MEMORANDUM

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TO: Jordan Mintz

FROM: Morris R. Clark

DATE: September 22, 1999

RE: **Federal Income Tax Treatment of Prepayments**

This memorandum addresses the federal income tax treatment of the receipt of certain prepayment proceeds. In particular, the **Factual Background** provides a brief overview the various Enron Corp. ("Enron") prepayment transactions and how such transactions were historically treated for federal income tax and accounting purposes. The **Short Answer** and **Discussion** provide both a synopsis and a more detailed discussion of the rules governing the **recipient's** treatment of prepayment transactions for federal income tax purposes. The **Discussion** also addresses our recommendations regarding the most tax efficient method of executing future prepayment transactions.

I. Factual Background

By way of background, Enron and its affiliates have entered into approximately $3 billion in prepayment transactions since 1992. Enron's prepayment transactions are generally structured as forward oil or gas sale contracts with a counterparty arranged by a financial institution. Historically, Enron's prepayment transactions have fallen into two categories: (i) taxable income accelerated ("TIA") prepayments – that is, prepayments where Enron needed to accelerate the recognition of income in order to take advantage of particular tax attributes; or (ii) strategic cash flow payments, where Enron entered into a prepayment simply as a means to generate cash flow. (In addition, Enron has, on one isolated occasion, entered into a commercial prepayment with an industry participant).

As alluded to above, Enron has elected to treat the TIA prepayment proceeds -- which originated from the 1992 and early 1993 prepay transactions -- as taxable income in the year of receipt in order to take advantage of certain Internal Revenue Code ("Code") § 29 tax credits available in those years. However, Enron elected to defer the recognition of income from the later strategic prepayment transactions because it had no desire to accelerate taxable income in those later years. Typically, once a taxpayer elects to either accelerate or defer recognition of prepayment proceeds, such election becomes irrevocable absent the express consent of the Internal Revenue Service ("Service"). However, Enron was able to both accelerate and defer recognition of certain prepayment proceeds by using separate entities to effectuate certain transactions. (See **Discussion - Section C**, below for a discussion of the particular elections made by the various Enron entities).

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For financial accounting ("book") purposes, prepayment transactions are generally treated as a component of Enron's price risk management liability[1] and income (including an interest component) is recognized as the "commodity" is delivered to satisfy the prepayment. (See **Attachment A** for a summary of the book/tax treatment of the various prepayment transactions).

II. Issue Presented

What is the proper treatment of Enron's receipt of prepayment or advance payment proceeds for federal income tax purposes?

III. Short Answer

Briefly stated, prepayments or advance payments[2] relating to non-inventoriable goods (goods not properly includible in the inventory of the taxpayer) must be included in the income of the recipient in either: (i) the taxable year of receipt; or (ii) the taxable year in which such prepayment would be properly accruable under the taxpayer's method of tax accounting, provided such method results in income being recognized no later than the time such payments are included in gross income for financial reporting purposes.

For example, a typical accrual method taxpayer would recognize income no later than year of receipt. However, manufacturers can use a modified accrual method which allows income recognition to be deferred until the goods are shipped, delivered or accepted. Furthermore, under certain limited circumstances, an accrual basis taxpayer can recognize proceeds received to modify certain "take or pay" contracts into income ratably over the life the contract.

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[1] Although the prepayment is treated as price risk management liability for financial accounting purposes, it is our understanding that the transaction is not treated as debt for credit rating purposes; rather, the prepayment is viewed as part of Enron's overall price risk management activity. Once the prepayment transaction is executed the commodity volumes that will be delivered in the future are recorded on the Company's commodity risk books. Since such books are accounted for under the mark-to-market method of accounting, the prepay transaction ultimately results in the recording of a mark-to-market liability; however, once the prepay transaction is recorded on its risk books, Enron, if necessary, will then enter into a financial swap to hedge the price and basis exposure associated with the prepay liability.

[2] The terms "prepayment" and "advance payment" are synonymous and are used interchangeably. Simply put, advance payments or prepayments are defined as any amount which is received in a taxable year by a taxpayer using an accrual method of accounting and such amount is made pursuant to an agreement for the sale of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business and such agreement is not completed within the taxable year. Treas. Reg. § 1.451-5(a)(1)(i). For consistency purposes, such payments will be referred to as "prepayments".

Notwithstanding the above, however, special rules relating to prepayments for inventoriable goods (e.g. gas, power[3] and other commodities) provide that such prepayments must be included in the recipient's income no later than the second taxable year following the receipt of a "substantial advance payment" -- effectively resulting in a two year deferral of income recognition. In the event that prepayment proceeds are taken into income in the second taxable year under the inventoriable goods exception, then the taxpayer must take into account the estimated cost of goods necessary to satisfy the agreement in the second taxable year. As a result, only the net prepayment amount will be subject to tax in the second year following receipt.

Generally, Enron's prepayment transactions involve goods held in inventory (e.g. oil or natural gas) and, as such, fall under the inventoriable goods exception. However, it should be noted that Enron does not have to defer recognition of the income; rather, it could choose to accelerate the recognition of income in the year of receipt as Enron has done historically with TIA prepayments. Although Enron could choose to recognize income in the year of receipt, it could defer recognition of the related cost of goods sold over time as product is delivered – thus creating, if needed, a significant mismatching of income and expense. (See **Discussion – Section B-1**).

IV. Discussion

A. Overview of Timing Rules

1. General Rule for Taxable Year of Inclusion

Generally, receipts should be included in gross income in the year in which they are actually or constructively received by the taxpayer, unless such receipts should be included in a different year in accordance with the taxpayer's method of tax accounting. Treas. Reg. § 1.451-1(a). For instance, under an accrual method of accounting, income is included in gross receipts **when all the events have occurred** which fix the right to receive such income and the amount of such income can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii). "All events" are normally deemed to occur at the earlier of when: (i) the required performance under the contract occurs; (ii) payment is due; or (iii) payment is made. (See Rev. Rul. 74-607, 1974-2 CB 149 where the Service applied the above rule to the accrual of interest and held that interest should be included in income ratably over the life of the loan since performance, i.e. making of the loan, occurred before payment).

[3] Although the Service has not explicitly addressed whether power should be considered inventory for purposes of the prepayment rules, the Service has held that electricity is an inventoriable good in several non-prepayment contexts. For example, Technical Advice Memorandum 9523001 held that the taxpayer (an independent power producer – "IPP" or qualifying facility – "QF") must use the accrual method of accounting because electricity was inventoriable merchandise. See also Private Letter Ruling 961004 (holding that capacity payments made by an electric utility to a QF should be included in the utility's electricity inventory costs).

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In addition to these general accrual rules, a taxpayer engaged in a manufacturing business may account for sales under a modified accrual method where taxable income is recognized when either: (i) the goods are shipped; (ii) the product is delivered or accepted; or (iii) title to the goods passes to the customer. Treas. Reg. § 1.446-1(c)(2)(C). Although a taxpayer using a modified accrual method has some flexibility regarding the timing of income recognition, the accrual method selected must clearly reflect income and must be consistently used by the taxpayer from year to year. Id. In that event, income realization may be pushed out a bit further.

The interaction of the general accrual rules with the modified accrual method can be illustrated by the following example:

> S, a manufacturer, uses the traditional accrual method for tax and financial accounting purposes. S has a contract with B which calls for S to provide 100 widgets to B each month. S usually ships the widgets to B on the 20th of each month. S also bills B on the 20th of each month with payment due by the 30th of each month. B typically receives the goods 7 days after shipping (when title passes) and has 5 days to inspect and accept the goods. Under the traditional accrual method of accounting, "all events" would occur when the required performance under the contract occurs -- that is on the 20th, the shipping date. However, if S used a modified accrual method, S could choose to recognize income when the widgets are accepted -- 12 days after the shipping date.

Thus, as a manufacturer, the taxpayer can elect to defer recognition of income until after the shipping date provided that its method of accounting is both consistent and clearly reflects income.

It should also be noted that in certain circumstances, the Service has allowed a limited exception to the "all events" test with regards to certain "take or pay" or other similar payments. Under this exception, an accrual basis taxpayer may be able to defer recognition of proceeds if the payment is made to modify an existing contract rather than terminate such contract. In these limited circumstances, the Service will allow the taxpayer to take the modification payment into income over the life of the modified contract. For example, the tax accounting rules relating to "take or pay" contracts has been invoked in certain prepay transactions involving the restructuring of power purchase agreements ("PPAs") between utilities and IPPs located in the Northeast United States (e.g. Connecticut Light & Power/AES and New England Power/Haverhill recently entered into PPA modifications structured as prepayments). (See **Discussion - Section A-2-b,** below for further discussion of the tax treatment of the recent IPP restructurings).

2. Rules Governing Prepayments

(a) *General Rule*

In addition to the all events test, there are two special rules governing taxable income

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recognition of prepayment proceeds. The first rule, the general prepayment rule, governs prepayments for **non-inventoriable goods** (e.g. relating to an agreement for the sale of goods that are not includible in the taxpayers inventory). It provides that a prepayment should be included in income in either:

(i) the taxable year of receipt;

(ii) the taxable year in which properly accruable under the taxpayer's method of accounting (provided that such method does not result in including prepayments in income later than the time such payments are included in gross receipts for financial reporting purposes); or

(iii) if the taxpayer's method of accounting does result in including prepayments in gross receipts for financial reporting purposes earlier than for tax purposes, then in the taxable year that such payments are included in gross receipts for financial reporting purposes. Treas. Reg. § 1.451-5(b).

Thus, in a non-inventory prepayment, the recipient can either recognize prepayment proceeds in the year received or defer recognition under an accrual method (e.g. a manufacturing company would be able recognize income under an accrual method as goods are shipped or delivered) provided that such deferral does not result in income being recognized later than for financial reporting purposes.

The general prepayment rules can be illustrated by the following example:

> S, a retailer, for tax and financial accounting purposes, follows an accrual method of accounting under which it accounts for its sales when the goods are shipped. S receives an advance payment for such goods. Such advance payment must be included in gross receipts for tax purposes either in the taxable year the payments are received or in the taxable year such goods are shipped.

Thus, as a retailer, the taxpayer can defer recognition of the prepayment proceeds for tax purposes until the taxable year that the goods are shipped, provided that such income is not recognized any earlier for financial accounting purposes.

(b) *Contrast with Loan Treatment*

The above example assumes that the prepayment will be settled by delivering the physical commodity. This is important because, by definition, a prepayment must be made pursuant to an agreement for the sale of goods. (See footnote 2, above). As such, the prepayment transaction must actually provide for the sale of the underlying physical commodity. A purported prepayment transaction that merely requires the prepayment recipient to pay a specific amount of money based on the notional principal amount of an indexed commodity would be analyzed as a loan for federal income tax purposes. Notwithstanding the sale of goods requirement, a prepayment recipient can arrange to

market or sell the underlying physical commodity on behalf of the counterparty as long as the actual cash proceeds from such sale are remitted to the counterparty. Furthermore, unlike a loan, the counterparty must assume the price risk of the sale – that is, the prepayment recipient cannot guarantee a certain return from the actual sale of the commodity.

It should also be noted that a production payment, another financing vehicle commonly used in the energy industry, is statutorily required to be treated as a loan for tax purposes. (See Code § 636). As such, a production payment does not have to undergo the same structural guidelines as a prepayment in order to obtain favorable tax treatment, ie. loan or deferral.

(c) *Exception for Prepayments Relating to Inventory Goods*

Notwithstanding the general prepayment rule, if an accrual basis taxpayer receives a prepayment with respect to an agreement for the sale of goods that are properly includible in its inventory (e.g. commodities) and on the last day of such taxable year:

(i) the taxpayer has goods on hand (or available through normal sources of supply) to satisfy the agreement in such year; and
(ii) the taxpayer has received "substantial advance payments" [4] under such agreement,

then **all prepayments received by the last day of the second taxable year following the year in which such "substantial advance payments" are received (and not previously included in income in accordance with the taxpayer's accrual method of tax accounting) must be included in income in such second taxable year.** However, such deferral cannot result in a taxpayer recognizing income later than for financial reporting purposes. Treas. Reg. § 1.451-5(b)(ii) and (c). As such, this two year deferral is not available if Enron recognizes prepayment income under the mark-to-market method of accounting for financial reporting purposes.

In the event that prepayments are required to be taken into income under the inventoriable goods exception, then the taxpayer must take into account the estimated cost of goods necessary to satisfy the agreement.[5] As such, only the net prepayment amount will be subject to tax in the second year following receipt.

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[4] "Substantial advance payments" are deemed to exist if the sum of all prepayments equal or exceed the total estimated costs and expenditures necessary to satisfy the agreement. Treas. Reg. § 1.451-5(c)(3). The substantial advance payment rules can be illustrated by the following example: X enters into a prepayment contract for the sale of goods over a five year period for a total contract price of $100. X estimates that his total inventoriable costs and expenditures for the goods will be $50. X receives a "substantial advance payment" in the year that he receives $50 or more under the contract, determined in the aggregate.

[5] However, it should be noted that a taxpayer only has to take into account the estimated cost of goods sold if the taxpayer has elected to defer the recognition of income under the inventoriable goods exception. For

The inventoriable goods prepayment exception can be illustrated by the following example:

> S, a retailer, uses for tax and financial accounting purposes an accrual method of accounting under which it accounts for its sales when the goods are shipped. During 1998, S receives an advance payment for goods currently held in its inventory in the amount of $100. These goods will be shipped over three years from 2001 through 2003. The estimated cost of such goods is $50. Under the non-inventory prepayment rules, S could elect to defer recognition of the prepayment proceeds until the goods are shipped – in years 2001, 2002, and 2003. However, under the inventoriable goods exception, S could only defer recognition of the prepayment until the second taxable year following receipt - or in year 2000. However, S would be able to take into account the estimated cost of the goods ($50) such that S would only take into account $50 of income in year 2000.

(d) *Taxable Income Accelerated Prepayments*

As noted above, the prepayment timing recognition rules allow a taxpayer the flexibility to elect to either: (i) recognize prepayment proceeds in the year of receipt; or (ii) defer recognition of the prepayment proceeds until a later tax year (no later than the second taxable year following receipt of the proceeds for an inventoriable goods transaction). Treas. Reg. § 1.451-5(b) and (c). Thus, a taxpayer who elects to recognize the prepayment proceeds in the year of receipt effectively elects out of the complicated deferral regime of Treas. Reg. § 1.451-5. (See Treas. Reg. § 1.451-5(b) and (c)(ii)).

By effectively electing out of the § 451-5 deferral rules, a taxpayer who recognizes prepayment proceeds in the year of receipt does not have to take into the estimated cost of goods sold on an accelerated basis. Rather, the taxpayer would recognize the cost of goods sold over time as product was delivered under traditional accrual principles – thus creating a significant timing mismatch.

By way of summary, if the prepayment relates to non-inventoriable goods, S would have to either: (i) recognize the prepayment proceeds in taxable income in the year of receipt; or (ii) defer recognition under an accrual method (e.g. S recognizes income as goods are shipped or delivered). On the other hand, prepayment proceeds for inventoriable goods should be included in S' taxable income no later than the second year after receipt of payment.

In light of recent developments in the power industry, it is also important to note that several recent PPA modifications were structured as prepayments for non-inventoriable goods. The IPPs have claimed that power was not an inventoriable good because of their status as QFs for federal energy regulatory purposes. As a QF, power can only be

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instance, a taxpayer who elects to recognize the prepayment proceeds in the year of receipt would recognize the cost of goods sold over time under normal accrual rules. (See **Discussion – Section A-2-d**, above).

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supplied from limited sources – mainly from itself or other QFs. As such, the IPPs contended that: (i) they did not currently have the power on hand; and (ii) the power was "not readily available" because it could not get the power on the open market due to regulatory limitations. However, in discussing this approach with outside counsel, the IPP's position was considered very aggressive because their reliance on federal regulatory interpretations are not binding on the Service.

B. Enron Prepayment Transactions

As noted at the outset of this memorandum, Enron has been involved in approximately $3 billion in prepayment transactions since 1992. Historically, Enron's prepayment transactions have fallen into two categories: (i) taxable income accelerated ("TIA") prepayments -- that is, prepayments where Enron needed to accelerate the recognition of income in order to take advantage of certain tax credits or losses; or (ii) strategic cash flow prepayments, where Enron has entered into a prepayment simply as a means to generate significant cash flow. (In addition, Enron has, on one isolated occasion, entered into commercial prepayments with an industry participant. However, this prepayment transaction has been completed and product is no longer being delivered pursuant to such transaction.)

The appropriate Enron entities that should be used to effectuate the various prepayment transactions is discussed in **Discussion - Section C,** below.

1. Taxable Income Accelerated Prepayments

Enron entered into three TIA prepayments during 1992 and 1993. (See **Exhibit B** for a list of prepayment transactions). These prepayments were entered into primarily as a means for generating taxable income in order to take advantage of § 29 credits generated by EOG which, at that time, was part of Enron's consolidated group. By way of overview, § 29 credits are used against regular tax liability, but cannot be used against the alternative minimum tax ("AMT"). Further, the Code does not authorize § 29 credits to be carried forward and, as such, a taxpayer loses the benefit of the credits if it does not have sufficient regular taxable income. (However, such credits would be added to the taxpayer's AMT credit carryforward). Therefore, Enron had to create regular taxable income to realize the benefit of the credits, thereby helping to reduce its effective tax rate.

The TIA prepayments were typically structured as forward oil sale contracts with a counterparty arranged by a financial institution (Chase Manhattan or Citibank), whereby the counterparty would make a significant up-front payment in exchange for Enron's obligation to deliver oil on a monthly basis over a 3 to 4 year period.[6] Since Enron holds oil in its inventory, these prepayment transactions were subject to the inventoriable goods exception which requires income to be recognized in either the year of receipt or deferred

[6] Typically, the financial institution counterparty does not actually take delivery of the oil or gas over the term of the prepayment. Instead, Enron will act as a marketer for the counterparty and sell the agreed upon volume of oil or gas in the open market and pay the proceeds from such sale to the counterparty.

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for a period no longer than two years. Again, in order to use the § 29 credits, Enron elected to recognize the proceeds from these prepayments in the year of receipt.

It should also be noted that since Enron elected to accelerate the recognition of income, it did not have to take into account the estimated costs of goods sold on an accelerated basis. Treas. Reg. § 1.451-5(c)(ii). Rather, Enron was able to recognize the cost of goods sold over time as product was delivered (under normal accrual methodology) – a timing mismatch that worked in Enron's favor since it needed to produce as much taxable income as possible during the tax years at issue.

For financial accounting purposes, the TIA prepayments are essentially treated as deferred revenue (a component of the price risk management liability) and income (with an interest component) is recognized under an accrual model over time as the product is delivered in satisfaction of the prepayment. The transaction is not treated as traditional debt for accounting and credit rating purposes, but rather, the prepayment is viewed as a part of Enron's overall price risk management activity. (See footnote 1, above).

2. Strategic Cash Flow Prepayments

The majority of Enron's prepayments have been structured as strategic cash flow prepayments and we anticipate additional prepayments this year. Rather than entering into these prepayments to manage our tax situation, these prepayments were entered into primarily as a means of generating cash flow for Enron. These strategic prepayment transactions were typically structured as either forward oil sale contracts or natural gas forward sale contracts with a counterparty arranged by a financial institution (Chase Manhattan), whereby the counterparty would make a significant up front payment in exchange for an Enron obligation to deliver oil or natural gas on a monthly basis over a period of several years (3-6 years). As previously explained, after EOG was deconsolidated from the Enron group, there was less of a need to generate regular taxable income to use § 29 credits. As a result, Enron elected to defer recognition of these prepayment proceeds. However, since both natural gas and oil are carried in Enron's inventory, these prepayments fall under the inventoriable goods exception and, as such, gain recognition may only be deferred for a period of two years after the year of receipt. (See **Discussion - Section A-2**, above).

For financial accounting purposes, the cash flow prepayments are treated as a component of Enron's price risk management liability with income, including an interest component, recognized over time as the product is delivered in satisfaction of the prepayment. However, the prepayments are not treated as traditional debt for balance sheet purposes, but rather, are treated as a fixed price commodity contract as part of Enron's overall price risk management activity.

3. Commercial Prepayments

Enron entered into one commercial prepayment in 1992. This prepayment was not entered into for tax or cash management reasons, but was merely entered into as a part of an underlying commercial transaction. This transaction was structured as forward oil sale contract with Texas Utilities Fuel Co. ("Tufco") as the counterparty. The prepayment amount was considerably smaller than any of the other accelerated or strategic prepayments. Since oil is an inventoriable good with respect to Enron, it could either recognize the prepayment income in the year of receipt or elect to defer recognition of such income for period not to exceed two years. However, because EOG had § 29 credits readily available in 1992, Enron, nevertheless, elected to accelerate the recognition of the Tufco prepayment proceeds.

Again, for financial accounting purposes, commercial prepayments are treated as a part of Enron's price risk management liability with income, including an interest component, recognized over time as the product is delivered. However, the prepayments are not treated as traditional debt for balance sheet or credit rating purposes.

C. Enron Prepayment Entities

As stated earlier, a taxpayer who receives prepayment proceeds has the option of either recognizing income in the year of receipt or deferring recognition until a later year. Although the taxpayer does not have to make an affirmative election on any particular tax form, the taxpayer must include an annual information schedule with its income tax return reflecting: (i) the particular recognition method used; (ii) the amount of prepayment proceeds recognized in the current year; and (iii) the total amount of payments received but not yet recognized. Treas. Reg. § 1.451-5(d). (See **Attachment C** for a copy of the annual information statement that is filed with Enron's consolidated tax return).

Once a taxpayer elects to either include prepayment proceeds in the year of receipt or to defer recognition until a later year, such tax treatment becomes the taxpayer's method of accounting for prepayments. The consequence of a prepayment election becoming a method of accounting is that the taxpayer cannot change such method of accounting without consent from the Service. Treas. Reg. § 1.446-1(e).

1. Entities Electing to Include Prepayments In Year of Receipt

The Enron entities used to facilitate the accelerated prepayments were Enron Reserve Acquisition Corp. ("ERAC"), Enron Power Services ("EPS") and EGS Hydrocarbon Corp. ("EGS"). ERAC and EPS made the accelerated recognition election in 1992, while EGS made its election in 1993.

At the end of 1994, EPS was merged (along with several other entities) into Enron Risk Management Services ("ERMS") as part of the "mega-merger" that created Enron Capital

& Trade Resources Corp. ("ECT"). Thus, under the tax attribution rules of Code § 381, ECT (and now Enron North America Corp. – "ENA") must continue to use the prepayment accounting method of EPS under the "principal accounting method test". Treas. Reg. § 1.381(c)(4)-1(c)(2)(iv). As such, ECT has effectively elected to accelerate the recognition of any prepayment proceeds. Thus, although ECT may be the preferred entity to effectuate prepayment transactions from a commercial or legal perspective (since the counterparty may already have a master swap agreement in place with ECT or because the counterparty otherwise has familiarity with ECT from other commercial deals), ECT may not be the preferred entity from a tax perspective (See discussion of recommended entities in **Discussion - Section D** below).

2. Entities Electing to Defer Recognition of Prepayments

The Enron entities used to facilitate the strategic prepayments were Enron Hydrocarbons Marketing Corp. ("Hydrocarbons"), Enron Cushing Oil Marketing, Inc. ("Cushing Oil") and Enron Natural Gas Marketing ("ENGM"). As stated earlier, these entities elected to defer recognition of prepayment proceeds because there were no readily available tax credits to justify accelerating the recognition of taxable income. Hydrocarbons' election was made in 1993[7], Cushing Oil's election was made in 1994, and ENGM's election was made in 1995.[8] ENGM continues to have 1997 prepayment proceeds that have not been fully recognized as income.

D. Future Prepayment Transactions

1. TIA Prepayments

As noted above, TIA prepayment transactions are entered into to generate taxable income to offset expiring tax attributes (tax credits or net operating losses). As such, these transactions should be effectuated with an entity that has elected to recognize prepayment proceeds in the year of receipt. It is recommended that ENA be used for any future TIA prepayments.

In light of the current focus on utilizing the Enron consolidated net operating loss ("NOL"), all future prepayment transactions (particularly year-end 1999 transactions) should be examined to determine whether it is feasible to recognize such prepayment proceeds in the year of receipt.

[7] It should be noted that Hydrocarbons entered into prepayment transactions with Chase in both 1993 and 1994. Although Treas. Reg. § 1.451-5 requires that all remaining income from the 1994 prepayment transaction (as well as the estimated remaining cost of sales) should have been recognized in 1996, such amounts were not reported in 1996. Rather, such amounts have been reported as deliveries are made. This prepayment is scheduled to expire in 1999.

[8] From 1993 to 1996, Enron created a new entity every year to effectuate its prepayment transactions. The new entities were created to isolate the particular transactions and in order to make the desired deferral election – which typically was not known until some time after the transaction was consummated.

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2. Financial Prepayments

Financial prepayments are entered into as a means of generating strategic cash flow. Since these transactions do not involve the utilization of offsetting tax attributes, financial payments should be effectuated with an entity that elects to defer recognition of prepayment proceeds. As such, ENGM should continue to be the entity used for all future strategic prepayment transactions.

Notwithstanding the above, however, there may be a number of circumstances where ENA is the preferred entity from a commercial or legal perspective (ie. ENA already has a master agreement in place with the counterparty or the counterparty would prefer to deal with ENA because of familiarity). In the event that commercial realities mandate that ENA act as the prepayment entity, we will consider whether it is feasible to change ENA's prepayment accounting method and use it for these transactions.

3. Commercial Prepayments

As noted above, commercial prepayments are entered into as part of an underlying commercial transaction. Although we have rarely entered into commercial prepayments, it is anticipated that we may have opportunities to enter into more of these transactions in the future. For financial accounting purposes, these transactions are currently treated as deferred revenue. However, there have been ongoing discussions regarding whether commercial prepayments can be accounted for under MTM. In the event that MTM is used for future prepayment transactions then, regardless of the entity used to effectuate the transaction, proceeds from commercial prepayments must be taken into taxable income no later than the time such income is recognized for financial accounting purposes – or the year of receipt for MTM income.

V. Conclusion

Generally, an accrual basis taxpayer must include income in gross receipts when all events have occurred which fix the right to receive such payment and the amount of income can be determined with reasonable accuracy. However, pursuant to special prepayment rules, **all non-inventory prepayment proceeds should be included in income in either the taxable year of receipt or defer recognition under an accrual method** (e.g. recognize income as goods are shipped or when goods are delivered) provided that such deferral does not result in income being recognized later than for financial reporting purposes.

In the case of prepayments relating to inventoriable goods, **the taxpayer must recognize taxable income from the prepayment no later than the second year after receipt** provided the prepayment constitutes a "substantial advance payment" and the taxpayer has goods on hand (or available through normal sources) to satisfy the commodity

contract. Again, this two year deferral is only available if such deferral does not result in income being recognized later than for financial reporting purposes. It should also be noted that due to this two year limitation, structuring a transaction as a loan rather than a prepayment (e.g. production payment) may be more advantageous to the recipient.

Enron has effectively elected to accelerate the recognition of income related to prepayments executed by ECT. As such, we should be careful to avoid using ECT (or now, ENA) as the counterparty for any future prepayment transactions until we further consider whether ENA can change its prepayment accounting method, or until we determine that the tax consequences should be accelerated to utilize the NOL. Rather, Enron should continue to use ENGM to effectuate future prepayment transactions so that we defer recognition of proceeds until after receipt. However, in light of circumstances where ECT is the preferred counterparty from a commercial or legal perspective, we may want to consider the feasibility of changing ECT's prepayment accounting method.

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Attachment A

TAXATION OF PREPAYMENTS

Outline of Book/Tax Treatment

I. Financial Prepayments

A. Book Treatment

- Treated as deferred revenue and income recognized over time as product is delivered to satisfy the prepayment; also has an interest component
- Not treated as debt on balance sheet but is treated as a price risk management liability

B. Tax

- Election to defer under accrual method
- Inventoriable goods exception would limit the deferral to the second taxable year following the year of receipt (2 year deferral)
- Also takes into account the estimated cost of goods, thus resulting in reporting of net revenue

II. Commercial Prepayments

A. Book Treatment

- Treated as deferred revenue and income recognized over time as product is delivered to satisfy the prepayment; also has an interest component
- Discussions ongoing regarding recognition under MTM

B. Tax

- Election to defer under accrual method
- Inventoriable goods exception would limit the deferral to the second taxable year following the year of receipt (2 year deferral)
- Also take into account the estimated cost of goods

IF MTM is adopted for future transactions:

- Must take into income no later than the year taken into income for financial accounting purposes (*ie*. Year 1 for MTM)
- Must take gross revenue into account
- Cost of goods are taken into account as product is delivered thereby potentially creating a substantial timing difference

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III. Taxable Income Accelerated Prepayments

A. Book Treatment

- Treated as a loan and income recognized over time as product is delivered to satisfy the prepayment; also has an interest component
- Not treated as debt on balance sheet

B. Tax

- Recognize proceeds in income in year of receipt
- Must take gross revenue into account
- Cost of goods are taken into account as product is delivered thereby potentially creating a substantial timing difference – which is a positive from a tax acceleration standpoint

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Attachment B

Enron Capital & Trade Resources Corp.

Schedule of Prepayments

Enron Company Name	Prepay Counterparty	Contract Date		Amount ($)	Taxed in Year of Receipt?
Enron Reserve Acquisition Corp.	Chase Manhattan & Bankers Trust	1992		$ 225,309,396.00	Yes
Enron Power Services, Inc.	Tufco	1992		$ 35,000,000.00	Yes
Enron Hydrocarbons Marketing Corp.	Chase Manhattan	1993		$ 230,006,022.00	No
EGS Hydrocarbon Corp.	Citibank	1993		$ 149,887,713.00	Yes
Enron Hydrocarbons Marketing Corp.	Chase Manhattan	1994	(1)	$ 207,901,069.00	No
Enron Cushing Oil Marketing, Inc.	Chase Manhattan	1994		$ 124,951,430.00	No
Enron Natural Gas Marketing	Chase Manhattan	1995		$ 224,440,450.00	No
Enron Natural Gas Marketing	Chase Manhattan	1996		$ 224,233,880.00	No
Enron Natural Gas Marketing	Chase Manhattan	1996		$ 124,549,095.00	No
Enron Natural Gas Marketing	Chase Manhattan	1997		$ 299,991,679.00	No
Enron Natural Gas Marketing	Chase Manhattan	1998		$ 249,062,500.00	No
Enron Natural Gas Marketing	Chase - Mahonia	1998		$ 249,619,352.00	No
Enron Natural Gas Marketing	Citibank-Delta/Vega	1998		$ 308,358,349.00	No
Enron Natural Gas Marketing	Citibank-Delta/Vega	1998		$ 190,000,000.00	No
Enron Natural Gas Marketing	American Public Energy Agency	1999		$ 250,000,000.00	
				$ 3,093,310,935.00	

Footnote (1): Tax inadvertently took the prepayment proceeds into income over the life of the prepayment delivery schedule, rather than in accordance with the prepayment rules of Treas. Reg. § 1.451-5.

Enron Corp. And Subsidiaries (47-0255140)
Corporation Income Tax Return
For The Year Ended 12/31/96

Statement Pursuant to Regulation 1.451-5(d)
for Enron Natural Gas Marketing (76-0481290)

Advanced Payments Received 1/1/96 to 12/31/96 Not Taken into Taxable Income Currently	$348,782,975
Advanced Payments Received Prior to 1/1/96 Taken into Taxable Income Currently	$ 49,673,885

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