outstanding stock (1,000 shares of common stock) of Maliseet Properties, Inc. ("Maliseet"), a Delaware corporation that was formed on April 16, 1985.[354]

On January 28, 1999, the following events occurred contemporaneously and as part of a prearranged plan in the implementation of Project Cochise:[355]

(1) BT Green, Inc., a New York corporation and member of the Bankers Trust consolidated group ("BT Green"), sold undivided interests in REMIC regular interests to Bankers Trust for approximately $2.7 million;

(2) BT Green sold to Enron its remaining undivided interests in the REMIC regular interests for $24.8 million;

(3) Enron contributed the REMIC regular interests that it purchased from BT Green to Maliseet in exchange for 39,000 shares of Maliseet Series A preferred stock and 572 shares of Maliseet Series B preferred stock;[356]

(4) Enron sold all of its Maliseet common stock to Bankers Trust for $100;

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[353] "Representations and Assumptions" described in the McKee Nelson, Ernst & Young LLP Federal income tax opinion letter from William S. McKee and James D. Bridgeman to R. Davis Maxey, dated March 21, 2001, at 12-13. EC2 000033999.

[354] Maliseet was the result of the recapitalization and renaming of Enron Interstate Pipeline Company by Enron in January 1999. "Structured Transactions Group: Business Review", dated October 2001. EC2 000038350. The Project Cochise materials in Appendix B contain this document.

[355] "Statement of Facts" described in the McKee Nelson, Ernst & Young LLP Federal income tax opinion letter from William S. McKee and James D. Bridgeman to R. Davis Maxey, dated March 21, 2001, at 4-12. EC2 000033991 through EC2 000033999.

[356] In general, the Series A preferred stock were junior to the Series B preferred stock and provided for cumulative quarterly dividends to be accrued at an initial annual rate of 5.06788 percent of the stated liquidation preference with respect to the stock. The Series B preferred stock were senior to the Series A preferred stock and provided for cumulative quarterly dividends to be accrued at an annual rate of 15 percent of the stated liquidation preference with respect to the stock. The Series A preferred stock provided voting rights, but the Series B stock did not. The Series A and Series B preferred stock each were immediately redeemable upon an affirmative vote of at least 80 percent of both the holders of the preferred stock to be redeemed and the common stockholders. In addition, the Maliseet Board of Directors could compel a redemption of the Series B preferred stock at any time on or after January 28, 2004 upon an affirmative vote of at least 80 percent of both the holders of the Series A preferred stock and the common stockholders.

(5) Bankers Trust contributed the REMIC regular interests that it purchased from BT Green and REMIC residual interests to Maliseet in exchange for 1,000 shares of the common stock of Maliseet worth approximately $1.25 million and a 20-year zero coupon debt instrument issued by Maliseet with a stated principal amount of approximately $5.4 million and a stipulated fair market value of approximately $1.6 million;[357]

(6) Enron and Bankers Trust executed a shareholders agreement whereby (a) either Enron or Bankers Trust could compel the recapitalization of Maliseet, which would redeem all of the Series B preferred stock on or after January 28, 2004, exchange the common stock and the debt instrument issued by Maliseet to Bankers Trust for 10-year notes of equal value that pay current interest, and exchange the Series A preferred stock issued by Maliseet to Enron for common stock of Maliseet, (b) Enron would ensure that Maliseet elected REIT status and qualified as a REIT at all times from January 1, 1999 to January 1, 2004, and (c) Bankers Trust agreed to treat Maliseet as having paid to Bankers Trust "consent dividends" (as defined in section 565) and to be treated for Federal income tax purposes as having received an actual cash dividend from Maliseet at the end of each taxable year in an amount equal to the consent dividend for such year;

(7) Bankers Trust purchased from Enron for $1,000 two put options that permitted Bankers Trust to require Enron to purchase from Bankers Trust any of the 10-year notes received by Bankers Trust in a recapitalization of Maliseet at any time on or after two years (in the case of one put option) or 78 months (in the case of the other put option) following such recapitalization;

(8) Enron and Bankers Trust entered into put and call options that permitted Bankers Trust to purchase (in the case of the call option) or Enron to require Bankers Trust to purchase (in the case of the put option) at a stipulated fair market value the Maliseet preferred stock held by Enron upon a change in law that prevented Maliseet from qualifying as a REIT, holding REMIC residual interests, or declaring consent dividends; and

(9) BT Ever, Inc., a New York corporation and member of the Bankers Trust consolidated group ("BT Ever"),[358] sold two aircraft, and leases to which they

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[357] The Bankers Trust London branch previously had purchased the REMIC residual interests in two packages--one package in September 1997 and the other package in December 1997. The REMIC residual interests currently generate phantom income and are not expected to generate phantom deductions until after January 1, 2004.

[358] Bankers Trust, as well as three of its affiliates and an affiliate of Potomac Capital Investment Corp. (a taxable subsidiary of Potomac Electric Power Co. and also a minority investor in Project Teresa), own non-voting participating preferred stock in BT Ever. EC2 000037412.

were subject, to an Enron subsidiary (ECT Investments Holding Corp., a Delaware Corporation) for $44,046,885.85.

On or before February 15, 1999, six directors of Maliseet each contributed $1,000 to Maliseet in exchange for one share of Series B preferred stock,[359] and 98 other investors each contributed $1,000 to Maliseet in exchange for one share of Series B preferred stock.[360]

After the contributions to Maliseet, Enron owned approximately 95 percent of the total combined voting power of all classes of stock of Maliseet that were entitled to vote and approximately 95 percent of the total value of shares of all classes of stock of Maliseet. Bankers Trust owned approximately five percent of the total combined voting power of all classes of stock of Maliseet that were entitled to vote and approximately five percent of the total value of shares of all classes of stock of Maliseet.

Because of the creation of non-cash phantom income on REMIC residual interests for Federal income tax purposes, the REMIC residual interests that Bankers Trust contributed to Maliseet had an aggregate adjusted tax basis ($120 million) significantly in excess of their aggregate fair market value ($165,000). Furthermore, the adjusted basis in the REMIC residual interests was expected to increase by approximately $268 million over the life of these interests because of such treatment.

In June 2000, ECT Investments Holding Corp. sold the aircraft and associated leases that it had acquired from BT Ever for approximately $36 million.

The diagram on the next page depicts the structure of Project Cochise at formation.

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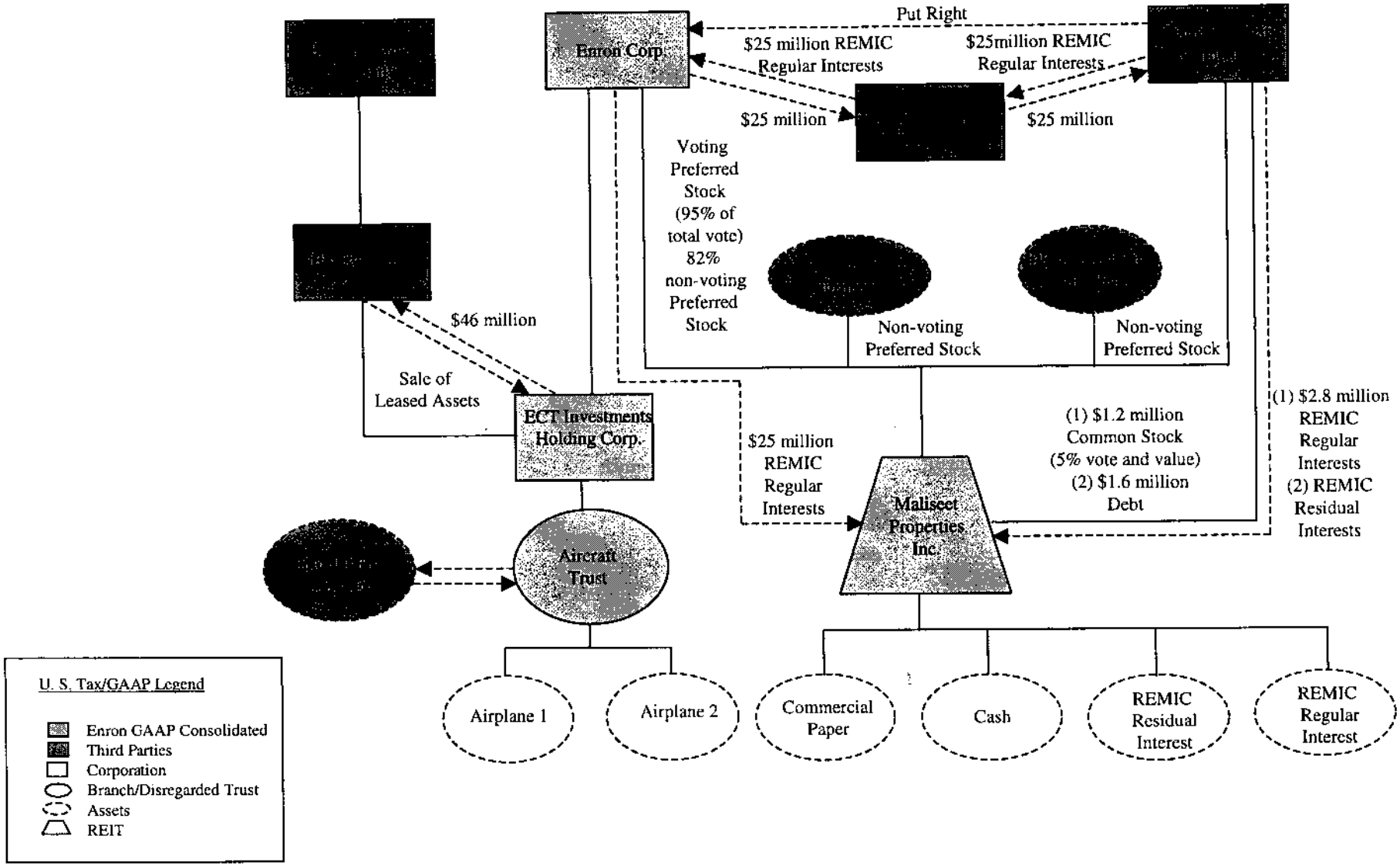
[359] The Maliseet directors who received shares were Jeffrey McMahon, James V. Derrick, Jr., Richard A. Causey, Robert H. Butts, Mr. Hermann, and Andrew S. Fastow. The stock subscription agreements with these directors were executed on behalf of Maliseet by Mr. Maxey as vice president of Maliseet. Maliseet stock subscription agreements dated February 12, 1999. EC2 000036853 through EC2 000036908.

[360] According to interviews with Enron tax department personnel, Enron utilized the services of a firm called REIT Funding, Inc. to assist in placing the Maliseet shares with the other 98 investors. Joint Committee staff interview with Alicia Lynn Lockheed Goodrow, September 23, 2002. Most of these investors were residents of the Atlanta, Georgia, metropolitan area, and all of the investors were residents of Georgia, Tennessee, North Carolina, or Florida. Maliseet stock subscription agreements, EC2 000054439 through EC2 000054738. At some point during the development of Project Cochise, consideration apparently was given to using partners of the law firm Akin, Gump, Strauss, Hauer & Feld as the outside investors in Maliseet. The Project Cochise materials in Appendix B contain a preliminary diagram of Project Cochise indicating that Series B preferred stock would be transferred to at least 99 partners of Akin, Gump, Strauss, Hauer & Feld "in satisfaction of legal services provided on matters unrelated to [Maliseet]."

Confidential

Project Cochise
Structure as of January 1999



Following the implementation of Project Cochise, it was intended that Maliseet would distribute current cash dividend payments on the Series A and Series B preferred stock, and would distribute any remaining taxable income through cash and consent dividends to Bankers Trust as holder of the Maliseet common stock.

Pursuant to the terms of the shareholders agreement between Enron and Bankers Trust, it was anticipated that either Enron or Bankers Trust would prompt the recapitalization of Maliseet after five years (i.e., on or after January 28, 2004), which would redeem all of the Series B preferred stock, exchange the common stock and the debt instrument issued by Maliseet to Bankers Trust for 10-year notes of equal value that pay current interest, and exchange the Series A preferred stock issued by Maliseet to Enron for common stock of Maliseet.[361] By then (or shortly thereafter), the REMIC residual interests would begin to generate tax deductions to reverse the previous REMIC non-cash phantom income that was distributed exclusively to Bankers Trust (primarily through consent dividends) as holder of the Maliseet common stock. Accordingly, it was expected that Maliseet would intentionally lose its REIT status (either through a revocation of its REIT election or by failing to qualify as a REIT) and would rejoin the Enron consolidated group, which would then take into account the tax deductions generated by the REMIC residual interests held by Maliseet.

Role of outside advisors

According to interviews with Enron tax department personnel, Bankers Trust promoted Project Cochise to Enron.[362] As noted above, Bankers Trust also was the exclusive financial advisor to Enron with respect to Project Cochise. Bankers Trust was the sole financial advisor for Enron irrespective that Bankers Trust was the only unrelated counterparty to the transaction (other than the handful of individual investors in Maliseet).

The documentation for Project Cochise indicates that William S. McKee and James D. Bridgeman of McKee Nelson, Ernst & Young LLP were the primary counsel responsible for the development and implementation of Project Cochise, with King & Spalding providing counsel on the more limited issue of REIT status qualification for Maliseet.[363] In connection with Project Cochise, McKee Nelson, Ernst & Young LLP provided a tax opinion letter that analyzed the tax implications of the transaction and concluded that:

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[361] The tax deductions included in Enron's projections with respect to Project Cochise would become available to Enron only upon the recapitalization of Maliseet. The Project Cochise materials in Appendix B contain projections and diagrams in connection with Project Cochise indicating that the recapitalization of Maliseet was a prearranged step in the implementation of Project Cochise.

[362] Interview with Mr. Maxey, August 6, 2002.

[363] Appendix C, Part IV of this Report contains the tax opinion letters Enron received from McKee Nelson, Ernst & Young LLP and King & Spalding in connection with Project Cochise.

(1) the contributions to Maliseet of REMIC regular interests by Enron and REMIC regular and residual interests by Bankers Trust "should" constitute non-taxable transfers of property under section 351;[364]

(2) the tax basis of the REMIC residual interests contributed to Maliseet by Bankers Trust "should" equal the tax basis of such interests in the hands of Bankers Trust immediately before the contributions;

(3) Enron "will" be treated as the owner of the Series A and Series B preferred stock received from Maliseet,[365] and "will" be treated as the owner of the two aircraft and leases to which they were subject;[366]

(4) section 269 "should not" apply to disallow any tax deductions generated by the reversal of earlier non-cash phantom income on the REMIC residual interests in the hands of Maliseet;[367]

(5) Maliseet's use of any tax deductions generated by the reversal of earlier non-cash phantom income on the REMIC residual interests "should not" be subject to limitation under section 382 solely as a result of either the contributions of the REMIC residual interests by Bankers Trust to Maliseet or the acquisition of Bankers Trust Corp. by Deutsche Bank;

(6) "it is more likely than not" that neither Maliseet, the REMIC residual interests, nor the transactions involved in Project Cochise are required to be registered as a tax shelter under section 6111;

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[364] Included in this opinion was the conclusion that Enron and the Bankers Trust London Branch were in "control" of Maliseet (within the meaning of section 368(c)) immediately after the exchange notwithstanding the 2004 recapitalization provisions in the shareholders agreement between Enron and Bankers Trust.

[365] Employing an economic substance analysis, this opinion was based upon representations from Enron that it would earn annual pre-tax profits of at least five percent with regard to its investment in the Series A preferred stock and 15 percent with regard to its investment in the Series B preferred stock, exclusive of finance costs and the time value of money.

[366] Employing an economic substance analysis, this opinion was based upon representations from Enron that it would earn an annual pre-tax profit of at least 4.12 percent with regard to its investment in the aircraft and leases, exclusive of finance costs and the time value of money.

[367] Included in this opinion was the conclusion that neither Enron nor the Bankers Trust London Branch "acquired" control of Maliseet in the transaction because Enron owned 100 percent of the vote and value of Maliseet before the transaction and owned 95 percent of the vote and value of Maliseet after the transaction.

(7) Enron "should not" be subject to penalties under section 6707 for failing to register Maliseet, the REMIC residual interests, or the transactions involved in Project Cochise as a tax shelter under 6111 prior to January 28, 1999;

(8) Maliseet "should" be entitled to a deduction for dividends paid under section 857(b)(2)(B), provided (a) Bankers Trust (the sole owner of the Maliseet common stock) properly consents to be treated as having received the consent dividends, (b) Maliseet timely files such consent with it Federal income tax returns, and (c) there are no arrearages of any accrued dividends on the Series A and Series B preferred stock as of December 31 of each taxable year; and

(9) for purposes of sections 6662 and 6664, there is "substantial authority" for the tax treatment of the transactions involved in Project Cochise and there is a "greater than 50 percent likelihood" that the tax treatment of such transactions will be upheld in litigation if challenged by the IRS.

To date, Enron has paid $1,022,774 in fees to McKee Nelson, Ernst & Young LLP in connection with Project Cochise.[368]

In addition, King & Spalding provided a tax opinion letter that analyzed the tax implications of the transaction and concluded that Maliseet "should" qualify as a REIT for Federal income tax purposes for its taxable year ended December 31, 1999, and that the organization and proposed method of operation of Maliseet "should" enable it to continue to satisfy the requirements for qualification and Federal income taxation as a REIT for its taxable year ended December 31, 2000 and subsequent taxable years.

As indicated above, Arthur Andersen provided a hypothetical accounting opinion letter to Bankers Trust that analyzed the financial accounting treatment of a hypothetical transaction that was substantially identical to Project Cochise. Based upon the Arthur Andersen opinion, Enron took various favorable financial accounting positions. For purposes of producing accounting income on its financial statements, Enron took the position that Project Cochise generated a deferred tax asset that was not discounted to take into account the time value of money.[369] In

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[368] The General Background materials in Appendix B contain the Estimated Project Fees schedule (June 4, 2001). Enron was unable to provide to the Joint Committee staff a copy of any engagement letter between Enron and McKee Nelson, Ernst & Young LLP with respect to Project Cochise, and was unable to provide information concerning the entire fee arrangement between Enron and McKee Nelson, Ernst & Young LLP with regard to Project Cochise. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003. It is unclear from a review of documents provided by Enron whether these fees actually were paid to McKee Nelson, Ernst & Young LLP (Mr. McKee's current firm) or King & Spalding (Mr. McKee's previous firm).

[369] According to internal Enron documents, the transaction would enable Enron "to record deferred tax assets at gross amounts well in excess of their present value." The Project Cochise materials in Appendix B contain an executive summary describing the accounting benefits of Project Cochise. EC2 000037381.

essence, this deferred tax asset purportedly arose because of the prearranged confluence of several factors, including:

(1) the treatment of the contribution of the REMIC residual interests to Maliseet as a purchase of the interests by Maliseet for financial accounting purposes (in contrast to the treatment of the contribution as a tax-free, carryover basis transaction for Federal income tax purposes);

(2) the disparity between the $120 million aggregate adjusted tax basis in the REMIC residual interests (which carried over to Maliseet for Federal income tax purposes) and the $165,000 aggregate fair market value of the assets;

(3) the fact that the taxable non-cash phantom income generated by the REMIC residual interests would be distributed to Bankers Trust through consent dividends on the Maliseet common stock held by Bankers Trust;

(4) the fact that such phantom income would reverse in later years and generate deductions for Enron after Maliseet relinquishes its REIT status and becomes reconsolidated with Enron for Federal income tax purposes; and

(5) the fact that FAS 109 provides for the recording of an undiscounted deferred tax asset that does not take into account the time value of money.

Apparently, no tax basis study was performed for Enron with regard to the REMIC residual interests that were transferred to Maliseet. However, Deutsche Bank and Morgan Stanley & Co., Inc. provided historical basis information concerning the REMIC regular and residual interests transferred to Maliseet.[370]

Subsequent developments

Project Cochise remains in place pursuant to the original plan and, with the assistance of PricewaterhouseCoopers, Enron continues to monitor Maliseet to ensure that it maintains its status as a REIT for Federal income tax purposes. Maliseet is not a debtor in the Enron bankruptcy.

IRS examination of Project Cochise

As with Project Steele, the IRS examination team undertook an expedited review of Project Cochise that was limited to examining whether Maliseet satisfied the REIT qualification requirements. Having determined that Maliseet was properly formed as a REIT, and did properly operate as a REIT, for the tax years under review, the IRS examination team stated that they would not review Project Cochise any further and would propose no tax liability adjustments relating to Project Cochise.[371]

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[370] EC2 000054739 through EC2 000054743.

[371] Interview with IRS examination team, August 8, 2002.

Discussion

In general

Like Project Steele, Project Cochise was designed to provide Enron financial accounting benefits from the acquisition of future tax deductions through REMIC residual interests, and at a cost that was significantly less than the acquired tax benefits. Determining whether Enron should be entitled to deduct the future tax deductions inherent in the REMIC residual interests necessarily involves an analysis regarding Enron's satisfaction of the literal requirements of the applicable statutory requirements as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate the purported tax benefits in tax-motivated transactions.[372]

A number of Code provisions are specifically designed to remove tax impediments from bona fide business transactions. In developing these provisions, the basic policies contemplate the bona fide conduct of business in the ordinary course. However, these provisions potentially can be utilized to effectuate unintended tax benefits. The Code and Treasury regulations recognize the potential for abusive activity and contain provisions intended to limit the benefits of arrangements that, although satisfying the literal requirements of a provision, are used to distort or defeat the basic purpose of the underlying statute.[373] These provisions address such policy concerns by limiting the benefit of the underlying statute through the use of general disallowance if specific factual tests are met, or if the principal purpose of the transaction is to evade or avoid income tax.

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[372] For detailed information concerning 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).

[373] *See, e.g.*, sec. 269 (acquisitions made to evade or avoid income tax), sec. 362(d) (limitation on basis increase attributable to assumption of liability), sec. 358(h) (reduction to basis of assets in connection with transfers of liabilities that give rise to a deduction), Treas. Reg. sec. 1.701-2 (partnerships formed or availed of in connection with a transaction with a principal purpose of reducing tax), and sec. 732(f) (adjustment to basis of assets of a distributed corporation controlled by a corporate partner). *See also* proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

Carryover basis of REMIC residual interests transferred to Maliseet

The Code and Treasury regulations also contain specific provisions intended to limit a taxpayer's ability to transfer tax attributes, such as net operating losses, built-in-losses, and various credit items.[374] The general purpose of these provisions is to limit the ability of such tax benefits by a taxpayer who did not suffer the economic loss that gave rise to the tax benefit.

Project Cochise purported to use the tax-free incorporation rules and resulting carryover basis rules to transfer losses and duplicate a single economic loss. The ability to transfer losses and duplicate a single economic loss through section 351 has been, and continues to be, a concern in the administration of tax policy.[375] In order for Project Cochise to achieve the desired tax result (and the corresponding financial accounting benefits), the transfer of the REMIC residual interests by Bankers Trust had to occur in a tax-free manner such that the REMIC residual interests tax basis would carry over to Maliseet.

It may be argued that the application of section 351(a) is predicated upon a valid non-tax business purpose and that the transfer by Bankers Trust to Maliseet did not have the requisite business purpose. Although it is unclear under present law whether section 351(a) does require a valid business purpose and, if so, how it is to be applied in the specific context of purported transfers under section 351(a), the tax opinion letter provided to Enron by McKee Nelson, Ernst & Young LLP includes no discussion of this issue in its analysis of the application of section 351 to Project Cochise. Moreover, the documentation of Project Cochise reviewed by the Joint Committee staff demonstrated no purpose for the transaction other than facilitating the generation of financial statement and tax benefits to Enron, as well as the duplication of losses built into the REMIC residual interests that Bankers Trust transferred to Maliseet.

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[374] *See, e.g.*, sec. 382 (limitation on net operating loss carryforwards and certain built-in-losses following ownership changes, sec. 383 (special limitations on certain excess credits, etc.), and Treas. Reg. sec. 1.1502-15 (SRLY limitation on built-in-losses).

[375] For example, in the year 2000, Congress enacted rules requiring a reduction in basis of assets in connection with transfers of certain liabilities in order to stop transactions that duplicated a single economic loss. *See*, the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000). *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Enacted in the 106th Congress* (JCS-2-01), April 19, 2001, at 154. In addition, President Clinton's Fiscal Year 2001 Budget Proposals contained a proposal that was aimed at limiting the ability of taxpayers to transfer built-in losses into the U.S. tax system by requiring marking to fair market value such assets when such assets become "relevant" for U.S. tax purposes (See Office of Management and Budget, *Budget of the United States Government, Fiscal 2001: Analytical Perspectives* (H. Doc. 106-162, Vol. III). See also Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000.) Most recently, the Treasury Department issued proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

In analyzing whether Project Cochise had a non-tax business purpose, McKee Nelson, Ernst & Young LLP placed significant weight in its tax opinion letter on the fact that the financial accounting benefits overshadowed the Federal income tax benefits of Project Cochise. As in Project Steele, a conclusion that a non-tax business purpose exists based on the accounting benefits of Project Cochise fails to consider the origin of the accounting benefit (i.e., solely reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement.[376]

Application of section 269 to transfer

The tax opinion letter provided to Enron by McKee Nelson, Ernst & Young LLP concerning Project Cochise contains a lengthy discussion and analysis of section 269, and concludes that the provision "should not" apply to disallow any tax deductions generated by the reversal of earlier non-cash phantom income on the REMIC residual interests in the hands of Maliseet. The tax opinion letter points out that Enron did not relinquish, and Bankers Trust did not acquire, control of Maliseet as a result of the transfers to Maliseet. Even if Enron had obtained control of Maliseet in the transaction, the tax opinion letter argues further that the application of section 269 to acquisitions of control[377] is limited to transactions securing the types of tax benefits that can be obtained only through the acquisition of control. In addition, the tax opinion letter argues that, although Maliseet acquired the REMIC regular and residual interests in a purported carryover basis transaction to which section 269 also could apply,[378] Project Cochise was not motivated by the tax avoidance or evasion purposes contemplated by section 269.

Acquisition of control.–With regard to acquisitions of control, the tax opinion letter concludes that section 269 applies only to the types of tax benefits that can be secured only through the acquisition of control by relying upon case law for the proposition that "section 269 does not apply to a case where the taxpayer would have obtained the tax benefit regardless of whether the taxpayer acquired control in the acquisition in question." Specifically, the tax opinion letter cites *Commodores Point Terminal Corp. v. Commissioner*,[379] in which the Tax Court interpreted the phrase in section 269 "which such person [or corporation] would not

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[376] *See, e.g., American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

[377] Sec. 269(a)(1).

[378] Sec. 269(a)(2).

[379] 11 T.C. 411 (1948), *acq.* 1949-1 C.B. 1.

otherwise enjoy" as conditional language that limits the denial of tax benefits under section 269 to those benefits that can be obtained only through the acquisition of control.[380]

The tax opinion letter also cites subsequent decisions in *Coastal Oil Storage Co. v. Commissioner*[381] and *Cromwell Corp. v. Commissioner*,[382] in which the Tax Court appeared to follow its earlier interpretation of section 269 in the *Commodores Point* case. In *Coastal Oil Storage*, the Fourth Circuit Court of Appeals reversed the Tax Court, in part based upon its apparent conclusion that section 269 can disallow tax benefits without regard to whether such benefits can be obtained only through the acquisition of control. However, the tax opinion letter discounts the Fourth Circuit decision in *Coastal Oil Storage* as deficient because, in contrast to the Tax Court decisions upon which the tax opinion letter does rely, the Fourth Circuit did not sufficiently take into account legislative history supporting the analysis adopted by the Tax Court.[383] Finally, the tax opinion letter cites several administrative rulings issued during the 1990s by the IRS National Office in which the National Office interpreted the scope of section 269 consistent with the interpretation adopted by the Tax Court.

Proscribed tax evasion or avoidance purpose.–The tax opinion letter concludes that Project Cochise was not imbued with the Federal income tax evasion or avoidance purpose proscribed by section 269 primarily on the basis that Maliseet would have obtained most of the future phantom deductions from the REMIC residual interests without regard to whether Maliseet received the interests with a high carryover basis (as opposed to a nominal fair market value basis). In particular, the tax opinion letter argues that the remaining future phantom income inclusions from the interests would increase Maliseet's basis in the interests by a greater amount than the initial carryover basis in the interests. Therefore, according to the tax opinion letter, the tax motivation for transferring the REMIC residual interests to Maliseet in a carryover basis transaction was quantitatively outweighed by the basis increases from the phantom income inclusions that would occur without regard to whether the transfer of the interests occurred in a manner that carried over the basis of the interests.

In addition, the tax opinion letter contends that the transfer of future phantom deductions imbedded in the REMIC residual interests by the taxpayer that has already recognized the associated initial phantom income inclusions does not distort the tax liabilities associated with a REMIC residual interest over the life of the interest. The tax opinion letter recognizes several

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[380] *See* 11 T.C. at 415-417 (stating that "[t]he word 'otherwise' can only be interpreted to mean that the deduction, credit, or allowance, if it is to be disallowed, must stem from the acquisition of control").

[381] 25 T.C. 1304 (1956), *aff'd in part and rev'd in part*, 242 F.2d 396 (4th Cir. 1957).

[382] 43 T.C. 313 (1964).

[383] The tax opinion letter also notes that the Fourth Circuit decision in *Coastal Oil Storage* would not be binding upon the Tax Court if it were to consider the application of section 269 to Project Cochise because an appeal of a Tax Court decision with regard to Project Cochise would lie in the Fifth Circuit.

unique tax rules associated with REMIC residual interests that are intended to ensure that the initial phantom income inclusions are taxed in light of the subsequent offsetting phantom deductions, but argues that none of these or the other tax rules relating to REMIC residual interests evidence a legislative plan or intent that the same taxpayer should recognize both the phantom income inclusions and the subsequent phantom deductions.

In its only acknowledgement that Project Cochise results in a duplication of the future phantom deductions to be produced by the REMIC residual interests transferred to Maliseet, the tax opinion letter states in a brief footnote that the transfer of the interests in a carryover basis transaction duplicates the future deductions through a difference between the low value and high basis of the common stock received by Bankers Trust from Maliseet in exchange for the REMIC residual interests. However, the tax opinion letter concludes that this duplication should not be taken into account for purposes of determining whether the requisite tax evasion or avoidance purpose under section 269 is present with regard to Project Cochise because section 269 only takes into account the tax motivation of Maliseet as the actual acquirer of the interests. According to the tax opinion letter, the potential benefits to Bankers Trust of duplicating the future phantom deductions is not pertinent in evaluating the tax motivation of Project Cochise under section 269.

Even if such duplication should be considered in examining the application of section 269 to Project Cochise, the tax opinion letter suggests that Bankers Trust would not have had a principal tax motivation for its participation in the transaction, as measured by the likelihood that Bankers Trust would trigger its recognition of the duplicated losses through a compelled recapitalization of Maliseet, followed by an exercise of the put option that it purchased from Enron as part of the transaction. In discussing the application of the section 351(a) control requirement to the transfers of REMIC regular and residual interests by Bankers Trust to Maliseet, the tax opinion letter states the following:

> [At the time of the transfers by Enron and Bankers Trust to Maliseet], the London Branch had no plan or intention of transferring, disposing of, or exchanging any of the Common Stock, other than possibly pursuant to a Recapitalization. In any event, however, a Recapitalization will not occur before January 1, 2004. Accordingly, because Enron and the London Branch together owned 100 percent of the outstanding stock of Maliseet immediately after the transfers of the [REMIC regular and residual interests] to Maliseet and had no plan or intention of disposing of such stock until possibly on or after January 1, 2004, Enron and the London Branch should be treated as satisfying the Control Requirement in connection with such transfers.

This statement may not be patently false but, at minimum, it understates the clear intention of Bankers Trust to activate the recapitalization provisions of the shareholders agreement and exercise its option to sell to Enron the notes that Bankers Trust would receive in the recapitalization. Internal company documents describing Project Cochise and quantifying the overall tax consequences of the transactions unambiguously demonstrate that the parties structured the transaction with every intention that Maliseet would be recapitalized at the earliest possible opportunity and Bankers Trust would exercise its put option, thus recognizing the duplicated loss. Taking into account the duplicated loss and the inevitability of its recognition in

2004 would cast substantial doubt as to whether Project Cochise was undertaken for the principal purpose of evading or avoiding Federal income tax under section 269 through the duplication of the loss that was built into the REMIC residual interests transferred to Maliseet.

Recommendations

Carryover basis of REMIC residual interests transferred to Maliseet

The Joint Committee staff recommendations regarding Projects Tanya and Valor include recommendations to limit the duplication of a single economic loss. These recommendations also are appropriate for consideration with respect to Project Cochise.[384]

Irrespective of whether an overall change is made to limit the duplication of a single economic loss under subchapter C generally, the Joint Committee staff believes it is appropriate to limit the ability to transfer REMIC residual interests in a carryover basis transaction. Under the statutory rules regarding the taxation of REMICS, phantom income is allocated to REMIC residual interest holders. The phantom income allocation inevitably creates built-in losses to the holders of the REMIC residual interests, thus making such interests a natural component for transactions designed to duplicate a single economic loss. As such, the Joint Committee staff recommends that either a corporation's basis in REMIC residual interests acquired in a tax-free transfer (or reorganization) be limited to its fair market value or that a transferor's basis in the stock received in exchange for REMIC residual interests be limited to the fair market value of the REMIC residual interests.[385]

Acquisitions made to evade or avoid Federal income tax

Project Cochise highlights the limited reach of section 269 as it applies to acquisitions of corporate equity interests for the principal purpose of obtaining tax benefits. Tax avoidance transactions involving the acquisition of a non-controlling interest in a corporation are no less pernicious (and actually may be more prevalent) than similarly motivated transactions involving the acquisition of a controlling interest in a corporation. Therefore, the Joint Committee staff recommends that Congress expand section 269 to apply to acquisitions of equity interests in a corporation, without regard to whether such interests provide to the acquirer control of the corporation, if the principal purpose of the acquisition is the evasion or avoidance of Federal income tax.[386]

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[384] Projects Tanya and Valor are discussed elsewhere in this section of the Report.

[385] *See* recommendations for Projects Tanya and Valor for a discussion of general issues with respect to this type of proposal.

[386] This recommendation is not limited to acquisitions in which the ownership percentage of a pre-existing interest in a corporation is increased. Accordingly, this recommendation also includes acquisitions involving a change to the capital structure of a pre-existing corporation (e.g., an existing shareholder relinquishes common stock and obtains preferred stock in the transaction), without regard to whether the change results in an increase in the percentage (by vote or value) of a pre-existing ownership interest.

With regard to acquisitions of corporate interests, present-law section 269 also is circumscribed by the judicial interpretation that the provision applies only to the types of tax benefits that can be obtained only through the acquisition of control of a corporation. Project Cochise demonstrates that tax motivated transactions can generate significant tax benefits that can be obtained through a non-controlling interest in a corporation. Regardless of whether the application of section 269 is limited to acquisitions of controlling interests in a corporation, the tax policy rationale is unclear for insulating from the application of section 269 tax benefits that can be obtained through either controlling or non-controlling corporate interests. Therefore, the Joint Committee staff also recommends that Congress expand section 269 to disallow tax benefits that can be obtained through either controlling or non-controlling interests in a corporation, if the principal purpose of the transaction in which the benefits are acquired is the evasion or avoidance of Federal income tax.

Because the application of section 269 to a particular transaction is conditioned upon the tax evasion or avoidance purpose for the transaction, the Joint Committee staff acknowledges that implementation of these recommendations would not necessarily eradicate transactions such as Project Cochise. Nevertheless, the Joint Committee staff believes that these recommendations would make section 269 generally more effective in deterring tax motivated transactions that involve the acquisition of an equity interest in a corporation.

5. Project Teresa

Brief overview

Project Teresa[387] was a synthetic lease arrangement designed to result in an increase in tax basis in depreciable assets (the most significant asset being the Enron North office building) with minimal economic outlay. This was accomplished in the following manner: Enron, through a deconsolidated entity, contributed depreciable assets and preferred stock of an affiliate to a partnership. Bankers Trust (the promoter of the transaction) contributed cash to the partnership. Enron affiliates would periodically acquire (or redeem) the preferred stock from the partnership, with the acquisition/redemption being treated as a taxable dividend eligible for an 80 percent dividends received deduction. Enron's basis in its partnership interest was increased by the total amount of the dividend (without regard to the dividends received deduction). Ultimately, the partnership was to be liquidated in a manner that would result in Enron receiving the depreciable assets with the increased basis. Enron would recover this increased tax basis through higher future depreciation deductions on the Enron North office building and the other depreciable assets.

Background[388]

Reported tax and financial statement effects

Project Teresa involved the reporting of dividend income in the early years, followed by increased depreciation deductions in later years. The transaction was projected to result in Enron reporting additional tax liability of $75.525 million for years 1997 through 2001.[389] During the entire life of the project, however, it was projected that Enron would report aggregate tax savings (though greater depreciation deductions on the Enron North office building) of $261.6 million.

The amount of the dividend income that was deducted by virtue of the dividends received deduction (but resulted in an increased partnership basis) gave rise to a permanent book-tax difference. In connection with Project Teresa, Enron recorded financial statement earnings (i.e., earnings through a reduction in the provision for income tax expense) of $226.0 million during the period 1997-2001.[390]

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[387] As in Project Tanya, Mr. Hermann named this transaction after a hurricane.

[388] The information regarding Project Teresa was obtained from Joint Committee staff interviews of Robert J. Hermann, Robert D. Maxey, Greek L. Rice, and Jordan H. Mintz, as well as from documents and information provided by Enron and the IRS.

[389] According to Enron, the deconsolidated entity paid approximately $107 million of Federal income tax from years 1997 through 2000.

[390] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 24. Current Enron management stated that Enron recorded a valuation reserve in December 2001 of approximately $269.8 million in connection with Project Teresa. The $43.8 million excess of the valuation reserve over the Project Teresa

Development of Project Teresa

Bankers Trust brought the idea for Project Teresa to Enron. The original contact appears to have been a "cold call" made by someone in the Bankers Trust marketing group to Mr. Rice, though the contact might have been established through Enron's finance group. In a letter dated May 16, 1996, Bankers Trust provided Mr. Hermann with certain discussion materials regarding a proposed joint venture arrangement developed by Bankers Trust. The discussion materials (modified in subsequent presentations) described the benefits of the transaction as follows:

(1) Accounting earnings -- recognize deferred tax assets over the five [year] life of the project.

(2) High basis tax asset -- create an asset(s) with a tax basis much higher than its FMV; the differential can be either recognized over time through depreciation or triggered sooner by a sale of the asset.

(3) Low tax risk – under current law, if modeled properly, the transaction will be revenue neutral to the IRS; thus, there is little motivation for the Service to challenge this structure upon audit.[391]

The transaction was designed to provide an after-tax accounting benefit of $230 million, and a net cash flow to Enron of $30.142 million.[392]

After the initial contact, Messrs. Hermann, Maxey and Rice met with representatives of Bankers Trust and the law firm of King & Spalding (that was representing Bankers Trust in connection with the transaction).[393] Following these discussions, Enron tax personnel began searching for assets that could be utilized in the transaction.

In February 1997, Messrs. Hermann, Maxey and Rice met in Washington, D.C., with representatives of Bankers Trust and King & Spalding to work through the details of the transaction. At the meeting, the Enron representatives indicated that they required a "should" level tax opinion for the transaction. There was some discussion as to who would provide the tax opinion. According to one participant, an attorney from King & Spalding indicated that it would

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financial benefits relates to the GAAP tax accounting for the taxable portion of the dividends. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 2. It is unclear why Enron used a valuation reserve (as opposed to a reversal of the financial income benefit).

[391] The Project Teresa materials in Appendix B contain the "Description of Partnership Leasing Proposal" in discussion materials from Bankers Trust dated March 27, 1997, EC2 000037929.

[392] *Id.* at EC2 000037931-37932.

[393] The law firm of Akin, Gump, Strauss, Hauer & Feld acted as special counsel to the Bankers Trust entity that was involved in Project Teresa.

receive a $1 million fee for the transaction regardless of whether King & Spalding provided the tax opinion. Ultimately, it was decided that King & Spalding would provide the tax opinion to Enron. There was also some discussion regarding the timing of the transaction. Of particular concern was the fact that Congress was considering legislation that would affect the transaction structure. Timing also was critical because the lease on the Enron North office building (the primary asset being considered for Project Teresa) was up for renewal. After a few days of meetings, Mr. Rice returned to Houston to apprise Richard A. Causey, Chief Accounting Officer of Enron Corp., of the developments in anticipation of a meeting of the Enron Corp. Board of Directors.

On March 25, 1997, the Executive Committee of the Enron Corp. Board of Directors met to discuss (among other items) Project Teresa. Edmund P. Segner presented an overview of the transaction, and Mr. Causey described the details of the transaction. Mr. Causey stated that the net effect of the transaction would be to create book earnings of $242.6 million during years 1997 through 2002 by virtue of the deemed dividends paid to the leasing partnership.[394] The Executive Committee adopted a resolution authorizing the transaction, including the contribution of the lessee rights in the Enron North office building to the leasing partnership and a schedule of fees.[395] The Enron Board of Directors heard a report regarding the Executive Committee action at its meeting on May 6, 1997.[396]

The business purpose given for the transaction was to raise third party capital and manage a portfolio of leased assets with enhanced earnings potential.[397] The tax opinion prepared by King & Spalding states "the predominant purpose of Enron and its Affiliates for participating in [the redemption transaction in Project Teresa] was to generate income for financial accounting purposes."[398]

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[394] Project Teresa estimated earnings benefit, EC2 000037959. According to minutes from the meeting, "[a] thorough discussion ensued during which Messrs. Causey, Rice, and Skilling responded to questions by the Committee."

[395] Minutes of the Meeting of the Executive Committee of the Board of Directors of Enron Corp., March 25, 1997, EC2 000037952-55.

[396] Minutes of the Meeting of the Board of Directors of Enron Corp., May 6, 1997, ENE 0000000199-200. The Board of Directors had been made aware of the transaction at its previous meeting on February 11, 1997. At that meeting, the Board of Directors reviewed a presentation regarding Enron's 1997 strategic goals, which contained a projection of future earnings that included a $280 million benefit during the years 1997 through 2001 attributable to the "building lease tax structure." Enron Board of Directors Meeting, February 11, 1997, EC 000044834.

[397] Project Teresa Tax Overview, EC2 000037866.

[398] King & Spalding opinion letter, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, to R. Davis Maxey, dated July 29, 1997, Appendix C, Part V, at 4.

Implementation of Project Teresa

The initial step in the implementation of Project Teresa was the organization and financing of the various participating entities. On March 21, 1997, Enron Corp., together with Potomac Capital Investment Corp. ("Potomac Capital," a subsidiary of Potomac Electric Power Co.) and EN-BT Delaware, Inc. ("EN-BT Delaware") (a subsidiary of Bankers Trust) contributed property to Organizational Partner, Inc. ("Organizational Partner" or "OPI") in exchange for OPI common stock and OPI preferred stock. The property that Enron contributed included: (1) its lessee interest in the Enron North office building,[399] (2) certain interests in aircraft operated by Enron Corp., (3) a note receivable from Houston Pipe Line Co. in the amount of $1.097 billion and (4) $10,250 in cash, in exchange for OPI common stock that represented 98 percent of the equity but only 75 percent of its voting rights.[400] Potomac Capital and EN-BT Delaware collectively contributed $22.4 million in cash in exchange for 20,000 shares of OPI preferred stock that represented two percent of the equity and 25 percent of the voting rights in Organizational Partner.

The second step involved the issuance of the preferred stock that would be used in the redemption transactions. On March 21, 1997, Enron Corp. contributed all of the common stock of Enron Operations Corp. and its subsidiaries to Enron Liquids Holding Corp. ("Enron Liquids") in exchange for 80 percent of the Enron Liquids common stock. Organizational Partner contributed the note receivable from Houston Pipe Line Co. and $10,250 in exchange for 20 percent of the Enron Liquids common stock (with a value of $97.5 million) and 10,000 shares (i.e., 100 percent of the issued and outstanding class) of Enron Liquids preferred stock (with a value of $1 billion).

The next step was the organization and funding of the partnership that was to hold the Enron Liquids preferred stock through the tax-deconsolidated entity. To accomplish this, on March 27, 1997, Enron Leasing Partners, LP ("Enron Leasing") was formed. Organizational Partner contributed to Enron Leasing: (1) the lessee interest in the Enron North office building, (2) $22.4 million in cash, and (3) the Enron Liquids preferred stock (worth $1 billion), in exchange for a 98 percent limited partner interest. Enron Property Management Co. contributed cash and U.S. Treasury obligations with a value of $10.433 million in exchange for a one percent general partner interest, and EN-BT Delaware contributed $10.433 million in cash in exchange for a one percent limited partner interest.

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[399] A contribution agreement between Enron Corp. and Organizational Partner dated March 21, 1997, states that, with respect to the lessee interest, Enron Corp. agrees to designate Organizational Partner as the lessee under the lease (and have the necessary documentation to effectuate the assignment) no later than April 30, 1997. Ecx000006707. The actual transfer occurred on April 14, 1997.

[400] Enron Corp. owned less than 80 percent of the vote of Organizational Partner, and, as a result, Organizational Partner was not a member of the Enron affiliated group (i.e., it was a tax deconsolidated entity). However, Organizational Partner was consolidated with Enron Corp. for financial statement purposes.

Once the entities were organized and funded, the next step was to generate dividend income. As originally contemplated, an Enron affiliate was to make periodic purchases of Enron Liquids preferred stock from Enron Leasing over a five-year period (with the purchase being treated as a dividend from a related corporation under the tax laws). Thus, on May 14, 1997, Enron Pipeline Company ("Enron Pipeline"), a wholly owned subsidiary of Enron Corp., purchased 1,980 shares of Enron Liquids preferred stock from Enron Leasing in exchange for an intercompany promissory note in the principal amount of $198 million creating dividend income to the partnership. However, a change to the tax laws that became effective in June 1997 eliminated the advantage associated with this structure.[401] Consequently, beginning in March 1998,[402] Enron Liquids implemented a plan of quarterly pro-rata redemptions of its preferred and common stock designed to achieve a similar tax result (i.e., redemptions treated as dividends under the tax laws). Thus, on March 31, 1998, Enron Liquids redeemed (on a pro-rata basis) 40 shares of its common stock in exchange for promissory notes with a principal amount of $16.979 million and 325 shares of its preferred stock in exchange for promissory notes with a principal amount of $32.5 million.[403] This amount represented 3.25 percent of each class of stock held by each shareholder. The predominant purpose of Enron Corp. and its affiliates for participating in the redemption was to generate income for financial accounting purposes.[404]

In 1999, Enron Liquids paid dividends on its preferred stock, and engaged in redemptions of its common and preferred stock, in the amount of approximately $170.7 million.[405] In November 1999, Enron Pipeline sold its remaining 1,045 shares of Enron Liquids preferred stock to Enron Corp. Subsequent to the sale, Enron contributed all of the stock in Enron Pipeline to Enron Operations Corp. (a subsidiary of Enron Liquids) in exchange for preferred stock. In 2000 and 2001, Enron Liquids paid dividends on its preferred stock and engaged in stock redemption transactions in the aggregate amount of approximately $686.2 million and $49.5 million, respectively.[406] In total, during the period 1997 through 2001, the amount of dividends on the Enron Liquids preferred stock and the stock sales and redemptions that Enron treated as dividends with respect to the Enron Liquids preferred stock, exceeded $1 billion.

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[401] Congress amended the extraordinary dividend rules of section 1059, which is discussed in greater detail below.

[402] At some time between May 14, 1997 and March 31, 1998, Enron Pipeline transferred 935 shares of Enron Liquids preferred stock to Enron Corp.

[403] In a letter to King & Spalding dated September 27, 2000, Mr. Maxey represented that Enron Liquid's current and accumulated earnings and profits for taxable year ended December 31, 1998, exceeded the aggregate amount of the promissory notes and cash transferred by Enron Liquids in connection with the March 31, 1998 redemption.

[404] *Id.*, at EC2 000033830.

[405] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 25.

[406] *Id.*, at answer 26.

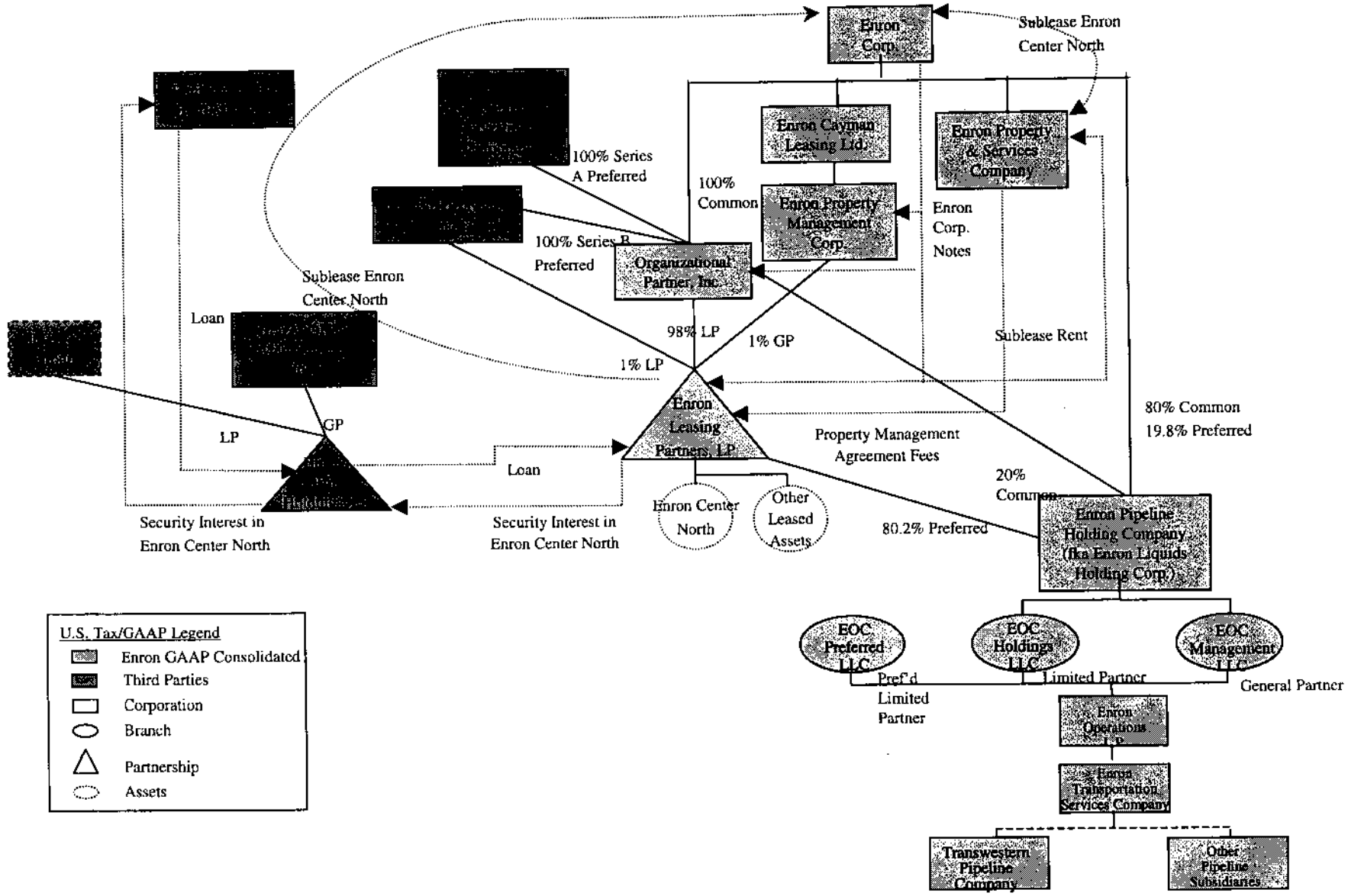
Although the precise exit strategy with respect to Project Teresa is uncertain, it would have involved a reconsolidation of Organizational Partner in the Enron consolidated group.[407] Thereafter, Enron Leasing would be liquidated, with Organizational Partner receiving the Enron North office building in a liquidating distribution (and a tax basis that reflects the gross amount of Enron Leasing's dividend income). This was projected to occur in 2003. At such time, Organizational Partner would begin to recover the increased tax basis via higher depreciation deductions.

The diagram on the next page depicts the general structure of Project Teresa as of December 2001.

[407] At any time after April 30, 2002, Organizational Partner had the option to redeem all the OPI preferred stock from Bankers Trust and Potomac Capital. Similarly, at any time after December 31, 2003, Bankers Trust and Potomac Capital had the right to force Organizational Partner to redeem the OPI preferred stock.

Project Teresa
Structure as of December 2001

Confidential



Role of outside advisors

Bankers Trust promoted the transaction to Enron. A schedule of fees presented at the March 25, 1997, Board of Directors Executive Committee meeting shows that Bankers Trust was to receive a fee of $11 million in connection with Project Teresa -- an amount representing approximately one percent of the increased basis in the partnership as a result of the deemed dividends. In 1998, the fee was reduced by $1.375 million to compensate Enron for its role as an accommodation party to Bankers Trust in connection with Project Renegade.[408] The fee to Bankers Trust was to be paid over time as follows: $6.2 million in 1997; $1.1 million in 1998; $1.2 million in 1999; $1.2 million in 2000 and $1.2 million in 2001.[409] According to Enron records, as of June 2001, Bankers Trust had received fees of $8.839 million in connection with Project Teresa.[410]

Enron relied on King & Spalding for its legal representation in connection with Project Teresa. The schedule of fees presented at the March 25, 1997, Executive Committee meeting shows that King & Spalding was to receive a fee of $1 million in connection with Project Teresa, which was to be paid after the close of the deal when the tax opinion was rendered.[411]

In the tax opinion, King & Spalding concluded that (1) the payment by Enron Pipeline to Enron Leasing for the purchase of the Enron Liquids preferred stock "should" be treated as a distribution in redemption of the stock of Enron Pipeline; (2) the distribution "should" be treated as a dividend distribution; (3) the adjusted basis of the Enron Liquids preferred stock retained by Enron Leasing "should" be increased by an amount equal to Enron Leasing's adjusted basis in the Enron Liquids preferred stock sold to Enron Pipeline; (4) the adjusted basis of Organizational Partner's interest in Enron Leasing "should" be increased by its distributive share of the dividend; (5) for purposes of the dividends received deduction, Organizational Partner "should" be treated as having received its distributive share of the dividend from Enron Pipeline; (6) it is "more likely than not" that Organizational Partner will be treated as owning 20 percent or more of the stock of Enron Pipeline for purposes of the dividends received deduction; and (7) the extraordinary dividend rules "should" not apply to the redemption transaction.[412] According to

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[408] Project Renegade is discussed in detail in the section of the Report that describes transactions in which Enron acted as an accommodation party.

[409] Executive Board Meeting -- Project Teresa, March 25, 1997, schedule of fees, EC2 000037962.

[410] The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/2001), EC2 000036379. According to current Enron management, no subsequent payments have been made. Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 30.

[411] Executive Board Meeting -- Project Teresa, March 25, 1997, schedule of fees, EC2 000037962.

[412] Appendix C, Part V, contains the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997.

Enron records, as of June 2001, King & Spalding had received fees of $1.046 million in connection with Project Teresa.[413]

The accounting firm of Ernst & Young provided an opinion letter regarding the effects on Enron Liquids earnings and profits resulting from Enron's contribution of the Enron Pipeline stock to Enron Operations Corp.

In addition to the fees paid to Bankers Trust and King & Spalding, Enron records reflect that it paid $250,000 of fees to others, bringing the total amount of fees paid with respect to Project Teresa to $10.135 million.

Appendix C, Part V, to this Report contains the tax opinion letters Enron received in connection with Project Teresa.

Subsequent developments

Organizational Partner defaulted on its dividend payments to Potomac Capital and EN-BT Delaware in connection with the OPI preferred stock. Enron Corp. is in default under its sublease agreement with Organizational Partner with respect to the Enron North office building, though a standstill agreement has prevented the lenders from foreclosing on the building. The intercompany receivables were partially written off in December 2001. Potomac Capital and EN-BT Delaware continue to hold their OPI preferred stock. No steps have been taken to unwind the structure.[414]

The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001. Enron received a tax shelter registration number in connection with Project Teresa.

Discussion[415]

Project Teresa was an elaborate structure designed to achieve a financial statement benefit that results from a shift of $1 billion in tax basis from a nondepreciable asset (i.e., the Enron Liquids preferred stock) to depreciable assets (the most significant asset being the Enron North office building) via the use of a partnership that Enron controlled. Project Teresa used the related party redemption rules and the dividends received deduction to generate additional tax basis (in excess of book basis). The partnership structure was necessary to accomplish the basis shift. In essence, Enron was willing to incur income tax on 20 cents of each dollar of dividend

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

[414] The Project Teresa materials in Appendix B contain the Project Teresa deal basics, EC2 000037870; Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answers 27, 31.

[415] Enron's bankruptcy effectively prevents Enron from realizing the tax benefits that were contemplated in Project Teresa. Nevertheless, this section discusses the tax benefits that Enron sought to achieve from the transaction (without regard to the bankruptcy).

income (borne by Organizational Partner, a deconsolidated subsidiary of Enron) in exchange for one dollar of future depreciation deductions.

Under the strategy devised in Projects Teresa, the benefits of the increased tax basis (in the form of greater depreciation deductions on the Enron North office building) would inure over a 39-year period and was not expected to be reflected in Enron's consolidated tax return until 2003. However, and potentially more important to Enron, the strategy permitted Enron to begin recording the benefits immediately for financial accounting purposes.[416]

Key to the success of Project Teresa was Organizational Partner's ability to receive a basis increase for the gross amount of the dividends received notwithstanding that 80 percent of such dividends were exempt from tax by virtue of the dividends received deduction. To accomplish this result, the redemption transactions had to be structured in a manner that would (1) generate dividend income (thus making them eligible for a dividends received deduction) and (2) avoid the application of the extraordinary dividend rules (which would require a basis reduction equal to the amount of the dividends received deduction). In addition, the redeeming corporation needed to have sufficient earnings and profits (so that the distributions are treated as dividends).

Also critical to Project Teresa was the use of a partnership. The partnership structure provided the mechanism to achieve the basis shift from the Enron Liquids preferred stock to the Enron North office building. The basis shift would have occurred on a liquidating distribution of the Enron North office building to Organizational Partner.[417]

Redemption transactions

As an initial matter, the redemption transactions had to involve a corporation that was not included in Enron's consolidated return because the consolidated return regulations generally reduce basis for untaxed dividends within a consolidated group. This explains why Organizational Partner was capitalized with stock with voting rights that differed from its value. By owning stock that represented 98 percent of Organizational Partner's value but only 75 percent of its voting power, Enron was able to exercise de facto control over the entity without causing it to be a member of Enron's consolidated group. Some might question Enron's non-tax business reason for allowing purported third parties to purchase a 25-percent voting interest in a

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[416] *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.

[417] Section 732(b), which is discussed in greater detail in the next section of this Report (in connection with the partnership transactions), provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is equal to the partner's adjusted basis in the partnership interest reduced by any money distributed in the same transaction.

company that was valued at over $1 billion for only $22.4 million, and whether Bankers Trust and Potomac Capital were truly independent third parties.[418]

The stock redemptions had to be structured in a way that would generate dividend income to Enron Leasing (the partnership that was 98 percent owned by Organizational Partner). The 1997 related party redemption (Enron Pipeline's purchase of 1,980 shares of Enron Liquids preferred stock from Enron Leasing) was structured as a redemption between related corporations.[419] By virtue of the applicable constructive ownership rules, Enron Leasing arguably was in control of both Enron Pipeline and Enron Liquids, and the redemption did not result in a diminution of Enron Leasing's stock interest in Enron Liquids.[420] Therefore, the parties characterized the transaction as a distribution in redemption of Enron Pipeline stock, with the result that the redemption was treated as a dividend. In the years subsequent to 1997, the redemptions took the form of pro-rata redemptions by Enron Liquids. A change to the extraordinary dividend rules in 1997 (discussed below) necessitated the change to a pro-rata redemption.

Also critical to the transaction is that any resulting dividend must qualify for the dividends received deduction. In a partnership structure, each partner takes into account separately its distributive share of certain partnership items, including dividends with respect to which a dividends received deduction is applicable.[421] In Project Teresa, Organizational Partner claimed an 80 percent dividends received deduction.[422]

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[418] As previously noted, after April 30, 2002, Organizational Partner had the option to redeem all the OPI preferred stock from Bankers Trust and Potomac Capital. Similarly, at any time after December 31, 2003, Bankers Trust and Potomac Capital had the right to force Organizational Partner to redeem the OPI preferred stock.

[419] *See* sec. 304(a)(1).

[420] In determining whether the acquisition is treated by reason of section 302(b) as a distribution in part or full payment in exchange for the stock, reference is made to Enron Leasing's ownership of the Enron Liquids stock. Sec. 304(b)(1).

[421] Sec. 702(a)(5). A partner will increase its basis in its partnership interest by that partner's distributive share of partnership income, including dividend income. Sec. 705(a).

[422] The issue is whether Organizational Partner qualifies for the 80 percent dividends received deduction (as opposed to a 70 percent deduction) by virtue of stock ownership through a partnership. As noted in the discussion of the relevant corporate tax laws, the Treasury Department has permitted stock ownership thresholds to be met by virtue of stock ownership through a partnership. *See*, Rev. Rul. 71-141, 1971-1 C.B. 211; *see also*, T.D. 8708, 62 Fed. Reg. 923, 924 (January 7, 1997) (for purposes of section 902, domestic shareholder includes a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock; IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply).

Extraordinary dividend rules

In addition to generating dividend income that qualifies for a dividends received deduction, Project Teresa had to be structured in a manner so as not to implicate the extraordinary dividend rules. If the dividend that Organizational Partner received as part of its distributive share of Enron Leasing income were treated as an extraordinary dividend, then Organizational Partner would be forced to reduce its basis in its partnership interest by the untaxed portion of the dividend, thereby eliminating an important aspect of the transaction.[423]

Congress enacted the extraordinary dividend rules in 1984 in response to a tax-motivated transaction (known as a "dividend strip" transaction) in which a corporation would acquire dividend-paying stock shortly before the stock's ex-dividend date, receive a dividend that is eligible for a dividends received deduction, and then sell the stock for a short-term capital loss.[424] The extraordinary dividend rules provide that if a corporation receives an extraordinary dividend with respect to stock and the corporation has not held the stock for more than two years after the dividend announcement date, then the corporation's basis in the stock is reduced (but not below zero) by the non-taxed portion of the dividends.[425] The non-taxed portion of the dividend generally is the amount of the dividends received deduction with respect to the dividend.[426]

While the original purpose of the extraordinary dividend rules was to prevent dividend strip transactions, Congress in recent years has expanded the scope of the extraordinary dividend rules to address other tax-motivated transactions that exploit the dividends received deduction. Of particular relevance to Project Teresa was the change made in 1997, in which the extraordinary dividend rules were expanded to treat certain dividends resulting from a related party redemption as an extraordinary dividend (thus resulting in a basis reduction equal to the amount of the dividends received deduction).[427] The law change was necessary because

> "Section 304 is directed primarily at preventing a controlling shareholder from claiming basis recovery and capital gain treatment on transactions that result in a

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[423] In addition, Enron Leasing would have to adjust its basis in the Enron Liquids preferred stock.

[424] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of The Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 138-39.

[425] Sec. 1059(a)(1). If the non-taxed portion of the dividends exceeds the corporation's basis in the stock, then the excess is treated as gain for the taxable year in which the extraordinary dividend is received. Sec. 1059(a)(2).

[426] Sec. 1059(b).

[427] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1013(b) (August 5, 1997) (effective for distributions and acquisitions after June 8, 1997). Specifically, section 1059(e)(1)(A)(iii)(II) provides that if a redemption of stock would not have been treated (in whole or in part) as a dividend absent section 304, then any amount treated as a dividend with respect to such redemption is treated as an extraordinary dividend.

withdrawal of earnings from corporate solution. . . . Different concerns may be present if the shareholder is a corporation, due in part to the availability of the dividends received deduction."[428]

Enron Pipeline's 1997 purchase of 1,980 shares of Enron Liquids preferred stock from Enron Leasing raised a number of issues regarding the potential application of the extraordinary dividend rules to the related party redemption.[429] These issues were rendered moot by the 1997 expansion of the extraordinary dividend rules. However, by modifying the transaction to make it a pro-rata redemption (and thus avoiding the related party redemption rules), Enron avoided the effects of the 1997 law change and continued to claim the desired benefits from Project Teresa.

Earnings and profits in a consolidated group

A distribution with respect to stock (including certain redemptions) is treated as a dividend only to the extent that the distribution is from the corporation's current or accumulated earnings and profits.[430] Enron contributed stock in Enron Pipeline to Enron Operations Corp. (a subsidiary of Enron Liquids) apparently in an effort to bolster the earnings and profits of Enron Liquids.[431]

There is little guidance regarding the tiering up of earnings and profits when the location of a member within a consolidated group changes. Two examples in the consolidated return regulations provide that "appropriate adjustments must be made to the members to prevent earnings and profits from being eliminated."[432] The regulations also provide an anti-avoidance

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[428] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, at 207.

[429] For a detailed discussion of these issues, *see* the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997, Appendix C, Part V, at 28-36.

[430] Sec. 316(a).

[431] *See,* tax opinion by Kevin A. Duvall of Ernst & Young to R. Davis Maxey, dated November 16, 1999, Appendix C, Part V. The sole issue raised in this tax opinion was the extent to which Enron Corp.'s contribution of Enron Pipeline stock will result in Enron Pipeline's earnings and profits being replicated in the earnings and profits of Enron Operations Corp. and Enron Liquids. The opinion letter concludes that, "more likely than not," Enron Pipeline's earnings and profits will be replicated, and therefore, Enron Liquids should have sufficient earnings and profits to treat $237 million of distributions and stock redemptions in 1999 as dividends for purposes of section 301.

[432] Treas. Reg. sec. 1.1502-33(f)(2). The regulations appear to focus on the elimination of earnings and profits through changing the location of a member within a group rather than the replication of earnings and profits.

rule warning that adjustments must be made as necessary to carry out the purpose of the section.[433]

Partnership issues

As previously noted, the partnership structure was essential in order to achieve the basis shift. Although the precise exit strategy with respect to Project Teresa is uncertain, it presumably involved Organizational Partner exercising its option to redeem all the OPI preferred stock from Bankers Trust and Potomac Capital (resulting in a reconsolidation of Organizational Partner in the Enron consolidated group). Thereafter, Enron Leasing would be liquidated, with Organizational Partner receiving the Enron North office building in a liquidating distribution with a tax basis that reflects the gross amount (not the taxed amount) of Enron Leasing's dividend income. Organizational Partner would recover the increased tax basis via higher depreciation deductions. If a section 754 election were not in effect, then any remaining asset owned by Enron Leasing would retain its basis (when the Enron North office building is distributed to Organizational Partner).[434]

The Treasury Department has issued regulations that apply the extraordinary dividend rules to partnerships.[435] Known as the partnership anti-abuse regulations,[436] the 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 Commissioner can recast the transaction for Federal tax purposes to achieve tax results that are consistent with the intent of subchapter K.[437] Under this theory, Enron Leasing should be viewed as inconsistent with the intent of subchapter K, considering that (1) the predominant purpose for the formation of Enron Leasing was to generate income for financial accounting purposes,[438] (2) the financial accounting income was attributable solely to the shifting of tax basis to depreciable assets (in

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[433] Treas. Reg. sec. 1.1502-33(g).

[434] As discussed in greater detail in the next section of this Report (in connection with the partnership tax laws), a section 754 election may have required a downward basis adjustment with respect to the assets owned by Enron Leasing following the liquidating distribution.

[435] Sec. 1059(g); Treas. Reg. sec. 1.701-2(f) example 2 (a partnership comprised of two corporate partners that receives an extraordinary dividend has to make appropriate basis adjustments).

[436] The partnership anti-abuse regulations are discussed in greater detail in connection with transactions that raise partnership tax issues.

[437] Treas. Reg. sec. 1.701-2(b). For a discussion of why the partnership anti-abuse rules should not apply to Enron Leasing, *see* the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997, Appendix C, Part V, at 38-44.

[438] *Id.*, at 37-38.

excess of book basis),[439] and (3) the accounting benefits of the transaction could not be accomplished without the partnership.[440] Such a conclusion is further supported by recent court decisions that have rejected the existence of an otherwise valid partnership because of the lack of a non-tax business purpose.[441]

Recommendations

In order to achieve the desired tax results from Project Teresa, Enron needed the assistance of an unrelated accommodation party. Bankers Trust, which was the promoter and (along with Potomac Capital) an investor in Project Teresa, facilitated the planned temporary deconsolidation of Organizational Partner (which gave rise to the dividends received deduction). Bankers Trust also participated in the partnership structure (through which the basis shift was accomplished). The following specific recommendations are perhaps appropriate to address specific issues raised by Project Teresa. However, specific tax rules cannot adequately address the broader concerns that arise when an accommodation party acts in concert with a taxpayer to achieve a desired tax result. Implicit in the income tax system is an assumption that unrelated parties have adverse economic interests. When this paradigm breaks down, it is not surprising that the tax laws generate unwarranted results. Transactions with accommodation parties must be addressed by a rigorous application of the various common-law doctrines applicable to tax motivated transactions.[442]

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[439] The argument that a financial accounting benefit constitutes a substantial non-tax business purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a non-tax business purpose requirement. *See, e.g., American Electric Power, Inc. v. U.S.,* 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner,* 113 T.C. 254, 287 (1999)).

[440] *See,* the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997, Appendix C, Part V, at 40.

[441] See, e.g., Boca Investerings Partnership v. U.S., 2003 U.S. App. LEXIS 429 at *12 (D.C. Cir. Jan. 10, 2003) ("As we noted in Saba Partnership, 'ASA makes clear that the absence of a nontax business purpose is fatal to the argument that the Commissioner should respect an entity for federal tax purposes,'' citing Saba Partnership, 273 F.3d at 1141 (quoting ASA Investerings, 201 F.3d at 512).

[442] 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

Similarly, the partnership anti-abuse rules were promulgated to deter partnership arrangements in which the principal purpose is to reduce taxes in a manner that is inconsistent with the intent of the partnership tax rules. In Project Teresa, the principal purpose for Enron Leasing appears to have been to facilitate the shifting of tax basis from a nondepreciable asset to depreciable assets (in excess of book basis). If this conclusion is correct, then the partnership anti-abuse regulations should be available to recast the transaction as appropriate. If the partnership anti-abuse regulations do not apply to a transaction such as Project Teresa, then the regulations need to be reevaluated.

In terms of specific recommendations, the extraordinary dividend rules were amended in 1997 to prevent a controlling corporate shareholder from structuring a redemption transaction with a related party to take advantage of the dividends received deduction. Enron concluded that it could circumvent the 1997 law change and continue to claim the desired benefits from Project Teresa. The Joint Committee staff recommends that the extraordinary dividend rules should be further strengthened.

In addition, while guidance exists to prevent the inappropriate elimination of earnings and profits, the Joint Committee staff believes that additional guidance is needed to address situations in which a consolidated group is attempting to create or replicate earnings and profits in a manner inconsistent with the purpose of the consolidated return rules.

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).

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.

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.

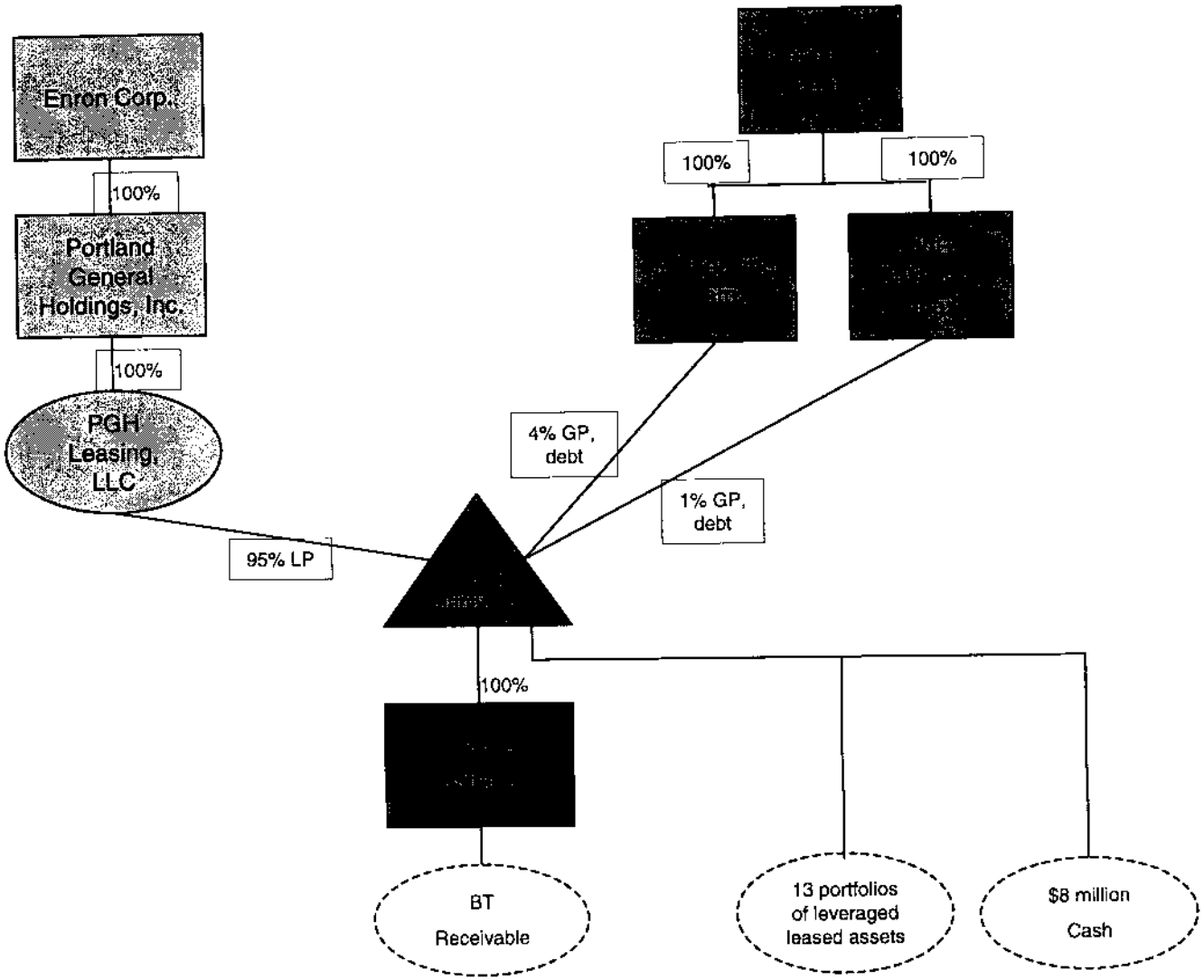
demand promissory note. In turn, Bankers Trust loaned approximately $250 million on a recourse basis to Seneca in exchange for Seneca's note. Seneca repaid $250 million to Toronto Dominion on September 17, 1998.

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.

Confidential

Project Tomas
Structure as of September 30, 1998



U. S. Tax/GAAP Legend

- Enron GAAP Consolidated
- Third Parties
- Equity Method Investment
- Corporation
- Partnership
- Branch
- Assets

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 Sepptember 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

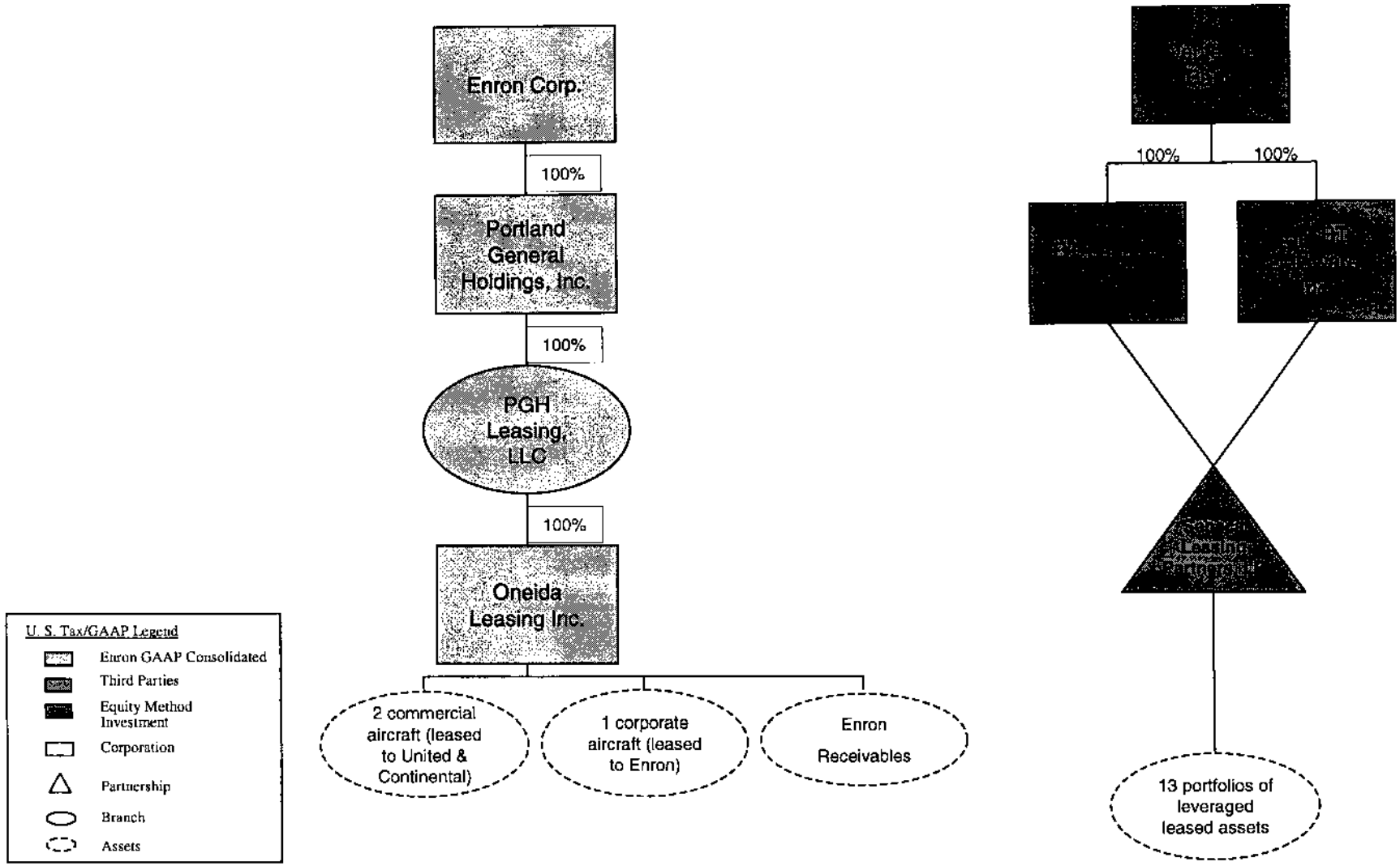
PGH LLC's interest in the Seneca partnership was liquidated on October 2, 2000, just over two years after the assets had been contributed to the partnership in September, 1998. After the liquidation of PGH's LLC interest, the leased assets remained in the partnership. The partnership was owned by the 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.

Confidential

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

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[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.

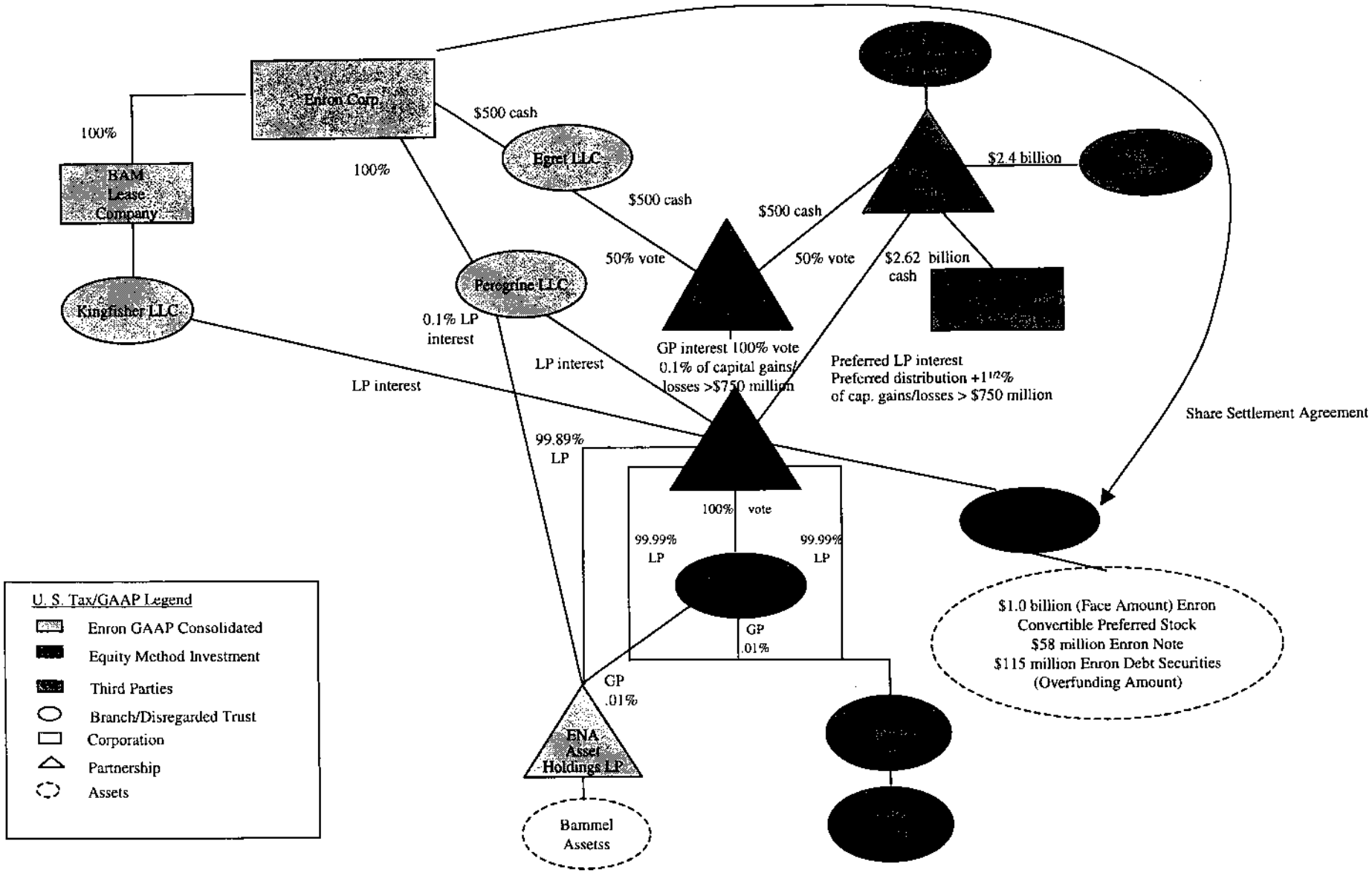
The strategy envisioned distributing the Bammel Assets back to HPL after 16 years, in redemption of HPL's partnership interest.[563] Under the partnership tax rules, HPL would ascribe its partnership tax basis (as increased through the partnership allocations) to the distributed pipeline. Thus, it was 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

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[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.

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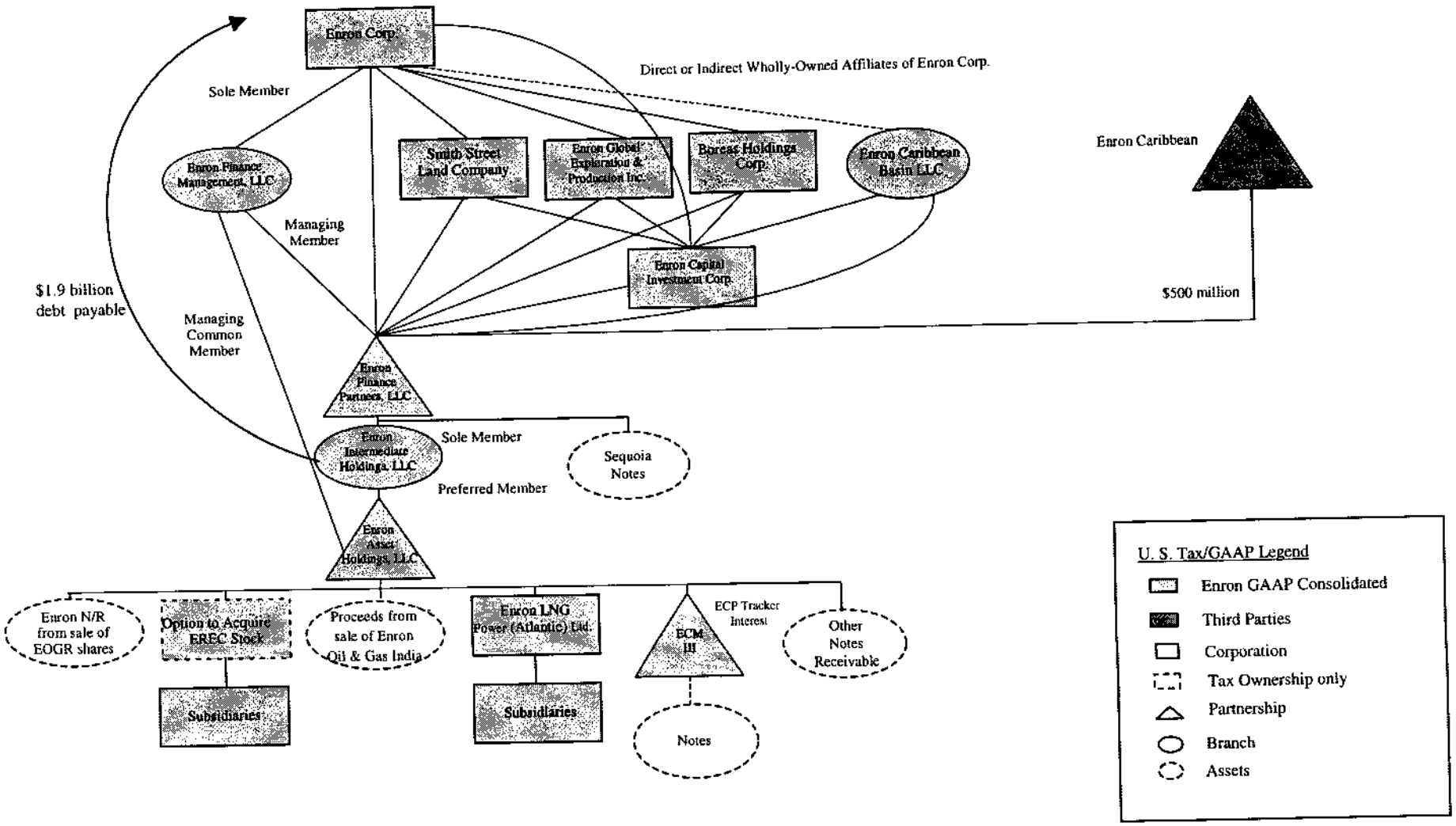
Project Tammy I
Structure as of December 2001



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.

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[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.

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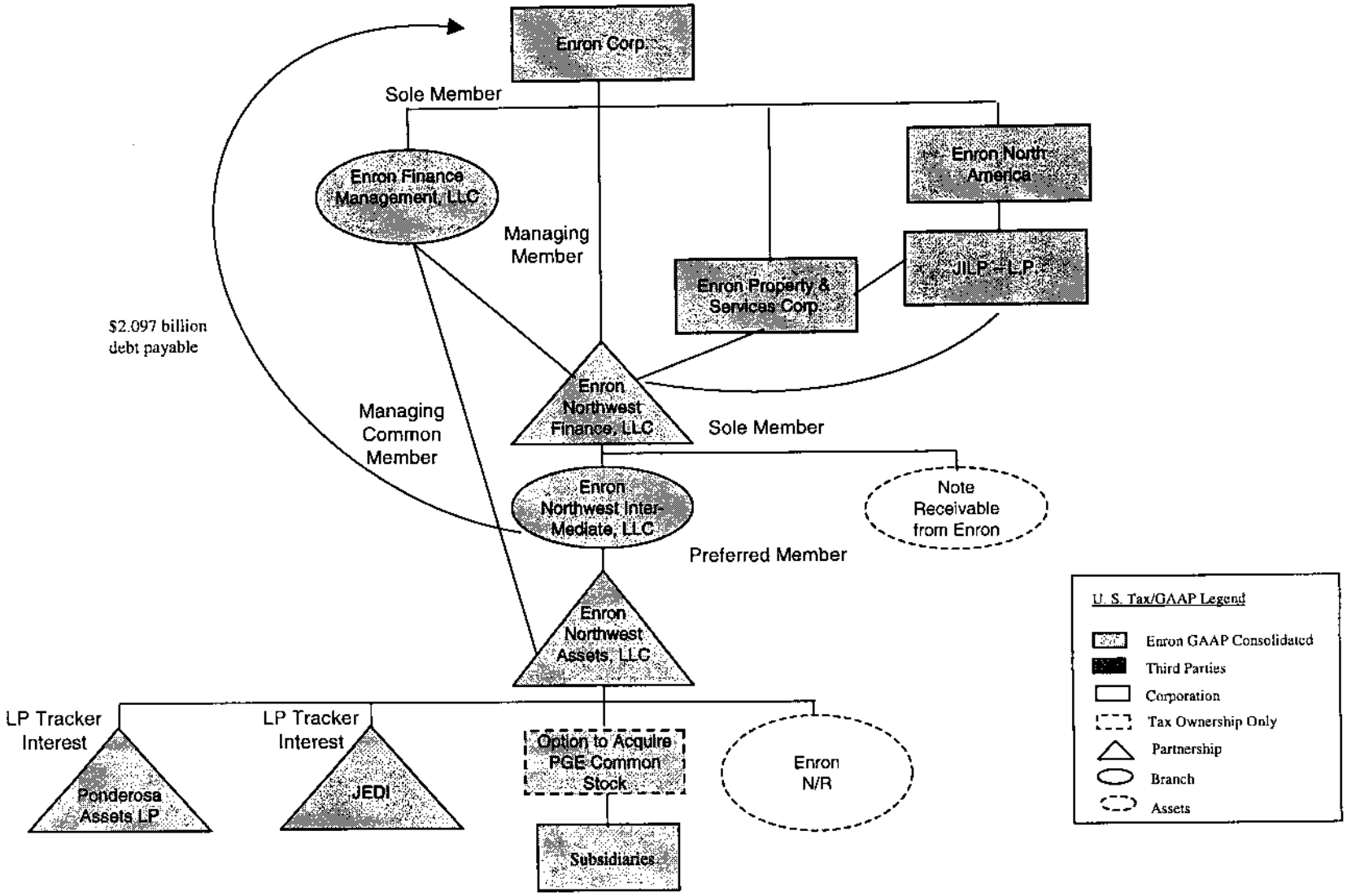
Project Tammy II
Structure as of December 2001



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).

D. Other Structured Transactions

1. Project Apache

Brief overview

Project Apache was a financing arrangement in which the Enron group borrowed funds from third-party foreign lenders. By channeling this third party borrowing through an Enron controlled foreign corporation and blending this borrowing with debt that the Enron group owed itself, the Enron group sought to claim U.S. tax deductions not only for interest paid on the third-party debt, but also for the interest paid to itself, without triggering any offsetting income inclusion on the Enron controlled foreign corporation's receipt of such interest. Viewed another way, the transaction was intended to generate deductions on the Enron U.S. consolidated return in an amount roughly equal to the entire cash flow paid by Enron to the third-party lenders -- not only the interest, but also the repayment of principal. The third-party borrowing also was designed to be treated as "mezzanine," or minority interest financing for financial reporting and rating agency purposes, notwithstanding its characterization as debt for U.S. Federal income tax purposes.

In general terms, the transaction involves a U.S. corporation and its unrelated foreign lenders indirectly establishing and funding a Dutch entity that in turn lends its funds indirectly to the U.S. corporation. The U.S. corporation indirectly contributes 60 percent of the cash in exchange for common ownership units representing 60 percent of the value of the entity, and the foreign lenders indirectly contribute 40 percent of the cash in exchange for preferred ownership units representing 40 percent of the value of the entity. The terms of the ownership units ensure that no earnings can be distributed on the U.S. corporation's common units while the foreign lenders' preferred units remain outstanding. The preferred units are redeemable at the option of the Dutch entity and are entitled to cumulative preferred distributions out of retained earnings and to a liquidation preference equal to the foreign lenders' initial investment in the Dutch entity.

The Dutch entity lends nearly all of its funds indirectly to the U.S. corporation, which deducts all of the interest on this debt on its U.S. tax return.[660] In view of the relative cash contributions to the Dutch entity, 60 percent of this debt is effectively owed by the U.S. corporation to itself, and 40 percent represents borrowing by the U.S. corporation from third parties.

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[660] In Enron's case, as explained in further detail below, the bulk of these deductions took the form of factoring deductions arising from purported sales of trade receivables to a financial asset securitization investment trust ("FASIT"). The discounts that generated the factoring deductions may be regarded as equivalent to interest, since the factoring transactions, to the extent that they had any significant non-tax effect, were economically similar to short-term secured borrowings (cf. Treas. Reg. sec. 1.861-9T(b)(3)(i), treating factoring discounts as interest expense for sourcing purposes). As explained below, this form was chosen in an effort to avoid the restrictions of section 163(j).

The Dutch entity is treated as a controlled foreign corporation, which ordinarily would entail current U.S. taxation of the entity's passive type earnings under subpart F. The interest that the Dutch entity receives indirectly from the U.S. corporation is subpart F income, and the Dutch entity's debt investment normally would be subject to the deemed repatriation rules of section 956. However, since the terms of the ownership units and the earnings of the Dutch entity are structured and managed in such a way as to render it impossible for any earnings of the Dutch entity to be distributed to the U.S. corporation, the U.S. corporation takes the position that none of the entity's subpart F income is allocable to the U.S. corporation, and that there is no deemed repatriation of earnings to the U.S. corporation under section 956. In other words, the parties effectively seek to specially allocate all adverse subpart F consequences to the foreign lenders, who are indifferent to it because subpart F does not apply to them.

When the transaction is unwound, the redemption of the foreign lenders' preferred units (i.e., the repayment of their principal) is treated under the terms of the instruments as a distribution of the Dutch entity's remaining undistributed earnings (i.e., the rest of the interest income received indirectly from, and deducted by, the U.S. corporation). The U.S. corporation takes the position that this elimination of the preferred units also eliminates all of the Dutch entity's earnings and profits for U.S. tax purposes, allowing the U.S. corporation to liquidate the entity without any recognition of income.

In sum, by effectively allocating all of the principal repayment on the combined debt to the U.S. corporation's common units and all of the interest payments on the combined debt to the foreign lenders' preferred units, the U.S. corporation ultimately claims U.S. tax deductions approximating the entire cash flow from its group to the foreign lenders -- both interest and principal -- while making no offsetting income inclusions under subpart F or otherwise.

Background[661]

Purported tax and financial statement effects

Project Apache was projected to increase Enron's financial net income by $167 million over the years 1999-2006. Ultimately, according to the company, the transaction increased financial net income by $50.7 million ($11.3 million, $20.6 million, and $18.8 million for 1999, 2000, and 2001, respectively) before the company declared bankruptcy at the end of 2001. This increase in financial net income was attributable to the tax benefit of interest and receivables factoring deductions that were not offset on the company's tax return by subpart F inclusions or other potential tax liabilities.

On its 1999 return, the company claimed $47.6 million of factoring deductions and $33 million of interest deductions on short-term debt, for a total of $80.8 million of deductions for the year in connection with the transaction. On its 2000 return, the company claimed $110.5 million of factoring deductions and $49.9 million of interest deductions on short-term debt, for a

[661] The Joint Committee staff obtained this information through interviews of Robert Hermann, James A. Ginty, and R. Davis Maxey, as well as from documents and materials provided by Enron Corp.

total of $160.5 million of deductions for the year in connection with the transaction. Sixty percent of these amounts were effectively circular -- i.e., paid by the Enron group to itself.

In addition, the Enron group's net borrowing in the amount of $500 million, which was treated as debt for U.S. tax purposes, was treated as minority interest, or "mezzanine" financing, for financial statement and rating agency purposes.

Development of Project Apache

The idea for Project Apache was brought to Enron by Chase Securities, an affiliate of Chase Manhattan Bank, in mid-1998. Mr. Hermann named the transaction after a favorite golf course in Arizona.[662]

As originally proposed, the transaction involved direct lending by the Dutch controlled foreign corporation to Enron.[663] After a concern was raised that interest on a direct loan might be subject to the restrictions of section 163(j), the transaction was redesigned to direct the loan through a FASIT, with the FASIT borrowing from the Dutch controlled foreign corporation and using the borrowed funds to purchase trade receivables from Enron affiliates, effectively loaning the funds to Enron based on the security of the receivables.[664] The transaction was structured to designate a third party as the owner of the FASIT, and Enron was able to take the equivalent of interest deductions largely in the form of receivables factoring deductions.

On September 25, 1998, a presentation was made to management regarding the transaction. The transaction was approved by a corporate officer of Enron, and Enron's Board of Directors' Executive Committee approved the transaction on November 2, 1998. At a meeting on December 8, 1998, Enron's full Board of Directors approved and ratified the transaction. Mr. Maxey and Mike Herman were instructed to execute the transaction.

Implementation of Project Apache

Blending third-party and related-party lending through controlled foreign corporation

In May of 1999, Enron Corp. transferred $748.5 million to Seminole Capital, LLC ("Seminole"), a newly formed Delaware limited liability corporation, in exchange for a 99.8 percent ownership interest in Seminole. The Lucelia Foundation, a New York not-for-profit

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[662] Joint Committee staff interviews.

[663] Memorandum from R. Davis Maxey to Robert J. Hermann, with transaction diagram, June 23, 1998, EC2 000037282, EC2 000037285; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (*see* Appendix B, Part X to this Report).

[664] Joint Committee staff interviews; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (*see* Appendix B, Part X to this Report).

corporation unrelated to Enron, transferred $1.5 million to Seminole in exchange for a 0.2 percent ownership interest. Seminole was treated as a partnership for U.S. Federal income tax purposes.

Seminole in turn transferred its $750 million to Cheyenne Finance SARL ("SARL"), a newly formed Luxembourg company, in exchange for the entire equity interest in SARL. SARL was treated as a corporation for U.S. Federal income tax purposes and was a controlled foreign corporation as defined in section 957.

Rabo Merchant Bank N.V. ("Rabo"), a Dutch bank unrelated to Enron, transferred $15 million to Choctaw Investors B.V. ("Investors B.V."), a newly formed Dutch company, in exchange for all of the Investors B.V. common stock. Investors B.V. then borrowed $485 million from a syndicate of mostly foreign banks.

SARL and Investors B.V. then formed Cherokee Finance VOF ("Dutch VOF"), a Dutch entity treated as a partnership for tax purposes in both the Netherlands and Luxembourg. SARL transferred its $750 million to Dutch VOF in exchange for all of the "common" ownership units of Dutch VOF (the "Common Units"). Investors B.V. transferred its $500 million to Dutch VOF in exchange for all of the "preferred ownership units of Dutch VOF (the "Preferred Units").[665] The holder of the Common Units had the right to elect two out of the three directors of Dutch VOF, and the holder of the Preferred Units had the right to elect one director. Pursuant to an election under the "check the box" regulations, Dutch VOF was treated as a corporation for U.S. Federal income tax purposes. Dutch VOF also was a controlled foreign corporation as defined in section 957, because Enron Corp. (through Seminole and SARL) indirectly owned more than 50 percent of the Dutch VOF stock.

The Common Units held indirectly by Enron Corp. could not receive any distributions of earnings while any of the Preferred Units remained outstanding. The Preferred Units had an initial liquidation preference of $500 million, as well as the right to a floating-rate cumulative preferred distribution out of retained earnings equal to a percentage of the liquidation preference, as declared by the Board of Directors. The Preferred Units were subject to redemption at a stated date ten years from issuance, at which time any outstanding units would be redeemed for their liquidation preference. Dutch VOF also had the right to redeem the Preferred Units in whole or in part at any time, again for the units' liquidation preference. The initial $500 million liquidation preference would be increased by the amount of any accrued but unpaid preferred distributions and would be decreased by the amount of any redemption proceeds received.

Generating receivables factoring and interest deductions through FASIT transactions

Of the $1.25 billion that Dutch VOF possessed immediately upon its formation by SARL and Investors B.V., Dutch VOF invested $1.23 billion in monthly senior debt obligations (the "Interim Notes") of Sequoia Financial Assets, LLC, a FASIT (the "FASIT"). When each Interim Note matured and was repaid, Dutch VOF would reinvest the proceeds in another Interim Note.

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[665] This $500 million represented Enron's net third-party borrowing in the transaction and was treated as minority interest financing for financial accounting purposes.

Dutch VOF earned interest on the Interim Notes in the form of short-term original issue discount. The FASIT in turn effectively loaned the Interim Note proceeds to Enron at the beginning of each month by making discounted purchases of third-party trade receivables from Enron North America and Enron Power Marketing, domestic affiliates of Enron Corp.[666] In cases in which the FASIT received payment on the receivables prior to the end of the month, these funds were used to purchase Enron North America commercial paper from Enron Corp. The transactions between Enron Corp. and its affiliates and the FASIT generated factoring deductions on the Enron consolidated return (reflecting the discount on the sales of the receivables), as well as interest deductions with respect to the commercial paper.

The "owner interest" in the FASIT was held by Ojibway, Inc., a domestic corporation unrelated to the Enron group. Ojibway contributed $2 million to the FASIT for this interest. Enron Corp. contributed $50 million to the FASIT in exchange for a subordinated interest in the FASIT.[667] Enron's interest in the FASIT was treated as a "regular interest" under the FASIT rules. The $1.23 billion Interim Notes held by Dutch VOF also were characterized as "regular interests" under the FASIT rules. Enron Corp. acted as the servicer of the FASIT. In this capacity, Enron Corp. not only handled the accounting, billing, collection, and other administrative functions with respect to the receivables sold by its affiliates to the FASIT, but also held the receivables and other assets of the FASIT and administered the monthly reinvestment program described above.

Intended exit strategy and net effects of transaction

At the time of the transaction, it was anticipated that Dutch VOF would exercise its right to redeem the Preferred Units of Investors B.V. in 2006, and that Dutch VOF and SARL would be liquidated immediately thereafter. Since all of Dutch VOF's earnings and profits (i.e., the interest paid by the FASIT) would have been allocated to the Preferred Units, the company would take the position that the redemption of the Preferred Units eliminated Dutch VOF's earnings and profits, and thus that Dutch VOF and SARL could be liquidated tax-free. In order to achieve this characterization, the redemption of the Preferred Units had to be treated as a dividend for U.S. tax purposes. In furtherance of this goal, Seminole had been granted an option to purchase all of the outstanding shares of Investors B.V. from Rabo. This option was intended to make Enron Corp. the "owner" of all of the stock of Investors B.V. and Dutch VOF under the constructive ownership rules of section 318(a)(4), such that the redemption of Investors B.V.'s Preferred Units would be treated as a dividend under section 302 and would eliminate Dutch VOF's earnings and profits.

Over the 7 years that the project was intended to have been in place, the structure would have generated receivables factoring and interest deductions on the Enron group's U.S.

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[666] The receivables arose primarily from Enron North America's natural gas and electric power businesses. The collection rate on these receivables exceeded 98 percent. "Discussion Material for Sequoia Financial Asset Trust," Mar. 2, 1999, at EC2 000037245.

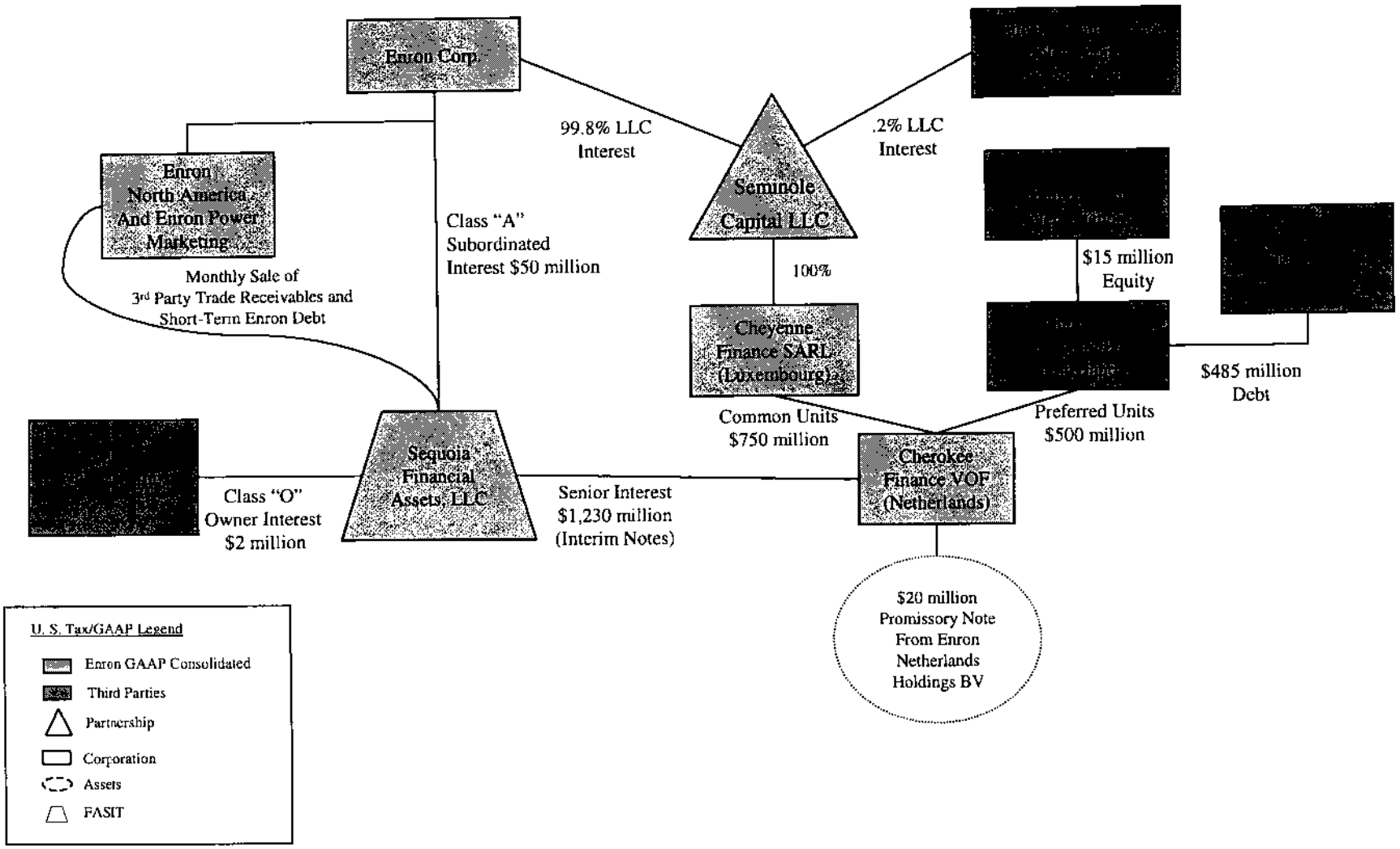
[667] Enron's subordinated interest was intended to insulate Dutch VOF, and hence the third-party foreign lenders, from credit risk on the receivables.

consolidated return approximating the entire cash flow from the Enron group to the unrelated foreign lenders. As it happened, the transaction generated $80.8 million and $160.5 million of such deductions for 1999 and 2000, respectively. These annual deductions were expected to increase gradually through 2006, thus generating deductions at least equal to the principal and interest on the $500 million that the Enron group borrowed from third parties in the transaction. It was intended that this benefit be unmitigated by any offsetting U.S. tax under subpart F or otherwise, despite the fact that 60 percent of the debt in the structure, or $750 million, constituted a circularity in the sense that it was owed by the Enron group to itself.

The diagram on the following page depicts the Project Apache structure.

Confidential

Project Apache
Structure as of May 28, 1999



Role of outside advisors

As noted above, Chase Manhattan Bank promoted the transaction to Enron. Chase Manhattan personnel presented the idea to Messrs. Hermann and Maxey in a meeting and gave them promotional materials.

Shearman & Sterling provided a "should" opinion as to the key intended tax consequences of the transaction, in particular the treatment of the transaction under subpart F, the characterization of various instruments as debt or equity, and the appropriateness of respecting the form of the transaction rather than disregarding it as an economic sham.

Shearman & Sterling also provided a separate tax opinion as to issues relating to the use of the FASIT in the transaction, including qualification as a FASIT ("will" opinion), treatment of Ojibway as the owner of the FASIT ("will" opinion), treatment of the receivables transactions as true sales ("should" opinion), the inapplicability of section 163(j) ("should" opinion), and the inapplicability of U.S. withholding tax on interest paid by the FASIT to Dutch VOF ("should" opinion). This latter opinion letter also included a separate "comments" section that addressed other issues, including the potential treatment of the FASIT as the originator of debt.

As of June 2001, Enron had paid over $14 million in fees in connection with the transaction, including $10,362,038 to Chase Manhattan, $2,070,000 in "syndicate bank fees" relating to various administrative costs of concluding the transaction, $1,108,940 to Shearman & Sterling for its U.S. tax opinions, and $300,000 to Freshfields LLC for a foreign-law opinion, among other fees.[668]

Appendix C, Part IX to this Report contains the tax opinions that Enron received in connection with Project Apache.

Subsequent developments

On January 13, 2003, the company advised the Joint Committee staff that no steps had been taken to unwind the Project Apache transaction structure, but that the parties had stopped cycling cash through the structure since Enron's bankruptcy filing.[669]

Following the bankruptcy filing, JP Morgan Chase Bank (the successor to Chase Manhattan Bank) exercised its right under the Dutch VOF organizing documents to appoint a majority of Dutch VOF's directors. JP Morgan Chase also initiated litigation against Enron on behalf of Dutch VOF and its investors, seeking the turnover of $2.1 billion of accounts receivable, commercial paper, cash, and other property that JP Morgan Chase believes is still

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[668] Enron Estimated Structured Transaction Project Fees as of June 4, 2001, EC2 000036379 (*see* Appendix B, Part I to this Report).

[669] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, Jan. 13, 2003, answer 74.

held by Enron in its capacity as servicer of the FASIT.[670] JP Morgan Chase claims that this property is not part of the Enron bankruptcy estate and fears dissipation of the assets if they remain in Enron's hands.

Discussion

In general

In order for Project Apache to provide the tax benefits intended, a number of different issues would have to be resolved in Enron's favor. First, the transaction would have to survive scrutiny under the judicial doctrines applicable to tax-avoidance transactions, despite the obvious tax motivation and large circular flow of cash at the heart of the transaction.[671] Second, the intended allocation of all of Dutch VOF's earnings and profits to the Preferred Units for subpart F purposes[672] would have to be sustained, in order for Enron to avoid current income inclusions under subpart F. Third, the receivables factoring and interest deductions arising from the FASIT transactions would have to be allowed, despite the tax motivation for the use of the FASIT and its close relationship to Enron.

Judicial doctrines and the circular flow of cash

The intended tax benefits of Project Apache arguably should be denied on the grounds that the bulk of the transaction lacked economic substance and non-tax business purpose. The overall transaction undoubtedly had a significant tax motivation, and in particular the circular flow of cash in the form of $750 million of debt (and the interest thereon) owed by the Enron group to itself appears to have lacked both economic substance and non-tax business purpose. Instead, this self-owed debt seems to have been created solely for the purpose of blending it with the third-party debt through Dutch VOF in order to generate interest and interest equivalent

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[670] Since the assets are under Enron's control, JP Morgan Chase could not be sure of the amount and composition of the assets and thus based its complaint on an estimate. The complaint thus also seeks a full and complete accounting of the assets. Complaint, *JP Morgan Chase Bank v. Enron Corp., et al.*, Chapter 11 Case No. 01-16034 (AJG), Adversary Proceeding No. 01-03637 (Bankr. S.D. N.Y.), Dec. 11, 2001, EC2 000054744.

[671] For detailed information on 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).

[672] *See* Treas. Reg. sec. 1.951-1(e)(2).

deductions in excess of those attributable to the third-party debt, while at the same time avoiding any of the offsetting income inclusions that normally apply. To the extent that the receivables factoring and interest deductions claimed by Enron are attributable to this circularity, they arguably should be denied as lacking economic substance and non-tax business purpose. Since this debt accounted for 60 percent of the overall debt in Project Apache, it could reasonably be argued that 60 percent of the deductions claimed by Enron in connection with the structure should be denied.

According to Enron, the non tax business purposes of Project Apache were to raise $500 million of outside financing that would qualify as minority interest financing for financial accounting and rating agency purposes, as well as to manage the trade receivables generated in the course of its affiliates' gas pipeline and electric power wholesale businesses by engaging in factoring transactions.

With respect to the first purpose cited, even if managing financial statement presentation and rating agency evaluations are found to constitute a valid business purpose, this purpose can justify only part of the transaction. This purpose fails to account for the complex and unusual manner in which Enron went about raising $500 million of minority interest financing. Indeed, this purpose fails to account for the majority of the debt involved in the transaction -- the business need to raise $500 million of outside financing does not explain the inclusion of $750 million of intra-group debt in the same structure. The only evident explanation for the use of the intra-group debt relates to the intended tax benefits of the transaction.

The receivables factoring business purpose cited also seems unconvincing. According to Enron tax department personnel interviewed by the Joint Committee staff, Enron did not even consider including trade receivables in the transaction until it concluded that the initial transaction design, which involved a more straightforward loan from Dutch VOF to Enron, was vulnerable to attack under section 163(j), which denies deductions for certain interest on related-party debt.[673] Thus, a tax-motivated transaction structure that did not involve any trade receivables was designed first, and the later inclusion of the receivables and use of the FASIT served the primary purpose of reducing one of the perceived tax risks in the transaction.

Moreover, to the extent that the factoring transactions were ultimately financed 60 percent by intra-group debt, the transactions cannot be said to have achieved the same non-tax effects as factoring transactions with unrelated parties. Factoring transactions generally serve the purpose of accelerating the conversion of trade receivables into cash, thus increasing liquidity and decreasing credit exposure. To the extent that a company effectively advances the bulk of the cash in a factoring transaction to itself and retains an indirect interest in the receivables, these benefits are not realized.

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[673] *See also* Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (Appendix B, Part X to this Report).

In sum, while the matter is not free from doubt, the Joint Committee staff believes that a strong argument could be made to deny the intended tax benefits of Project Apache under longstanding judicial doctrines addressing tax-motivated transactions.

Avoidance of subpart F and other potential offsetting tax liabilities

Allocation of subpart F income away from Enron.–The deductions generated by Project Apache would confer no net tax benefit to Enron if they were offset by subpart F inclusions. Under section 951(a), a U.S. shareholder of a controlled foreign corporation generally must include in income its pro rata share of the corporation's subpart F income for the year, as well as its pro rata share of the corporation's deemed repatriations for the year determined under section 956. Enron Corp., as an indirect 60-percent shareholder of Dutch VOF, which was a controlled foreign corporation, ordinarily would have been subject to current U.S. tax with respect to 60 percent of Dutch VOF's subpart F income. Dutch VOF's interest income was treated as subpart F income, and thus, under normal circumstances, it would be expected that Enron Corp. would include 60 percent of this interest income on a current basis for U.S. tax purposes. This of course would have the effect of offsetting 60 percent of the deductions generated in the transaction, thus eliminating the intended tax benefit. This treatment would, however, comport with the overall economics of the transaction, given that 60 percent of the total lending in Project Apache was a self-owed circularity.

Enron sought to avoid these current subpart F inclusions by structuring Dutch VOF's ownership instruments in such a way as to allocate all of the earnings and profits to the Preferred Units held by Investors BV, and none of the earnings and profits to the Common Units held by SARL, and thus indirectly by Enron. In determining a shareholder's pro rata share of subpart F income in cases involving multiple classes of stock, Treas. Reg. section 1.951-1(e)(2) provides that the subpart F income attributable to a class of stock is that proportion of the controlled foreign corporation's total subpart F income that the earnings and profits distributable to such class in a hypothetical year end distribution of all of the corporation's earnings and profits would bear to the corporation's total earnings and profits. Since Dutch VOF's ownership instruments provided that no earnings distributions could be made on the Common Units as long as any Preferred Units remained outstanding, Enron took the position that the Common Units would be entitled to no distribution at all in a hypothetical distribution of all of Dutch VOF's earnings and profits in any particular year, and thus that none of Dutch VOF's subpart F income was allocable to the Common Units (and thus to Enron Corp.) under Treas. Reg. section 1.951-1(e)(2). Even if Dutch VOF's right to redeem the Preferred Units were taken into consideration in this analysis, Enron took the position that the result would not change, on the basis that even a complete redemption of the Preferred Units would be treated as a dividend distribution by reason of the option attribution arrangement described above in connection with Enron's intended exit strategy.

The allocation method applicable to subpart F income also applies in the case of section 956 inclusions, and thus Enron took the same allocation position with respect to both subpart F income and section 956 inclusions.

Enron found support for this allocation position in the case of *Barnette v. Commissioner*,[674] a memorandum opinion of the Tax Court addressing a similar issue that arose under the foreign personal holding company regime.[675] The issue was one of 15 issues decided in the case, which addressed several tax years of an individual who had been convicted of both tax fraud and government contracting fraud in connection with the foreign business arrangements at issue.[676] The present discussion of the case is limited to the issue pertinent to Enron's subpart F position in Project Apache.

Among other tax reduction strategies, the taxpayer in the *Barnette* case arranged for a Panamanian foreign personal holding company that he controlled to issue a new class of preferred stock, with a conceded purpose of deflecting foreign personal holding company income away from himself. As in Project Apache, the terms of the ownership instruments provided that no distributions could be made on the taxpayer's common stock while the preferred stock remained outstanding. Under the applicable Treasury regulation, if a foreign personal holding company has outstanding both preferred and common stock, and the preferred stock is entitled to a specified dividend before any distribution can be made on the common stock, foreign personal holding company income is treated as being distributed first with respect to the preferred shares.[677] Thus, like Enron under the subpart F multiple-classes-of-stock regulation, the taxpayer in *Barnette* took the position that none of the "tainted" foreign income was allocable to the common shares that he held. The IRS, on the other hand, contended that all such income should have been allocated to the taxpayer's common shares, since there was no reason for the creation of the preferred shares other than tax avoidance.

The court ruled in favor of the taxpayer on this issue, sustaining his allocation of foreign personal holding company income away from himself under the regulation, despite the acknowledged tax motivation for the issuance of the preferred stock and related transactions. The court concluded that, even if the sole purpose for creating and transferring the preferred stock were tax avoidance, the stock's existence still could not be ignored. Since the transactions at issue altered the taxpayer's financial position, the court decided that no non-tax business purpose was necessary. In other words, the court seems to have concluded that the foreign personal holding company income allocation regulation was to be applied literally, and its results

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[674] 63 T.C.M. (CCH) 3201 (1992), *reh'g denied*, 64 T.C.M. (CCH) 998 (1992).

[675] The foreign personal holding company regime (secs. 551-558) is an anti-deferral regime that preceded subpart F, and that now has been largely supplanted by it. Under coordination rules applicable for taxable years of U.S. shareholders beginning after July 18, 1984, subpart F generally trumps the foreign personal holding company regime. Sec. 951(d). During the taxable years at issue in the *Barnette* case, however, the foreign personal holding company rules generally trumped the subpart F rules. Sec. 951(d), prior to amendment by P.L. 98-369.

[676] The case also involved several tax years of the individual's company and certain members of his family.

[677] Treas. Reg. sec. 1.551-2(c).

respected, even with respect to a tax-motivated structure entirely lacking any non-tax business purpose.

Given the similarities between the foreign personal holding company issue raised in the *Barnette* case and the subpart F issue raised in Project Apache, the *Barnette* case arguably lends support to Enron's position that none of Dutch VOF's subpart F income should be allocated to Enron, regardless of the tax motivation behind the structuring of the ownership instruments. Nevertheless, if the issue were litigated, a court would approach the issue de novo and accord the *Barnette* case little or no precedential weight. As a memorandum opinion (as opposed to a "regular," or "T.C." opinion) of the Tax Court, the case is not regarded as controlling precedent by any court, including the Tax Court itself.[678] Memorandum opinions are generally limited to their specific facts; if a case raises novel legal issues, the Tax Court generally issues a "regular" opinion, which the court then regards as controlling precedent.

Thus, a court determining how to apply Treas. Reg. section 1.951-1(e)(2) to Enron and Dutch VOF would be free to analyze the issue on its own merits and would not be bound by the earlier memorandum decision of the Tax Court applying Treas. Reg. section 1.551-2(c) to the taxpayer in *Barnette*. On this basis, it is impossible to predict how a court might resolve the issue. A literal application of the regulation to the carefully structured ownership instruments of Dutch VOF appears to yield the results intended by Enron. However, it is possible that a court would sustain an argument along the same lines advocated by the IRS in the *Barnette* case. In other words, a court might conclude that the transaction was structured to generate tax benefits not intended by the Congress, that there was no significant non-tax business purpose for the complex manner in which the transaction was structured, and that the subpart F income allocation sought by Enron would violate the purpose of subpart F and would abuse the rule set forth in Treas. Reg. section 1.951-1(e)(2), thus requiring an allocation of some subpart F income to Enron.

A court might reach this conclusion on a somewhat narrower basis by disregarding Seminole's option to purchase the Investors B.V. stock as lacking any non-tax business purpose. The court then could apply the hypothetical of Treas. Reg. section 1.951-1(e)(2) by treating Dutch VOF's redemption right as exercised, and treating the hypothetical redemption of the Preferred Units as a sale instead of a dividend distribution, which in turn would leave earnings and profits distributable to the Common Units in a hypothetical year-end distribution, thus requiring an allocation of subpart F income to Enron.

Avoidance of other potential offsetting tax liabilities.–Subpart F was the main, but not the only, potential source of U.S. tax that needed to be avoided in order for Project Apache to generate the net tax benefits intended. For example, if the interest paid to Dutch VOF had been subject to U.S. withholding tax, then the transaction would not have been worthwhile, even if the other tax issues raised by the transaction were resolved in Enron's favor. In this regard, Enron took the position that no withholding tax applied, principally because the interest earned by

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[678] *See, e.g., Darby v. Comm'r*, 97 T.C. 51, 67 (1991); *Nico v. Comm'r*, 67 T.C. 647, 654 (1977), aff'd in part and rev'd in part on other grounds, 565 F.2d 1234 (2d Cir. 1977); *McGah v. Comm'r*, 17 T.C. 1458 (1952).

Dutch VOF on the Interim Notes took the form of short-term original issue discount, which is exempt from withholding tax.[679]

Another potential U.S. tax problem for the structure, the passive foreign investment company regime,[680] was avoided by reason of Dutch VOF's status as a controlled foreign corporation, and Enron's status as a U.S. shareholder of Dutch VOF. Under section 1297(e), which Congress enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. Thus, even though Enron took the position that it would not be allocated any of Dutch VOF's subpart F income, Enron's status as a U.S. shareholder of Dutch VOF within the meaning of section 951(b) nevertheless exempted Enron from the application of the passive foreign investment company rules in connection with Dutch VOF.

Use of a FASIT to avoid earnings stripping rules

As explained above, Project Apache as originally conceived did not involve the use of a FASIT. Rather, the original transaction design would have used direct lending by Dutch VOF to Enron to cycle funds through the structure and generate the desired deductions.[681] Only after a concern was raised that the interest on such a direct loan might be subject to disallowance under section 163(j) was the transaction redesigned to direct the loan through a FASIT.[682] Since the limits of section 163(j) generally apply only to interest paid between related parties, Enron took the position that interposing an unrelated FASIT between itself and Dutch VOF rendered those limits inapplicable. The FASIT rules[683] in turn made it possible for Enron to place a relatively small "owner interest" in the FASIT with an unrelated party, and thereby to take the position that the FASIT was unrelated to Enron, despite the fact that Enron: (1) was the largest investor in the

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[679] Sec. 871(g)(1)(B). Even if the interest did not qualify as short-term original issue discount, the portfolio debt exception of section 881(c)(2)(B) might have shielded the interest from withholding taxes. In addition, U.S. income tax treaties with the Netherlands and Luxembourg arguably would have provided a further backstop against the imposition of withholding tax.

[680] Secs. 1291-1298.

[681] Memorandum from R. Davis Maxey to Robert J. Hermann, with transaction diagram, June 23, 1998, EC2 000037282, EC2 000037285; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (*see* Appendix B, Part X to this Report).

[682] Joint Committee staff interviews; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (*see* Appendix B, Part X to this Report).

[683] Secs. 860H - 860L.

FASIT; (2) exercised day-to-day control over the FASIT through the servicing arrangement; and (3) treated the FASIT as an Enron consolidated entity for financial reporting purposes.

Although the Treasury Department has never issued final regulations under section 163(j), a comprehensive set of proposed regulations was issued in 1991.[684] Under these proposed regulations, the IRS would have broad authority to disregard entities created with a principal purpose of avoiding section 163(j). Specifically, the proposed regulations provide that "[a]rrangements, including the use of partnerships and trusts, entered into with a principal purpose of avoiding the rules of section 163(j) and [the proposed regulations] shall be disregarded or recharacterized to the extent necessary to carry out the purposes of section 163(j)."[685]

In the case of Project Apache, it is clear from Joint Committee staff interviews with Enron personnel involved in planning the transaction, as well as from documentary evidence and the structure of the transaction itself, that the FASIT arrangement was established "with a principal purpose of avoiding section 163(j)." In addition, given that the arrangement was used to ensure that no interest or interest-equivalent deductions would be disallowed on what in substance was a related-party borrowing, and that Enron maintained that the payments in question were not subject to any offsetting Federal tax (e.g., withholding tax, or tax arising under subpart F), recharacterizing the transaction would "carry out the purposes of section 163(j)."[686] Thus, if the proposed regulation had applied to the transaction, the conditions for the application of the anti-avoidance rule would have been present.

Proposed regulations do not have the force of law, but taxpayers commonly use them as guidance and as indicators of the government's position on the issues addressed. In this case, Enron disregarded a proposed regulation that was directly on point and contrary to its return position.

The Shearman & Sterling opinion letter that addressed FASIT-related issues briefly discussed the proposed regulations and concluded that "the anti-abuse rule in the proposed regulations should not be applicable to disregard [the FASIT], because no principal purpose of the transaction is to avoid section 163(j)."[687] In light of the evidence that avoiding section 163(j) in fact was the principal purpose for using a FASIT in the first place, the Joint Committee staff finds this statement in the opinion letter troubling.

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[684] Prop. Reg. sec. 1.163(j)-1 *et seq.*

[685] Prop. Reg. sec. 1.163(j)-1(f).

[686] This issue, of course, would not be reached if it were determined that Dutch VOF's subpart F income was taxable to Enron, since the amounts then would be subject to Federal tax, canceling out the benefit of the interest deductions. Sec. 163(j)(3)(A).

[687] Letter from Shearman & Sterling to Enron Corporation and Cherokee Finance VOF c/o Rabobank Management B.V., May 28, 1999, at 10-11 (Appendix C, Part IX to this Report).

Although the analysis of the opinion letter is somewhat elliptical on this point, it implies that avoidance of section 163(j) could not have been a principal purpose of using the FASIT, since payments of interest directly from the obligors on the receivables (i.e., Enron's natural gas and electric power customers) to Dutch VOF would have been payments between unrelated parties, and thus would not have been subject to section 163(j).[688] Of course, the FASIT was not interposed in any larger lending transaction between Enron's customers and Dutch VOF; it was interposed in a larger lending transaction between Enron and Dutch VOF. The purported sales of trade receivables by Enron affiliates to the FASIT may be viewed as secured financings comprising merely one component of the larger financing arrangement -- in other words, Dutch VOF loaned funds to the FASIT, and the FASIT in turn effectively loaned the funds to Enron on the strength of the receivables. Viewed in this manner, the transaction may be understood as avoiding section 163(j), since the interest, if paid directly by Enron to Dutch VOF (and not subjected to Federal tax) potentially would have been subject to section 163(j). The opinion letter raises this possibility, and dismisses it, in a footnote.[689]

The opinion letter's explanation of the transaction is that "the principal purpose of the arrangement is to create a revolving securitization vehicle for accounts receivable generated by [domestic affiliates of Enron]."[690] Again, this declared purpose is implausible, given that the idea to use a FASIT in fact arose as a solution to a perceived section 163(j) problem, and that the structure did not generate the non-tax benefits (increased liquidity, decreased credit exposure) that normally accompany third-party factoring transactions, due to the circularity at the heart of the arrangement. The Joint Committee staff believes that, at a minimum, the opinion letter reflects an unquestioning reliance on company representations as to business purpose, as well as a failure to look beyond isolated parts of an overall transaction to evaluate it in its totality.

Notwithstanding these concerns about the opinion letter's analysis of the proposed regulations, the fact remains that the lack of final regulations on this issue, combined with the availability under the FASIT rules of an entity that Enron could control but treat as unrelated for tax purposes, enabled Enron to take the position that section 163(j) could be avoided through the expedient of interposing an additional entity.[691]

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[688] The opinion letter acknowledges that this reasoning would not apply to the Enron-group commercial paper held by the FASIT. The opinion letter instead downplays the importance of this debt, implying that it could not be significant enough to form "a principal purpose" of avoiding section 163(j). *Id.*, at 10-11.

[689] *Id.*, at 11, n.7.

[690] *Id.*, at 10.

[691] Subsequent to the closing of the transaction, the Treasury Department issued proposed regulations under the FASIT rules, which included a broad anti-abuse rule. Prop. Reg. sec. 1.860L-2 (Feb. 7, 2000). In view of the company's treatment of the anti-abuse rule provided in the proposed regulations under section 163(j), it would seem unlikely that a second anti-abuse rule in proposed form would have caused Enron or its advisors to reach a different conclusion as to the appropriateness of the use of the FASIT.

Recommendations

In general

As discussed above, Project Apache raises a set of familiar concerns encountered in connection with tax-motivated transactions, in particular issues relating to the economic substance and business purpose doctrines. In addition to these general concerns, however, the transaction also raises some specific issues regarding the potential abuse of particular statutory and regulatory provisions. The Joint Committee staff believes that amendments to some of these provisions should be considered in order to render them less prone to abuse in tax-motivated transactions.

Allocation of subpart F income

Project Apache exploited a highly mechanical earnings and profits allocation rule in Treas. Reg. sec. 1.951-1(e)(2) in an effort to achieve results that cannot have been envisioned or intended by the Treasury Department when it issued the regulation. The putative ability to allocate all of the subpart F income of Dutch VOF to tax indifferent foreign parties was critical to Enron's position that it could blend its third-party debt with self-owed debt within Dutch VOF in order to generate inflated interest and interest-like deductions without incurring any offsetting tax liability under subpart F. The transaction thus illustrates that special allocation abuses similar to those that have been encountered in the partnership taxation area[692] are also possible in the context of controlled foreign corporations. Enron took the position that it could specially allocate the subpart F "taint" to tax-indifferent parties, and it was able to find some support for this position under both the regulation and analogous non-subpart-F case law.

The Joint Committee staff believes that this tactic is inconsistent with the purposes of subpart F and that the results that it purports to produce are inappropriate. The Joint Committee staff recommends adding an exception to the subpart F income allocation method set forth in the regulation for cases involving allocations of earnings and profits to tax-indifferent shareholders, if such allocations are made for tax avoidance purposes. If such an exception had been applicable to Project Apache, the transaction would not have been viable.

Passive foreign investment company regime

Another concern raised by Project Apache involves the statutory elimination of the so-called overlap between the passive foreign investment company regime and the subpart F regime. In 1997, Congress enacted section 1297(e) in order to mitigate the complexity and uncertainty that arose when a foreign corporation met the definitions of both the controlled foreign corporation rules of subpart F and the passive foreign investment company rules, thus requiring shareholders to negotiate two sets of anti-deferral rules in connection with the same investment. Section 1297(e) largely eliminates this overlap by providing that a corporation generally is not treated as a passive foreign investment company with respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a

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[692] *See, e.g.*, sec. 704(b); Treas. Reg. sec. 1.704-1(b)(2) (addressing special partnership allocations that lack "substantial economic effect").

"U.S. shareholder" as defined in section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules, and a U.S. shareholder generally no longer needs to contend with these rules in connection with the ownership of controlled foreign corporation stock.

As applied to Project Apache, section 1297(e) enabled Enron to claim exemption from the passive foreign investment company rules with respect to its ownership of Dutch VOF stock on the basis of Enron's subpart F status as a U.S. shareholder, despite the fact that Enron had implemented a structure designed to render it impossible for Enron to recognize any income under subpart F in connection with the stock. Thus, in a case in which Enron was a 60-percent U.S. shareholder of a foreign corporation with nothing but passive assets and passive income, Enron could take the position that neither subpart F nor the passive foreign investment company rules applied.

The Joint Committee staff believes that the exception to the passive foreign investment company rules for U.S. shareholders of controlled foreign corporations should be geared more closely to the U.S. shareholder's potential taxability under subpart F, as opposed to mere status as a U.S. shareholder under subpart F. Accordingly, the Joint Committee staff recommends adding an exception to section 1297(e) for cases in which the likelihood that a U.S. shareholder would have to include income under subpart F is remote. In such a case, the subpart F rules and the passive foreign investment company rules cannot be said to "overlap" in the manner that the Congress found objectionable in 1997. Rather, allowing the two regimes to "overlap" in these cases would allow the passive foreign investment company rules to serve the useful purpose of providing a backstop to subpart F. If the passive foreign investment company rules had applied to Enron in Project Apache, the transaction as structured would not have been viable, even if Enron's position under subpart F were sustained.

FASIT rules

As explained above, the availability under the FASIT rules[693] of an entity that Enron could control but treat as unrelated for tax purposes enabled Enron to take the position that section 163(j) could be avoided through the expedient of interposing an additional entity. In view of the wide range of rules under the Code that apply special restrictions to transactions between related parties, the ability to treat a FASIT as unrelated for tax purposes while maintaining effective control of it for other purposes renders FASITs prone to abuse in a wide range of situations. Regulatory anti-abuse rules,[694] if issued in final form, might mitigate this potential to some extent, but history suggests that the administration of such rules would be problematic, leaving considerable potential for abuse remaining. Moreover, recent commentary suggests that the FASIT rules, which were first enacted in 1996, are not widely used in the manner envisioned by the Congress and thus have failed to further their intended purposes.[695]

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[693] Secs. 860H - 860L.

[694] *See, e.g.*, Prop. Reg. sec. 1.163(j)-1(f); Prop. Reg. sec. 1.860L-2.

[695] *See, e.g.*, New York State Bar Association, "Report on Securitization Reforms" (Dec. 20, 2002) ("It is clear that the FASIT rules are not being used to any significant degree and

The Joint Committee staff believes that the abuse potential inherent in the FASIT vehicle far outweighs any beneficial purpose that the FASIT rules may serve, and thus recommends that these rules be repealed.

Earnings stripping regulations

The lack of final regulations under section 163(j) has created a void in an area in which more definitive guidance is needed. Project Apache illustrates that taxpayers may treat proposed regulations as a one-way street, to be relied upon when supportive of the desired return position, and to be disregarded when contrary to such position. If the anti-abuse rule of the proposed regulations under section 163(j)[696] had been in final form, Enron might have reconsidered this transaction. As noted above, the administration of such rules is always problematic, but the existence of a finalized anti-abuse rule directly on point would induce at least some change to a company's cost benefit assessment of a transaction like Project Apache. Accordingly, the Joint Committee staff recommends that the regulations implementing an anti-abuse rule to combat the avoidance of section 163(j) should be finalized expeditiously.

2. Project NOLy[697]

Project NOLy was a series of transactions structured to generate sufficient taxable income so that Enron could offset all of its tax losses from earlier years. Enron engaged in this transaction because it would allow Enron to settle and close tax examinations for those years. Project NOLy involved the constructive sale rules and the partnership rules. The following is a discussion of these rules, followed by a detailed discussion of Project NOLy.

Discussion of relevant tax laws

Tax treatment of section 1259 constructive sales

For transactions entered into after June 8, 1997, taxpayers are required to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest, or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the transaction.[698] If the requirements

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accordingly are not achieving their purpose"); New York State Bar Association, "Simplification of the Internal Revenue Code" (March 18, 2002), reprinted in 95 Tax Notes 575 (April 22, 2002) ("In our experience, the FASIT legislation is not being used by those who would be expected to benefit from it and it is unlikely that situation will change"); Letter from James M. Peaslee and David Z. Nirenberg to Assistant Treasury Secretary (Tax Policy) Mark A. Weinberger (June 6, 2001), reprinted in 91 Tax Notes 2079 (June 18, 2001) ("The FASIT legislation has failed").

[696] Prop. Reg. sec. 1.163(j)-1(f).

[697] The project was named for "Molly," a girlfriend of one of the attorneys on the transaction. Joint Committee staff interview.

[698] Sec. 1259, enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1001(a). A "position" is defined as an interest, including a futures or forward contract, short

for a constructive sale are met, the taxpayer recognizes gain in a constructive sale as if the position were sold at its fair market value on the date of the transaction and immediately repurchased.[699]

In general, a taxpayer is treated as making a constructive sale of an appreciated position if and when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same (or substantially identical) property; (2) enters into an offsetting notional principal contract with respect to the same (or substantially identical) property; or (3) enters into a futures or forward contract to deliver the same (or substantially identical) property.[700] In addition, in the case of an appreciated financial position that itself is a short sale, a notional principal contract, or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same (or substantially identical) property as the underlying property for the position.[701] Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.[702]

A forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery, or for cash settlement, of a substantially fixed

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sale, or option. A "position" includes a notional principal contract or other derivative instrument that provides that a taxpayer make or receive payments (or contractual credits) that approximate the economic effect of ownership of stock, a debt instrument or a partnership interest. For example, a contract that provides a right to receive payments (or contractual credits) based on a calculation having the effect of interest on a notional principal amount is treated as a position with respect to a debt instrument.

[699] Sec. 1259(a)(1).

[700] Sec. 1259(c)(1). A constructive sale does not include a transaction involving an appreciated financial position that is mark to market, including positions governed by section 475 (mark to market for securities and commodities dealers and traders) or section 1256 (mark to market for futures contracts, options and currency contracts). Nor does a constructive sale include any contract for sale of an appreciated financial position which is not a "marketable security" (as defined in section 453(f) if the contract settles within one year after the date it is entered into).

[701] *Id.*

[702] Sec. 1259(c)(1)(E). Future Treasury regulations are anticipated to treat as constructive sales other financial transactions that, like those specified in section 1259, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income and gain with respect to the appreciated financial position. It is anticipated that the Treasury regulations, when issued, will provide specific quantitative standards for determining whether several common transactions will be treated as constructive sales. H.R. Rep. No. 105-148, at 442-443 (1997).

amount of property and a substantially fixed price.[703] Thus, a forward contract providing for delivery of property, such as shares of stock, the amount of which is subject to significant variation under the contract terms does not result in a constructive sale.[704]

Tax treatment of partnership formation

Generally, a partner does not recognize gain or loss on the exchange of property for a partnership interest[705] and a partner's basis in a partnership interest acquired by contribution of property to a partnership is the amount of money plus the partner's adjusted basis of the property contributed.[706] In Rev. Rul. 80-235[707] the IRS held that if the property contributed to a partnership is an obligation of the contributing partner, that partner's basis is not increased to reflect the partner's obligation because the partner has no basis in its own obligation under certain circumstances. Treasury regulations provide that if parties enter into an off-market swap with significant nonperiodic payments, the contract is treated for Federal income tax purposes as two separate transactions, an on-market swap and a loan.[708] Consequently, it could be argued that the loan part of the swap transaction would be within the holding of Rev. Rul. 80-235 and the contributing partner would receive no basis in its partnership interest as a result of contributing its own obligation.

Liquidation of a partnership

Gain is not recognized to a partner as a result of a distribution from a partnership except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.[709] No loss generally will be recognized to a partner upon receipt of a distribution from a partnership except upon a distribution in complete liquidation of a partner's interest in the partnership if no property other than money, unrealized receivables and inventory is received.[710] If the criteria for recognizing a loss are met, the loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of the money distributed and the basis to the distributee, as determined

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[703] *See* Sec. 1259(d)(1).

[704] H.R. Rep. No. 105-148, at 442 (1997).

[705] Sec. 721.

[706] Sec. 722.

[707] 1980-2 C.B. 229. *See* also, *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315 (1991) *aff'd without published opinion*, 8 F3d 26 (9th Cir. 1993).

[708] Treas. Reg. sec. 1.446-3(g)(4).

[709] Sec. 731.

[710] Sec. 731(a)(2).

under section 732, of any unrealized receivables and inventory distributed.[711] Gain or loss recognized as a result of a distribution pursuant to section 731 is treated as gain or loss from the sale or exchange of the partnership interest of the distributee partner[712] and is generally treated as gain or loss from the sale of a capital asset.[713] If a distribution is made to a partner of the partner's obligation received by the partnership in exchange for a partnership interest, there is no direct authority as to how this should be treated.[714] Commentators have indicated that this should be treated as a nonevent for tax purposes.[715] As a result the loss on the liquidation would be recognized to the extent basis exceeds the amount of cash distributed plus the basis to the distributee of any unrealized receivables and inventory received.[716]

Capital loss carryback

Capital losses are required to be carried back three years and, if not used in the carryback years, carried forward five years.[717] A capital loss carryback cannot increase or produce a net operating loss for the year to which it is carried back.[718] Treasury regulations provide ordering rules for capital loss carrybacks in situations when there are also net operating losses at issue.[719] Generally, the capital loss carryback would offset capital gains in the carryback year to the extent a net operating loss is not created or increased in the carryback year. To the extent a net operating loss from a year prior to the year that produced the capital loss was carried into the carryback year and offset capital gains, that net operating loss is freed up to be carried to a subsequent year.[720]

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[711] *Id.*

[712] *Id.*

[713] Sec. 741.

[714] Treas. Reg. sec. 1.731-1(c)(2) and Rev. Rul. 93-7, 1993-1 C.B. 125, involve partner obligations that were either a loan or were acquired from a third party.

[715] McKee, Nelson & Whitmire, Federal Income Taxation of Partnerships and Partners, Para. 19.02[5] (1997).

[716] Sec. 731(a)(2).

[717] Sec. 1212(a)(1)(A) and (B).

[718] Sec. 1212(a)(1)(A)(ii).

[719] Treas. Reg. sec. 1.1212-1(a)(3).

[720] *See* Examples 4 and 5 of Treas. Reg. sec. 1.1212-1(a)(3).

Statute of limitations on NOL carryover years and adjustment of NOL carryover

Generally tax must be assessed within three years from the date a return for that year is filed.[721] Courts have held that, although the period of limitations for the year a net operating loss carryover arose is not open, the amount of net operating loss carryover from a barred year can be recalculated when determining a deficiency for an open year.[722]

IRS Appeals' "no immediate tax consequence" policy

If a taxpayer does not agree with adjustments made by an examiner, generally a taxpayer has the opportunity to take that dispute to Appeals, a dispute resolution function within the IRS. Most cases considered by Appeals involve disputed tax liability and as a general rule Appeals will not consider cases when there is "no immediate tax consequence."[723] However, cases can arise in which there is no disputed tax liability for the period under consideration. In such cases, if required by law, IRS policy, regulation, ruling or procedure, Appeals will consider issues that do not have an immediate tax consequence.[724] Appeals has indicated that one example of such a case is a year in which a net operating loss carryover arises and the carryforward year has not yet been examined.[725] The IRS has recently established other dispute resolution procedures and at least one of these might be available in no immediate tax consequence situations.[726]

Brief overview of Project NOLy

Project NOLy was a series of transactions structured to "soak up" losses generated in the 1996 through 2000 taxable years so that Enron could settle and close tax examinations for those years. The transactions involve using limited liability companies ("LLCs") taxed as partnerships and the constructive sale rules of section 1259 to generate capital gains that can be offset by NOL carryovers to and losses incurred in 2000. Because the exact amount of the losses for 2000 was not known, Enron used two techniques to try to match the amount of gain as closely as possible to the ultimately determined losses. First, it set up 14 different LLCs, each with a different amount of potential gain available, so that when the amount of the losses was finally determined, it could be matched as closely as possible by using a combination of LLCs. Also,

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[721] Sec. 6501(a).

[722] *Hill v. Commissioner*, 95 T.C. 437, 440 (1990) and *Stiebling v. Commissioner*, 1994 T.C. Memo 233, *aff'd without published opinion* 113 F3d 1242 (9th Cir. 1997). *See* also Rev. Rul. 56-285, 1956-1 C.B. 134.

[723] IRM 8.1.2.2.3(1) (February 2, 1999). Apparently one reason for this position is that Appeals resources should not be used in cases when there is no tax currently at issue.

[724] IRM 8.1.2.2.3(2) (February 2, 1999).

[725] *Id.*

[726] Internal IRS correspondence indicates that early referral might be available in such a situation. See Rev. Proc. 99-28, 1999-2 C.B. 109, for a description of the early referral program.

Enron used certain technical provisions of the constructive sale rules to delay determining how much gain to report in 2000 until the end of March 2001.[727] Enron intended to recognize the corresponding loss in a subsequent year.

Background[728]

Reported tax and financial statement effects

Enron reported a capital gain of $5.6 billion on its 2000 consolidated tax return as a consequence of Project NOLy and paid taxes of $63 million in that year. The partnerships were liquidated in late 2001, causing recognition of a capital loss of $5.6 billion.[729] That capital loss was carried back to 2000, offsetting capital gain that resulted from the constructive sale in that year.[730] Pursuant to the ordering rules, NOLs would be freed up allowing them to be carried to subsequent years.[731] Enron anticipated that application of the capital loss carryback would also result in a refund of the $63 million in taxes paid in 2000.[732]

For financial purposes, this transaction was considered to be neutral.[733]

Development of Project NOLy

Project NOLy was initially developed internally within Enron. Enron wanted to close out examinations on back years from which there were loss carryovers and believed that to do so they needed to trigger enough gain so that there was tax liability for 2000. The Managing Director and General Tax Counsel asked one of the directors in the Tax Department to devise a plan to accomplish this. A plan was developed that utilized the constructive sale rules of section 1259 to generate gain in 2000 by segregating the gain portion of existing financial contracts into partnerships so that the gain could be recognized. Pursuant to section 1259, a taxpayer is deemed to have sold an appreciated financial asset if derivatives or short sales are used to lock in the gain. The gain part of the project had to be completed by the end of 2000. However, by

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[727] Sec. 1259(c)(3) discussed in more detail below.

[728] The information regarding Project NOLy was obtained from Joint Committee staff interviews of Robert J. Hermann, Greek L. Rice, and Stephen H. Douglas as well as from documents and information provided by Enron and the IRS.

[729] Enron Presentation to the Joint Committee on Taxation Staff, June 7, 2002, at 15. The General Background Materials in Appendix B contain this document.

[730] *Id.*

[731] Treas. Reg. sec. 1.1212-1(a)(3).

[732] EC2 000038222. Part of a document entitled, "Chiricahua Partnerships and Related Transactions ("Project NOLY")" provided to the Joint Committee staff by Enron.

[733] Joint Committee staff interview.

using 14 different LLCs taxed as partnerships and certain technical requirements of section 1259(c)(3), determining the exact amount of the gain to be recognized was postponed until late March 2001.

The business purpose of Project NOLy was stated to be to economically segregate the "in-the-money" portion of the financial trading book of Enron North America, Corp., a wholly owned subsidiary of Enron Corp. ("ENA").[734] The reason 14 LLCs were needed to do this was not given.

Implementation of Project NOLy[735]

ENA routinely entered into positions, including swaps, futures contracts, options and forward contracts with third parties relating to the price of natural gas and other commodities. Usually ENA would enter into offsetting positions with its wholly owned subsidiary Risk Management and Trading Corp. ("RMT") pursuant to an ISDA Master Agreement[736] dated March 31, 1997, and periodic confirmations executed in association with that agreement ("ENA Master Swap). This served to place the risks for these types of transactions in one entity, RMT, which made managing the risk easier.

On December 20, 2000, 14 Delaware LLCs were formed by RMT and FS 360 Corp., a wholly owned subsidiary of RMT ("FS 360").[737] These 14 LLCs, which elected to be taxed as partnerships, were named RMT Chiricahua I[738] through RMT Chiricahua XIV ("Chiricahuas"). FS 360 owned a .01 percent interest in the capital, profits and losses of each partnership, which it acquired in exchange for a cash contribution to that entity. RMT acquired a 99.99 percent

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[734] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 114. The answer references a memorandum to Robert J. Hermann from Stephen H. Douglas dated August 29, 2001. Appendix B, Project NOLy contains this document.

[735] This section is based in large part on an opinion letter from Vinson & Elkins to Enron Corp. dated February 26, 2001, contained in Appendix C, Part X to this Report; a draft opinion letter from Vinson & Elkins to Enron Corp. dated December 17, 2001, also contained in Appendix C, Part X to this Report; summaries of the transaction provided to the Joint Committee staff by Enron at EC2 000038199-206 and a memorandum from Stephen H. Douglas to Robert J. Hermann dated August 29, 2001. Appendix B, Project NOLy contains this memorandum.

[736] An ISDA Master Agreement is a standard form agreement copyrighted by the International Swap Dealers Association that sets forth the terms and conditions governing any specific swaps made pursuant to the agreement among the parties to it.

[737] Current Management is not aware of any internal approval process for Project NOLy. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 110.

[738] The Chiricahua partnerships were named for a golf course at the Desert Mountain Golf Club in Scottsdale, Arizona. Joint Committee staff interviews.

interest in the capital, profits and losses of each entity, in exchange for a cash contribution and its agreement to enter into an ISDA Master Agreement dated December 20, 2000, between RMT and the Chiricahuas and the associated confirmation dated December 27, 2000 ("RMT Swaps"), which represented offsetting positions with respect to certain of the contracts held by RMT. All of the RMT Swaps were substantially in the money at the time of execution and represented a transfer of value from RMT to the Chiricahuas. The amount of the net cash payments required to be made under each of the RMT Swaps to each Chiricahua was based upon the specific terms set forth in the associated confirmation based on the notional volumes and prices set forth therein. It was anticipated that a substantial net payment would be made by RMT to each Chiricahua over the life of the RMT Swaps rather than requiring a payment to be made by the Chiricahuas to RMT. None of the Chiricahuas was required, under the terms of the RMT Swaps, to make any net payments in the aggregate to RMT in excess of the amounts actually received by such entity from RMT.

Tularosa LLC was a Delaware LLC whose members were ENA and Mangas I Corp., a wholly owned subsidiary of ENA ("Mangas"). ENA owned a 99.99 percent interest in Tularosa and Mangas owned the remaining .01 percent interest. Subsequent to the execution of the RMT Swap, RMT entered into an ISDA Master Agreement dated December 20, 2000 with Tularosa and an associated confirmation dated December 27, 2000, for a total return swap ("Tularosa Swap") with respect to RMT's membership interest in each Chiricahua. Under the terms of the Tularosa Swap, RMT was entitled to receive from Tularosa on the settlement date, a fixed sum equal to the fair market value of RMT's membership interests in the Chiricahuas on the initial contract date and RMT was required to pay Tularosa the fair market value of the membership interests in the Chiricahuas on the settlement date, plus the amount of any distributions from the Chiricahuas during the term of the contract. The Tularosa Swap was effective December 27, 2000, and the settlement date was January 2, 2002. Enron Corp. guaranteed Tularosa's obligation under the Tularosa Swap. By entering into the Tularosa Swap, RMT became subject to the constructive sale rules of section 1259, causing it to recognize $5.6 billion in gain (the difference between its basis in the Chiricahuas and the fair market value of its interest in the Chiricahuas) in the 2000 taxable year.

Because it would take a few months to determine precisely the amount of losses at the end of its 2000 taxable year, Enron sought to use technical rules contained in section 1259(c)(3) to delay final determination of the amount of gain until the end of March 2001. There is an exception to constructive sale treatment for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into.[739] This exception to the constructive sale rules is only available if the taxpayer holds the appreciated financial position to which the transaction relates throughout the 60-day period beginning on the date such transaction is closed and at no time during such 60-day period is the taxpayer's risk of loss reduced (under the principals of section 246(c)(4)) by holding positions with respect to substantially similar or related property.[740]

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[739] Sec. 1259(c)(3).

[740] *Id.*

To this end, less than 30 days after the end of the taxable year, on January 29, 2001, RMT and Tularosa entered into an early settlement of the Tularosa Swap. This early settlement triggered a $701.8 million termination payment by Tularosa to RMT (because gas prices had declined since December 27, 2000) and was considered to be a closed transaction, nullifying the constructive sale, provided the 60-day rule was not applicable.[741] However, Enron intended to use the 60-day rule to further extend the time for determining how much gain was needed to offset the losses. By March 27, 2001, Enron's Tax Department had concluded that the entire $5.6 billion gain should be recognized in 2000. In order to ensure that the entire gain was recognized, RMT and Tularosa entered into a new total return swap within 60 days of termination of the termination of the original Tularosa Swap. This brought the transactions within the 60-day rule[742] with the result that the $5.6 billion gain was deemed to be recognized in 2000. RMT's basis in the Chiricahuas was increased by the same amount.

At the time Project NOLy was developed and implemented, it was assumed that it would be unwound in January 2002.[743] However, due to Enron's financial deterioration in 2001, a decision was made to unwind Project NOLy in 2001 by liquidating the Chiricahuas thereby triggering the offsetting $5.6 billion capital loss. The Chiricahuas were liquidated in December 2001.[744]

The following consequences resulted from the liquidation of the Chiricahuas.[745] FS 360 redeemed its original $500,000 investment and all other assets and liabilities were transferred to RMT. The only assets of the Chiricahuas were accounts receivable from RMT, the RMT Swaps and cash. When the liquidation occurred, RMT was distributed cash and the RMT Swaps. RMT's basis now included the $5.6 billion gain recognized in 2000. Because it received relatively little cash and its own liability, the RMT Swaps, on which it recognized no gain or loss, a large capital loss, essentially equal to the $5.6 billion capital gain in the previous year, was recognized. The recognition of this loss and the resultant carryback to earlier years was projected to result in a refund of the $63 million of tax paid in 2000. Because the capital loss carryback from 2001 cannot increase or produce an NOL, the approximately $2.5 billion of operating losses that arose in 2000 would continue to offset capital gains of that amount in 2000.

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[741] *Id.*

[742] *Id.*

[743] Opinion letter from Vinson & Elkins to Enron Corp. dated February 26, 2001, at 2. Appendix C, Part X to this Report contains this letter.

[744] Enron Corp. Presentation to the Joint Committee on Taxation Staff, June 7, 2002, at 15. The General Background materials in Appendix B contain this document.

[745] Draft opinion letter from Vinson & Elkins dated December 17, 2001, at 4-10. Appendix C, Part X to this Report contains this letter.

However, the pre-2000 NOL carryovers would be freed up and available to be carried to subsequent years.[746]

The diagram on the next page depicts the Project NOLy structure as of December 2000.

[746] EC2 000038222. Part of a document entitled, "Chiricahua Partnerships and Related Transactions (Project NOLy)" provided by to the Joint Committee staff by Enron.

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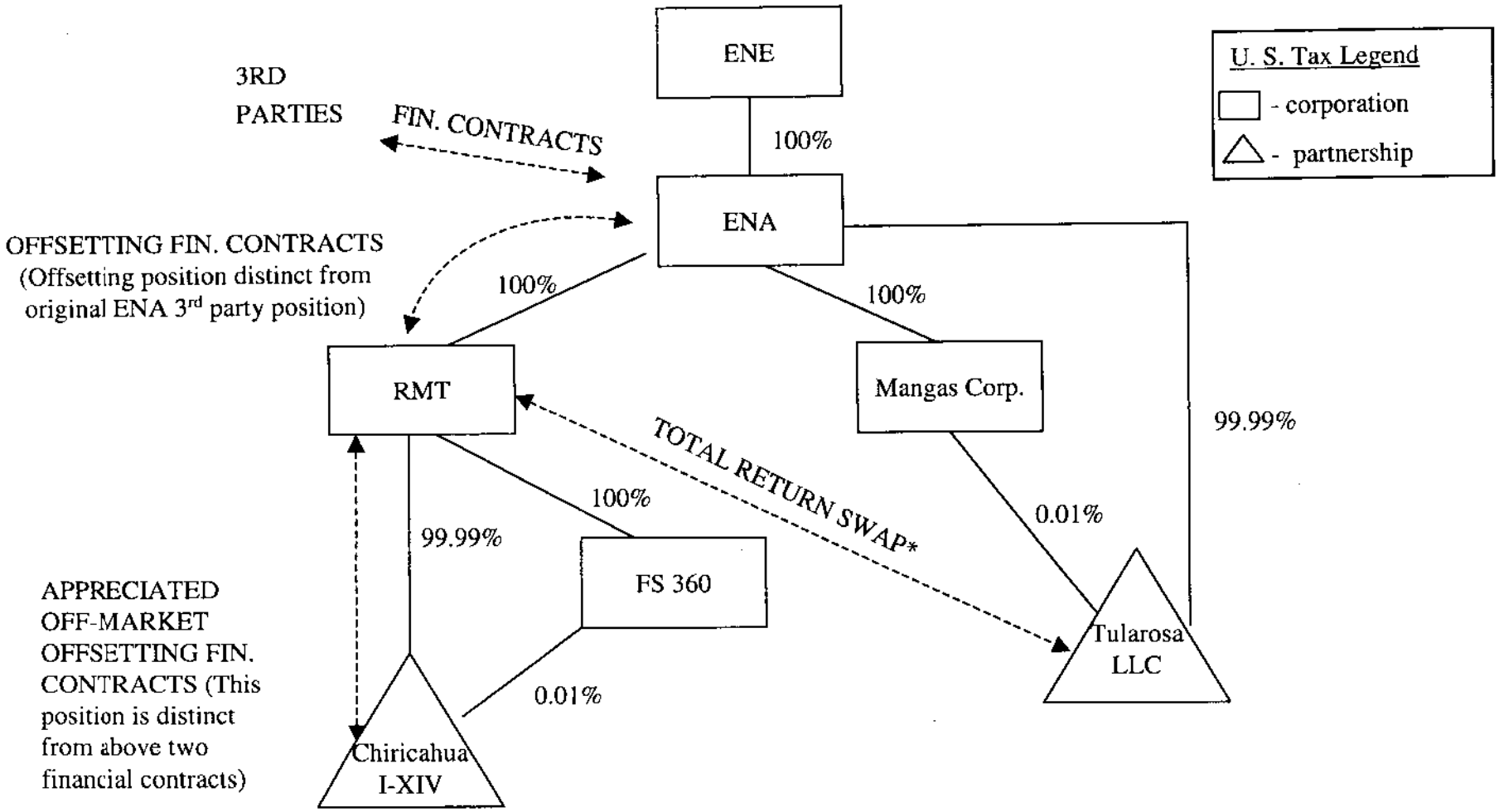
Project NOLy – December 2000



*Total return swap contract whereby Tularosa LLC agrees to pay RMT $5.556 billion in return for RMT's obligation to pay to Tularosa LLC all returns related to RMT's interest in Chiricahua LLC. Net cash settlement of difference between (i) FMV of Chiricahua interest at settlement date + distributions on such interest, and (ii) $5.556 billion fixed payment.

Role of outside advisors

Although the plan that became Project NOLy originated within the Enron Tax Department, Vinson & Elkins became involved during the development stage. Arthur Andersen was involved on the accounting side of the transaction and concluded that it was a "neutral" transaction for financial accounting purposes.[747]

In an opinion letter dated February 26, 2001, Vinson & Elkins opined that the transactions should result in the following: (1) a constructive sale of RMT's membership interest in Chiricahua under section 1259; (2) the recognition of gain in an amount equal to the excess of the fair market value of RMT's member interest in Chiricahua over its basis in such interest; and (3) an increase in RMT's basis in its interest in Chiricahua in an amount equal to the gain recognized as a result of the constructive sale.[748] An important element in conclusion (2) was that RMT did not receive any basis for its interest in any of the Chiricahuas as a result of its agreement to enter into the RMT Swap because it was an obligation of a partner in which the partner had no basis.

In a separate letter, Vinson & Elkins opined with regard to the tax consequences of the liquidation of all of the Chiricahuas concluding the liquidation should generate capital losses that Enron would be able to carry back to 2000. Vinson & Elkins also concluded that RMT's basis in the Chiricahuas would be increased by the amount of gain recognized on the constructive sale in 2000. When the partnerships were liquidated, RMT received only cash and the RMT Swaps. Vinson & Elkins concluded that for the same reasons it was viewed as a nonevent in the formation of the Chiricahuas, it should be viewed as a nonevent in the liquidation. Consequently, RMT should be regarded as receiving only cash in the liquidation enabling it to recognize a loss in the amount its basis exceeded the cash received.

Appendix C, Part X to this Report contains the tax opinions Enron received in connection with Project NOLy.

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[747] Joint Committee staff interviews and letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 107, which indicates that current management of Enron is unaware of "any documents relating to the financial accounting for Project NOLy, other than a passing comment in a document Bates stamped EC2 000038207." The Project NOLy materials in Appendix B contain this document -- a memorandum to Robert J. Hermann from Stephen H. Douglas dated August 29, 2001. The document states "[t]he transaction will not result in negative accounting consequences for ENA because the tax gain resulting at the outset of the transaction will be offset with subsequently recognized tax losses in an equal amount..."

[748] Enron indicated that the February 26, 2001 opinion letter was a final opinion. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 111. However, the copy bears numerous hand-written changes, and therefore does not appear to be the final version.

Fees billed by Vinson & Elkins for project NOLy totaled approximately $90,000.[749] Enron's current management is not aware of any fees paid to Arthur Andersen in connection with services that may have been performed with respect to Project NOLy.[750]

Subsequent developments

By mid-October of 2001, IRS was close to completing the examination cycle involving the losses that were to be carried forward. At that time, it was likely that the examination would be agreed with the exception of one issue. IRS appears to have been concluded that the Appeals Office could take jurisdiction of the remaining disputed issue in the years the NOLs arose.[751] If the disputed issue were resolved, this would allow the examination cycle for those years to be closed.

The IRS is in the process of examining Enron's tax returns for years 1995 through 2001.

Discussion

Enron had loss carryovers from the 1996 through 1999 taxable years into the 2000 taxable year of approximately $3 billion.[752] Based on operations in 2000, it was anticipated that additional operating losses of more than $2 billion would be generated in that year.[753] The Enron Tax Department wanted to close out the earlier loss years to finalize the tax treatment of items in those years, but believed that they needed to use up the loss carryovers and pay some tax in order to do so. Project NOLy was designed to generate sufficient gains to soak up all of the NOLs and losses so that Enron paid some tax in 2000.

The IRS has provided exceptions to its general policy that the Appeals Office will not accept cases unless there is tax at issue.[754] One of the exceptions to this no immediate tax consequence policy is for adjustments made to an NOL carryforward when the carryforward year has not yet been examined. By mid-October of 2001, IRS was close to completing its

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[749] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 113. The answer indicates that Enron has paid $77,228.62 of this amount. The remainder, $13,363.75, was billed in the fall of 2001 and related to the liquidation of the Chiricahua entities, but may not have been paid due to the bankruptcy filing.

[750] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 108.

[751] Internal IRS correspondence.

[752] Opinion letter from Vinson & Elkins to Enron Corp. dated December 17, 2001. Appendix C, Part X to this Report contains this letter.

[753] *Id.*

[754] IRM 8.1.2.2.3(2) (February 2, 1999).

examination of a cycle including years in which the net operating loss carryforwards arose with only one issue remaining unagreed. IRS appears to have concluded that an Appeals forum would be available to Enron in that situation to resolve the unagreed issue.[755]

The stated reason for Project NOLy was to finalize the treatment of items in the years the net operating losses were generated, 1996 through 1999. These were the years in which Enron implemented a number of the structured transactions described in this Report. It appears that the purpose behind Enron's implementation of Project NOLy was to use technical tax rules to manipulate its tax situation in order to put the IRS in the position that it would have to sign off on years in which Enron implemented other structured transactions.

Project NOLy is also another example of the disparity between financial statement treatment of a transaction and tax treatment of the same transaction. For financial statement purposes, Project NOLy was neutral. However, for tax purposes, the taxpayer recognized $5.6 billion of capital gains in one year and an essentially equal amount of capital losses in the next year.

[755] IRS internal correspondence.

E. Transactions in Which Enron is an Accommodation Party

1. Project Renegade

Brief overview

Enron was an accommodation party in Project Renegade. Project Renegade was designed to enable Bankers Trust to achieve favorable tax benefits while Enron received an accommodation fee of $1.375 million for engaging in the transaction.

Project Renegade involved Bankers Trust loaning $320 million to ECT Equity Corporation ("ECT Equity"), a wholly owned subsidiary of Enron, in return for a long-term note payable. Almost immediately, ECT Equity contributed the $320 million to Enron Finance Holding Corporation ("Enron Finance"), a wholly owned subsidiary of ECT Equity, which loaned $8 million of the proceeds to Enron Corp. and contributed the remainder ($312 million) to Wiltshire Financial Assets, LLC ("Wiltshire") in return for approximately 98 percent ownership of Wiltshire.[756] Wiltshire also received a capital contribution of $8 million from a Bankers Trust subsidiary in return for approximately a two percent ownership interest. Subsequently, Wiltshire used the $320 million to purchase from Bankers Trust $320 million note issued by the ECT Equity. Thus, after the circular flow of funds through the various entities, Enron had effectively borrowed $8 million from Bankers Trust. However, as a result of certain tax rules with respect to financial asset securitization investment trusts ("FASITs"), Bankers Trust was able to achieve its desired tax goals.

Background[757]

Reported tax and financial statement effects

Project Renegade generated $1.375 million of taxable income in 1998. The taxable income was the fee paid by Bankers Trust to Enron for acting as an accommodation party in the transaction. In lieu of paying Enron directly, Enron stated that Bankers Trust reduced its fee for advising on Project Teresa by $1.375 million.[758] In addition, Project Renegade increased

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[756] Wiltshire elected to be classified as a financial asset securitization investment trust for Federal income tax purposes.

[757] The information regarding Project Renegade was obtained from Joint Committee staff interviews of Robert J. Hermann and R. Davis Maxey, as well as from documents and information provided by Enron Corp. and the Internal Revenue Service.

[758] An amended Project Teresa engagement letter between Bankers Trust and Enron was signed on December 29, 1998 to reflect the fee reduction. EC2 000037573 - EC2 000037592.

reported financial statement earnings in 1998 by approximately $800,000 ($1.375 million accommodation fee less associated income taxes on such amount).[759]

Development of Project Renegade

Bankers Trust promoted the concept of Project Renegade to Enron in December 1998.[760] Enron named the proposed project after one of the five golf courses at Desert Mountain Golf Club.[761] The project was presented to Enron as a structure that would enable Enron to use a special purpose entity, owned by Bankers Trust and Enron, to raise capital.

On December 18, 1998 the Executive Committee of the Board of Directors of Enron reviewed the proposed structure. Richard A. Causey presented the proposal to the Executive Committee with Mr. Hermann in attendance.[762] Mr. Causey's presentation indicated that the proposed transaction would create a financial structure that would enable Enron to obtain financing from independent investors at a lower cost of funds.

The presentation to the Executive Committee indicated that a financial institution would loan Enron $320 million in exchange for a long-term note. Subsequently, the note would be contributed by the financial institution to a limited liability company in which Enron would acquire four tranches of debt obligations issued by the limited liability company in an amount approximately equal to the $320 million loaned by the financial institution. As part of the transaction the financial institution agreed to use its best efforts to offer for sale to independent investors the most senior tranche of the debt obligations. The total amount offered was expected to be approximately $80 million. The interest rate payable was expected to be significantly lower than currently available to Enron on borrowed funds. The Executive Committee was informed of two specific risks of entering into the transaction and mitigating factors to such risk. The two specific risks identified were (1) the ability of the outside party to market the debt obligation, and (2) the Federal income tax consequences of the transaction.[763] The Executive

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[759] The tax return and financial statements are also impacted by the payment of interest expense on the net $8 million loan from Bankers Trust. The interest expense is accounted for in the same manner as any third party loan.

[760] Discussion Material for Project Renegade dated December 17, 1998 prepared by Bankers Trust. The Project Renegade materials in Appendix B contain the materials. EC2 000037527-EC2 000037544.

[761] Enron also used three of the other four Desert Mountain Country Club golf course names to identify other tax department structured transactions. They are Cochise, Apache, and Chiricahua. The other golf course, Geronimo, was also used, but none of the transactions that used its name were completed.

[762] Minutes of the December 18, 1998 meeting of the Executive Committee, EC 000037550.

[763] Presentation materials titled "Below Market Financing Proposal." EC2 000037546-EC2 000037548.

Committee was informed that the marketing risk was mitigated by (1) the best efforts underwriting agreement, and (2) the fact that the transaction could be unwound at the end of the marketing period. The tax risks were mitigated by (1) an indemnification agreement between Enron and Bankers Trust for any adverse tax consequences to Enron, and (2) the fact that the transaction could be unwound in the event of any adverse tax law change.[764] At the conclusion of the presentation, the Executive Committee adopted resolutions approving the transaction.[765]

Enron's stated business purpose for entering into the transaction was to obtain a net borrowing at a relatively low interest rate and earning fee income for engaging in the transaction with Bankers Trust.[766]

Implementation of Project Renegade

On December 23, 1998, Bankers Trust London branch loaned $320 million to ECT Equity. The note was a 25-year note with interest payable semiannually and principal due at the end of the term.[767] Also, on December 23, 1998, ECT Equity and Bankers Trust entered into a deposit agreement that required ECT Equity to deposit the loaned funds with Bankers Trust for seven days with no right of withdrawal.[768] The deposit agreement would terminate on December 29, 1998, if ECT Equity requested the funds be credited to the account of Enron Finance. Enron Finance also entered into an agreement with Bankers Trust on December 23, 1998, to deposit the funds loaned to ECT Equity on December 29, 1998 unless Enron Finance purchased approximately $312 million of debt securities from Wiltshire.

In addition, on December 23, 1998, Enron Finance and Bankers Trust also entered into a put option that permitted Bankers Trust to sell the $320 million ECT Equity note to Enron Finance unless the note had been validly assigned to Wiltshire before December 30, 1998.[769] Enron Corp. and Bankers Trust also entered into an agreement to permit Enron to purchase the

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[764] *Id.*

[765] Information contained in the minutes of the December 18, 1998 meeting of the Executive Committee. EC 000037551. The Board of Directors of Enron was provided the details of the transaction as part of its meeting on February 8, 1999. At such time, the Board of Directors of Enron approved the recommendation of the Executive Committee, EC2 000037556.

[766] Per Project Renegade tax overview. EC 000037523.

[767] The note had a temporary interest rate of 7.2825 percent for the period December 23 through December 29. In addition, Enron indicated that the permanent rate was also 7.2825 percents. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 5.

[768] The deposit earned interest at a rate of 4.9844 percent per annum.

[769] After assigning the note to Wiltshire, Bankers Trust would have recouped $312 million of the $320 million loaned to ECT Equity and Enron would own all but $8 million of the note.

ECT Equity note on December 30, 1998, if the note had not been validly assigned to Wiltshire, and Bankers Trust had not exercised its put option. Thus, through the various deposit agreements and put agreement, Bankers Trust was able to ensure Enron would complete the steps and make certain the funds would be deposited with Bankers Trust during the implementation of the transactions.

In accordance with the preconceived plan, on December 29, 1998, ECT Equity loaned $320 million to Enron Finance. Enron Finance subsequently loaned $8 million of the proceeds to Enron Corp. and exchanged approximately $312 million for $72 million of Class A interests, $40 million of Class B-1 interests, $40 million of Class B-2 interests, and $160 million of Class B-3 interests of Wiltshire.[770] Subsequently, an affiliate of Bankers Trust exchanged $8 million for an equivalent amount of Class A interests of Wiltshire and Bankers Trust London Branch exchanged $1,000 for all of the Class O interests of Wiltshire. Wiltshire then used the $320 million to purchase the ECT Equity note from Bankers Trust London branch.

Upon its formation, Wiltshire elected to be classified as a FASIT for Federal income tax purposes. The Wiltshire LLC agreement reflects the Class A and Class B interests as regular interests under the FASIT rules (such rules generally treat the interests as a debt instrument) and the Class O interest as the designated ownership interest. Under the Wiltshire LLC agreement the cash flow generated from its assets ($320 million ECT Equity note receivable) was to be used in the following order: (1) to pay the current yield and principal on the Class A interests; (2) the current yield on the Class B-1, Class B-2, and Class B-3 interests, respectively; (3) the principal on the Class B-1, Class B-2, and Class B-3 interests, respectively; and (4) the Class O interests.

In addition, on December 29, 1998, Bankers Trust and Enron Finance entered into a tax indemnity agreement. In general, the tax indemnity agreement provided that Bankers Trust would pay any taxes, penalty, and interest that Enron incurred as a result of its participation in the transactions in excess of the amount of taxes that would be due if the interests Enron Finance purchased were treated as debt instruments with the same economic terms as the Class A and Class B interests purchased.[771]

Enron Finance, Bankers Trust London branch, and BT Alex Brown Incorporated ("BT Alex Brown") entered into a placement agreement on December 29, 1998 in which Enron engaged BT Alex Brown as its exclusive placement agent (on a best efforts basis) for the sale of $72 million of Class A interests in Wiltshire until June 30, 1999. BT Alex Brown's fee was $50,000 plus out-of-pocket expenses. However, the fee was to be paid by Bankers Trust not Enron.

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[770] The Class A interests accrued interest at 5.7 percent per annum, the Class B-1 accrued interest at 7.126283289 percent per annum, the Class B-2 accrued interest at 7.276283289 percent per annum, and the Class B-3 accrued interest at 7.426283289 percent per annum. It was anticipated that the Class A interests would be fully amortized by December 31, 2002.

[771] The Project Renegade materials in Appendix B contain the tax indemnity agreement. ECx000002324-Ecx000002336.

Bankers Trust and Enron Finance also entered into a purchase option agreement on December 29, 1998, permitting Enron Finance the right to purchase Bankers Trust Class O interests in Wiltshire on or after December 15, 2006, provided no Wiltshire Class A interests are then outstanding.

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

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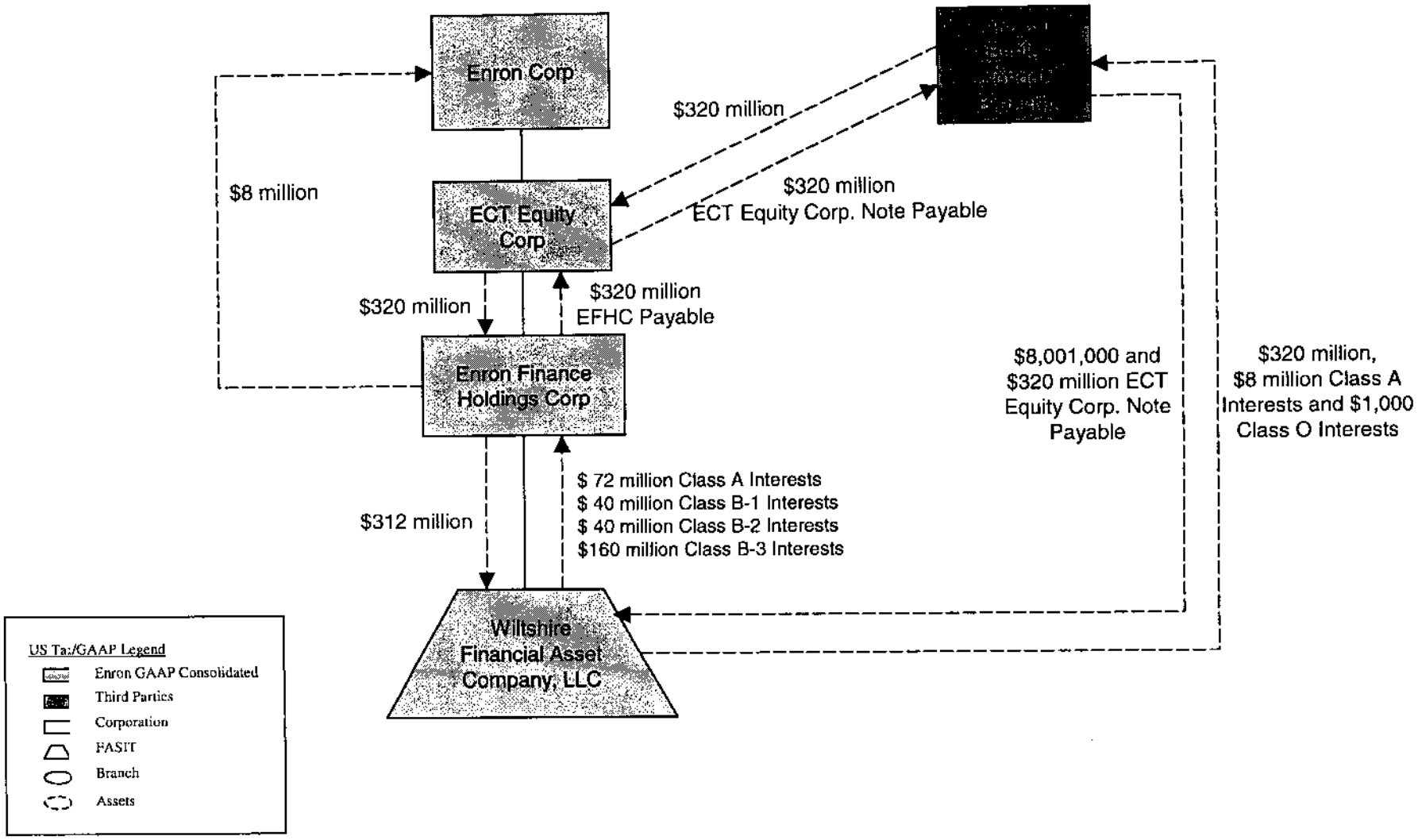
Project Renegade
Structure as of December 29, 1998



Subsequent developments

The placement of the $72 million of Wiltshire Class A interests held by Enron Finance was not a success. Enron stated that it was unaware of the efforts, if any, that BT Alex Brown made to sell the Class A shares or what market conditions resulted in the sale being unsuccessful.[772] As such, except for interest on approximately $8 million, the interest on the $320 million ECT Equity note held by Wiltshire was returned to Enron Corp. via Enron Finance's interest in Wiltshire.

Discussion

Enron's corporate resolutions state that Enron engaged in Project Renegade to obtain financing at a significantly lower cost of capital than could be obtained through more traditional means. However, Enron tax personnel involved in the project indicated that the primary reason for entering into the arrangement was to earn an accommodation fee. The fact that Project Renegade only provided Enron with $8 million of financing, and such financing was anticipated to fully amortize within five years, lends credence to their statements that Enron engaged in the transaction as an accommodation party. In addition, Enron could not produce any risk analysis, investment analysis, or other documentation regarding the determination of the appropriate market rate of interest on the Class A and B interests in Wiltshire.[773] Enron also could not produce any analysis illuminating the financial reasons an investor would be willing to purchase a general obligation ECT Equity debt instrument at a lower yield than a comparable Enron debt instrument.[774] The lack of contemporaneous financial analysis also indicates that Enron's main objective in the transaction was to earn an accommodation fee.

A review of the documents involved in Project Renegade reflects that many agreements were subject to additional agreements with related parties that effectively altered the actual economic arrangement of the parties and further supports the notion that Enron would not have engaged in the transactions absent the accommodation fee.

For example, ECT Equity borrowed $320 million from Bankers Trust in return for a 25-year note. However, deposit agreements among ECT Equity, Enron Finance, and Bankers Trust required the funds to be deposited with Bankers Trust for one week with no right of withdrawal except for the purpose of enabling ECT Equity and Enron Finance to effectuate the prearranged steps to facilitate Bankers Trust goals. If the prearranged steps were not completed within one week, an option agreement between Bankers Trust and Enron permitted Bankers Trust to put the ECT Equity note to Enron. Thus, through the deposit agreements and the option agreement,

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[772] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 44.

[773] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 47.

[774] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 46. Enron stated that this type of analysis would normally be undertaken by outside advisors.

Bankers Trust could ensure that the $320 million would never be outside its control unless ECT Equity and Enron Finance completed the prearranged steps. If the steps were completed, Bankers Trust was assured of having only $8 million of capital at risk.[775] Thus, although ECT Equity and Bankers Trust documented a $320 million note, the economic reality was that Bankers Trust was willing to put only $8 million of capital at risk and only if Enron and its controlled subsidiaries engaged in the prearranged steps for the benefit of Bankers Trust.[776]

Although Enron did not engage in Project Renegade to generate a Federal income tax benefit for itself, Project Renegade highlights the potential for abuse of tax code provisions if taxpayers act in concert. In this transaction Enron and Bankers Trust, arguably in an attempt to shroud the facts of its financial relationship, had Bankers Trust pay the accommodation fee via a reduction of fees owed to Bankers Trust with respect to another structured transaction.

As the focus of this Report is to address Enron's tax situation, the Joint Committee staff has not been able to review Bankers Trust's tax situation to determine the reasons Banker Trust desired to engage in the transaction. However, the structure appears to have enabled Bankers Trust to report taxable gain on the sale of the $320 million ECT Equity note to Wiltshire in 1998 that would reverse at a later date.[777]

The taxable gain results from the treatment required for contributions of property to a FASIT under section 860L. In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. A taxpayer generally computes any recognized gain based on the fair market value of the contributed assets. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the applicable federal rate, compounded semiannually, or such other rate that the Secretary shall prescribe by regulations. Using this formula, Bankers Trust, as the Federal income tax owner of the Wiltshire FASIT, likely reported a taxable gain on the sale of the ECT Equity note irrespective no such gain occurred on the sale.

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[775] This result occurs because one of the prearranged steps required Wiltshire to purchase the ECT Equity note from Bankers Trust for $320 million. Wiltshire paid for such purchase using $312 of the $320 million purportedly loaned to ECT Equity and returning the $8 million contributed by Bankers Trust for a Class A interest.

[776] The Bankers Trust materials presented to Enron specifically highlighted the circular cash flow arrangement with the end result being a $10 million loan to Enron. The Project Renegade materials in Appendix B contain the documents. EC2 000037544. The executed documents resulted in only an $8 million loan to Enron.

[777] Although taxpayers do not normally accelerate taxable income, there are circumstances when such acceleration is beneficial to taxpayers (e.g., *see* Project NOLy in this Report). As stated above, the Joint Committee staff has not reviewed Bankers Trust tax situation.

In summary, the Joint Committee staff believes that the documents reviewed reflect that Project Renegade had no purpose to Enron other than to facilitate its participation as an accommodation party in a tax motivated transaction undertaken by Bankers Trust.

2. Project Valhalla

Brief overview

Project Valhalla was a financing transaction structured to provide tax benefits to Deutsche Bank under foreign law. Enron served as an accommodation party and effectively received a fee for its participation in the transaction. It appears that the transaction allowed Deutsche Bank to receive from Enron a stream of income that was treated as a nontaxable dividend under German law, but to finance this stream of income with deductible interest payments made to Enron. Enron's fee took the form of a rate spread between these two amounts.

In implementing Project Valhalla, Enron formed a German entity that was treated as a corporation under German law, but that elected to be treated as a disregarded entity for U.S. Federal tax purposes. Deutsche Bank transferred $2 billion to this entity in return for participation rights that provided for minimum distribution payments at a 7.7-percent rate of interest. The participation rights were treated as debt for U.S. Federal tax purposes, but as equity for German tax purposes. The German entity used the cash received from Deutsche Bank to purchase preferred stock in an Enron domestic affiliate, and then used the dividend income from the preferred stock to fund the minimum distribution payments on the participation rights.

At the same time, the parties established a largely offsetting loan and payment stream, in which Enron transferred $1.95 billion to a Deutsche Bank branch in exchange for a promissory note bearing interest at a rate of 8.74 percent.

Under German law, since the participation rights were treated as equity, the minimum distribution payments associated with these rights were treated as dividends, which Deutsche Bank was able to receive free of tax under German law. At the same time, the payments of interest to Enron on the note presumably were deductible to the Deutsche Bank branch. Taken together, it appears that this treatment allowed Deutsche Bank to use deductible payments to finance a stream of tax-exempt income.

From Enron's perspective, the rate spread in its favor between the note and the participation rights generated net pre-tax interest income and effectively constituted Enron's accommodation fee. Enron deducted the smaller payments on the participation rights as interest expense, and included the larger payments received on the note as interest income, thus reporting net interest income on its U.S. Federal consolidated return as a result of the transaction.

Background[778]

Reported tax and financial statement effect

The $2 billion in participation rights less the $1.95 billion note resulted in a net $50 million borrowing by Enron from Deutsche Bank.

The interest rate spread in Enron's favor was expected to yield approximately $100 million of pre-tax income, or approximately $65 million in financial net income, over the intended five-year life of the structure.[779] Enron reported approximately $7 million of financial net income from the transaction for 2000, and $9 million through the third quarter of 2001. The primary tax return effect for 2000 was net taxable income of $11 million.[780]

Development of Project Valhalla

Based on Joint Committee staff interviews, it appears that Deutsche Bank originated the idea for Project Valhalla and prepared the early promotional materials for the transaction. R. Davis Maxey and Tina Livingston were the primary Enron personnel working on the transaction.

On December 13, 1999, Richard A. Causey introduced the idea for Project Valhalla to Enron's Board of Directors' Finance Committee. Mr. Causey described the transaction as a proposed subsidiary preferred stock financing. He stated that as part of Enron's overall financing plan, the Company was proposing the sale of up to $2.2 billion of securities to a non-affiliated investor group. The proposed sale of securities was approved for recommendation to Enron's Board of Directors.[781]

The following day, Herbert S. Winokur, Jr. addressed Enron's Board of Directors and recommended the Finance Committee's proposal for a subsidiary preferred stock financing. The Board approved the proposal maintaining that it was in Enron's best interest to provide financing and liquidity to its affiliates and provided for the sale of up to $2.2 billion of securities to an investor or investor group not affiliated with Enron.[782]

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[778] The information regarding Project Valhalla was obtained from Joint Committee staff interviews of Robert Herrman, James A. Ginty, R. Davis Maxey, Jordan Mintz, and Tina Livingston, as well as from documents and information provided by the Enron Corporation.

[779] Enron "Project Valhalla Business Review," EC2 000038364-65.

[780] Enron "Tax Overview of Project Valhalla," EC2 000038072.

[781] Agenda for the Meeting of the Finance Committee of the Enron Board of Directors, December 13, 1999, item #3, at EC2 000038092; Minutes of the Meeting of the Finance Committee of the Enron Board of Directors, December 13, 1999, paragraph 4, at EC2 000038098.

[782] Minutes of the Meeting of the Board of Directors of Enron Corp., December 14, 1999, EC2 000038084-87.

Implementation of Project Valhalla

In May 2000, Enron and Enron Diversified Investments Corporation ("EDIC"), a domestic affiliate of Enron, formed Enron Valkyrie ("Valkyrie"), a Delaware limited liability company that elected to be classified as a partnership for U.S. Federal income tax purposes. Enron contributed $67,535,500 in exchange for a 95 percent membership interest in Valkyrie, and EDIC contributed $3,554,500 in exchange for a five percent membership interest in Valkyrie. Under Valkyrie's company agreement, all items of income, gain, loss, deduction, and credit were allocated in accordance with the members' respective interests.

Shortly thereafter, Valkyrie formed Valhalla GmbH ("Valhalla"), a German limited liability company. Valkyrie contributed $71.09 million to Valhalla in exchange for all of the common shares of Valhalla. Valhalla, in turn, contributed $71.09 million to Rheingold GmbH ("Rheingold"), a German limited liability company, in exchange for all of the common shares of Rheingold. Rheingold obtained additional financing through a loan from Enron of $106.63 million and issuance of a note to Enron evidencing the loan with interest payable at a rate of 7.7 percent.[783] Valhalla and Rheingold both elected to be treated as disregarded entities for U.S. Federal income tax purposes.

Following this series of transactions, Valhalla and Rheingold entered into a subscription and procurement agreement, pursuant to which Valhalla agreed to procure a subscriber for, or to subscribe for, certain participating debt rights in Rheingold. The subscription price for the participation rights was $2 billion. Then Rheingold, Valhalla, and Deutsche Bank entered into an agreement on the participation rights, pursuant to which Valhalla waived its right to subscribe for such rights and Rheingold issued the participation rights to Deutsche Bank in exchange for $2 billion.

Deutsche Bank is a German corporation that is engaged in the banking and financial services business. It is a resident of Germany for German tax purposes and therefore is eligible for benefits under the U.S.-German income tax treaty. Under German corporate law, Deutsche Bank, as holder of the participation rights, had no voting rights and generally had the rights of a creditor. The terms of Deutsche Bank's participation rights were as follows: (1) participation with the common stock in distributions made by Rheingold to the extent of their ratable share of Rheingold's capital; (2) entitlement to minimum distributions paid annually by Rheingold at a rate of 7.7 percent to the extent Rheingold had sufficient distributable profits; (3) participation in liquidation proceeds to the extent of their ratable share of Rheingold's capital; and (4) a fixed maturity of 35 years.[784]

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[783] In order to address certain German tax and accounting issues, the note provided for repayment of the greater of: (1) the Euro equivalent of $106.63 million at the exchange rate on the date of issuance; or (2) the Euro equivalent of $106.63 million on the day the note was repaid. Rheingold had the right under the note to prepay all or any portion of the principal amount of the loan.

[784] Agreement on Participation Rights, May 2, 2000, Ecx000009413.

Subsequent to Deutsche Bank purchasing the participation rights, Valhalla, Valkyrie, and Deutsche Bank entered into put and call option agreements. The agreements generally required Deutsche Bank to sell the rights back to the Enron group within a five-year period. Deutsche Bank and Valhalla entered into a put option agreement pursuant to which Valhalla granted Deutsche Bank the right to sell its participation rights to Valhalla upon the occurrence of a "put circumstance."[785] At the same time, Valkyrie and Deustche Bank entered into a call option agreement[786] pursuant to which Deustche Bank granted Valkyrie the right to acquire the participation rights upon the occurrence of a "call circumstance."[787]

The sale and repurchase agreements served two purposes. They facilitated unwinding the financing transaction in a manner that would minimize both U.S. and German tax consequences, and they provided a mechanism for substantiating Valhalla's beneficial ownership of the participation rights under a U.S. debt-equity analysis. If the participation rights were treated as an equity interest for U.S. tax purposes, it would jeopardize Rheingold's disregarded entity status and result in additional tax to the Enron group. Therefore, the terms related to the put and call option agreements were structured to prevent beneficial ownership of the rights from transferring to Deutsche Bank.

Risk Management and Trading Corporation ("RMT"), a domestic affiliate of Enron, was engaged in the business of hedging and trading financial instruments and commodities. Rheingold used the funds it received from Deutsche Bank's purchase of the participation rights, along with the funds it received from Valhalla's capital contribution and the loan from Enron, to purchase two classes of RMT preferred stock. The first class ("Series 1") was non-voting, non-participating (except to the extent of a fixed 7.54048 percent dividend), and not convertible into any other class of RMT stock. The second class ("Series 2") included voting rights, but was non-participating (except to the extent of a fixed 7.54048 percent dividend).[788] Valkyrie granted Rheingold the right to put the RMT preferred stock to Valkyrie at a price that was the greater of (1) the original issue price of the preferred stock or (2) the U.S. dollar equivalent of the original Deutsche mark price on the date the put was exercised.[789]

As one of the final steps to the transaction, Enron loaned $1.95 billion to Deutsche Bank's New York branch in accordance with the terms of a promissory note. Later in 2000, Deutsche Bank's London branch took the place of the New York branch as obligor on the note.

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[785] Put Option Agreement between Deutsche Bank AG and Valhalla, May 2, 2000, Ecx000009474.

[786] Call Option Agreement, May 2, 2000, Ecx000009432.

[787] The put and call circumstances included, among other things, a downgrade in Enron's long-term credit rating.

[788] Securities and Purchase Agreement between Risk Management and Trading Corp. and Rheingold GmbH, May 2, 2000, Ecx0000099500.

[789] Put Option Agreement between Enron Valkyrie, LLC and Rheingold GmbH, May 2, 2000.

The note was due and payable on May 2, 2005 (or earlier if a "payment event" occurred) and required Deutsche Bank to make annual coupon payments at a fixed rate of 8.74 percent.[790] The spread between the 8.74 percent interest rate on the note and the 7.7-percent rate on the participation rights[791] served as Enron's accommodation fee on the transaction.

The $1.95 billion promissory note largely offset Enron's $2 billion liability to Deutsche Bank with respect to the participation rights. Enron personnel interviewed by the Joint Committee staff could not fully explain why Enron made a net $50 million borrowing from Deutsche Bank on the transaction, but recalled that Deutsche Bank requested that the two instruments not completely offset each other.

The parties intended for the financing arrangement to remain outstanding for a period of up to five years, until May 2005.

The diagram on the following page depicts the Project Valhalla structure.

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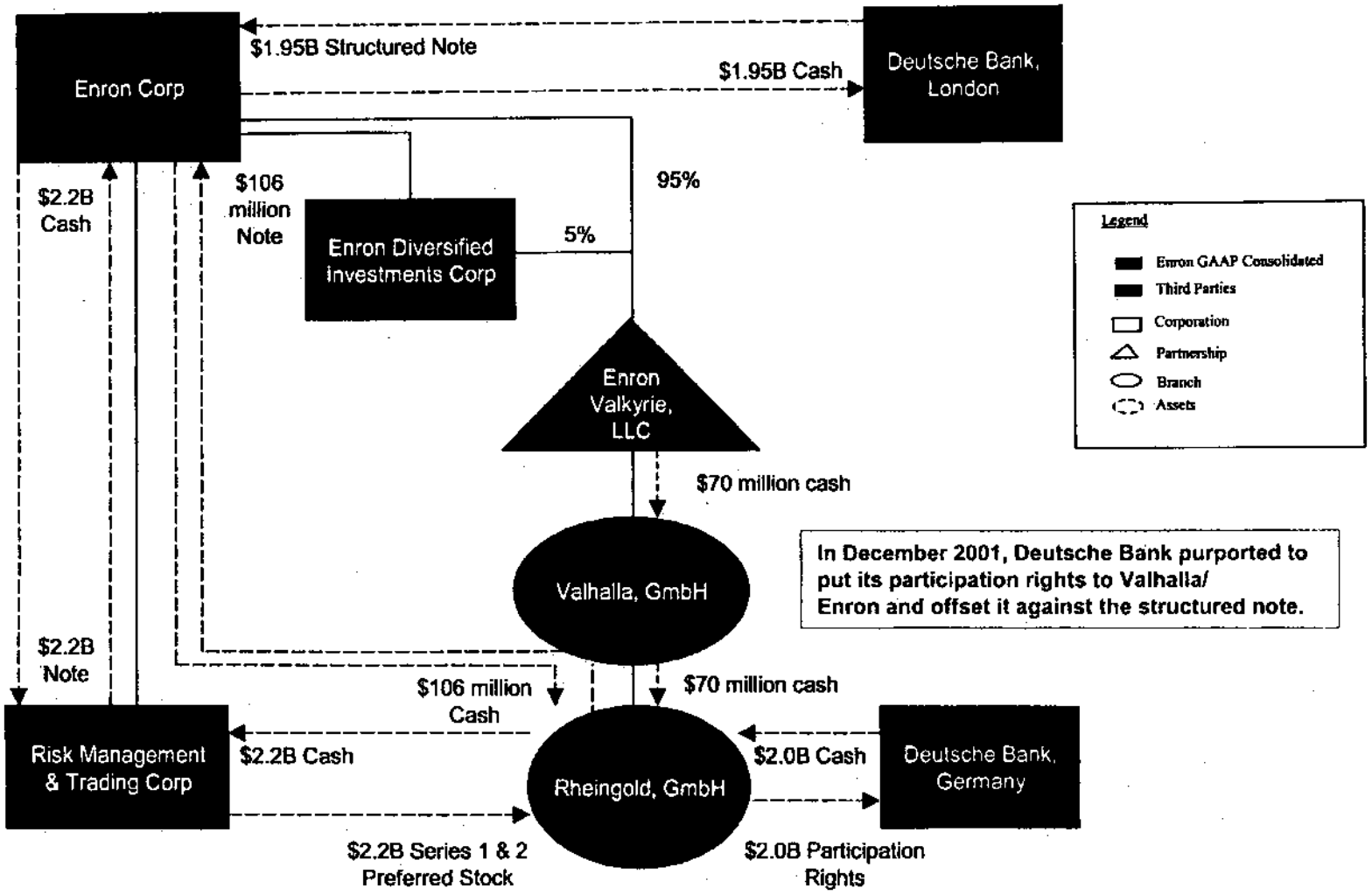
[790] This rate was fixed through the use of an interest rate swap. Enron personnel interviewed by the Joint Committee staff stated that, for reasons unknown to Enron, Deutsche Bank requested the use of a swap to generate the fixed rate, instead of using a simple fixed rate note in the first place.

[791] Promissory Note issued by Deutsche Bank AG New York Branch to Enron Corporation, Ecx000009541.

General Structure



Confidential: Attorney – Client Privilege

EC2 000038067

Role of outside advisors

In connection with Project Valhalla, Vinson & Elkins provided a tax opinion discussing the U.S. Federal tax treatment of the transaction. The specific issues addressed in the opinion were: (1) the treatment of Valhalla and Rheingold as disregarded entities; (2) the treatment of the transactions comprising the financing transaction as a loan from Deutsche Bank to Valkyrie (including the purchase of the participation rights, the put and call agreements, and the purchase of RMT preferred stock); (3) the continued status of RMT as a member of the Enron group after the issuance of Series 1 and Series 2 preferred stock; (4) Enron and EDIC's eligibility for a dividends-received deduction with respect to dividends from RMT allocated to them under Valkyrie's company agreement; (5) the deductibility by Enron and EDIC of their distributive shares of Valkyrie's interest expense with respect to the minimum distributions paid on the participation rights; (6) the applicability of U.S. withholding tax on dividends payments from RMT to Rheingold; and (7) the applicability of U.S. withholding tax on interest payments made by Rheingold to Deutsche Bank.

Enron also received a tax opinion from Clifford, Chance and Punder, which addressed a number of German tax issues.

Appendix C, Part XI to this Report contains the tax opinions that Enron received in connection with Project Valhalla.

Subsequent developments

Shortly before the filing of Enron's bankruptcy petition, Deutsche Bank gave notice of intent to exercise its option to put the Rheingold participation rights to Valhalla, and to treat Deutsche Bank's obligations on the promissory note as thereby satisfied. No other steps have been taken to unwind the structure.[792]

Discussion

As explained above, Project Valhalla was structured to provide tax benefits to Deutsche Bank, by allowing Deutsche Bank to use deductible payments to finance a stream of income that was tax-exempt under German law. Because the Joint Committee staff's focus in this report is on Enron and its U.S. tax issues, the staff was not able to gather detailed information or conduct a complete analysis of the Deutsche Bank tax benefits at the center of the transaction.[793]

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[792] Letter from Enron's counsel (Skadden, Arps) to Lindy Paull, Joint Committee on Taxation, dated Jan. 13, 2003, at 10.

[793] Although a complete analysis of Deutsche Bank's tax benefits is beyond the scope of this report, it seems clear that the transaction raises significant issues regarding the ability of taxpayers to exploit differences and inconsistencies between different countries' tax systems (e.g., with respect to debt-equity characterization, or entity classification). *See, e.g.*, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, vol. I at p. 96 (noting that the interaction between the tax

Enron acted as an accommodation party in Project Valhalla and received a fee for its participation in the transaction in the form of an interest rate spread in its favor. This fee was included as net interest income on Enron's U.S. consolidated tax return. Strictly speaking, from a U.S. Federal tax perspective, Enron's benefit from Project Valhalla was a non-tax benefit, as it originated entirely in pre-tax income and actually increased Enron's tax liability. Nevertheless, some may question the appropriateness of Enron's facilitating, for a fee, the tax-avoidance arrangements of another party.

Leaving aside the question of the appropriateness of Enron's serving as an accommodation party, Enron's tax issues in the transaction mainly involved ensuring that, apart from the net increase in taxable income attributable to the accommodation fee, the structure created a tax-neutral result for Enron. For example, the participation rights had to be characterized as debt for U.S Federal income tax purposes, the payments on those rights had to be deductible as interest expense, and the dividend payments received by Rheingold from RMT had to qualify for the dividends-received deduction, among other issues. These issues are addressed in the tax opinion letter that Enron received from Vinson & Elkins.[794] In this regard, it does not appear that Enron derived any inappropriate U.S. Federal tax benefits in connection with the transaction -- the sum and substance of Enron's tax treatment of the transaction was that the company deducted interest expense that it paid to a third party and included interest income that it received from a third party.

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laws of the United States and those of foreign countries "can lead to tax arbitrage opportunities for taxpayers, particularly when the foreign laws and the U.S. tax rules yield inconsistent tax results for the same transaction").

[794] *See* Appendix C, Part XI, to this Report.