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and its affiliated Companies

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November 7, 1997

Mr. R. Davis Maxey
Enron Corp.
Senior Director
1400 Smith Street
Houston, TX 77002-7361

Dear Dave:

Enclosed, for your files, is a copy of the memorandum regarding the financial accounting for the REMIC Subco transaction which you discussed with Brian McGuire in San Diego. As you will see, the memorandum is addressed to Bill McKee and was drafted in order to provide Bill with an overview of the financial accounting benefits of the transaction.

Very truly yours,

Thomas Finley

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June 2, 1997

Mr. William McKee
King & Spalding
1730 Pennsylvania Avenue, N.W.
Suite 1200
Washington, DC 20006-4706

Dear Bill:

Enclosed is a memo we have prepared which supports "de-linking" the accounting benefits to be derived from entering into the joint venture transaction from the cash tax benefits arising from the carryover of the tax basis in the REMIC Residual Interests ("RRIs"). As the attached memo illustrates, the accounting benefits of the transaction are derived from treating the transaction as a "bargain purchase" of assets for accounting purposes, even though there is no bargain purchase from an economic perspective and the transfer of such assets is a carryover basis transaction under Section 351 for tax purposes. The carryover of tax basis does not directly create the accounting benefits. As discussed in more detail in the memo, the bargain purchase element of the transaction arises because: (1) the accounting rules require recording a Deferred Tax Asset attributable to the book-tax basis difference in the RRIs based upon the gross tax basis in the RRIs without taking into account when the benefit of such tax basis will be realized economically; and such amount will exceed (2) the consideration paid for the assets which is attributable to the benefit of the carryover tax basis. Because the amount determined under (2), above, is determined based upon the present value of the benefits expected to be derived from the tax basis in the RRIs, the amount paid for the benefit of the tax basis in the RRIs will always be less than the benefit of the tax basis recorded on the balance sheet as a Deferred Tax Asset. The accounting rules deem that a bargain purchase occurs in such situations. No income statement benefit is derived from the bargain purchase in a straight Section 351 transaction. As discussed below, it is only where other steps are introduced into the transaction that the bargain purchase provides a book income statement benefit.

MV = PURCHASE PRICE

The memo uses three scenarios to illustrate the impact of the bargain purchase upon the accounting benefits of the transaction. In the first scenario (the "Base Case"), the consideration for the RRIs is paid solely in stock. As a result, the benefit of the bargain purchase is recorded as an addition to stockholders' equity and no income statement benefit will be realized. In the second scenario, a recapitalization provision is added which will cause the equity interest issued

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in exchange for the RRIs to be exchanged (in the future) for debt of the JIE. In the third scenario, assets in addition to the RRIs are contributed. It is this recapitalization provision (as illustrated in scenario two) and the contribution of the additional non-RRI assets (as illustrated in scenario three) which generate the income statement accounting benefits from the deemed bargain purchase. Significantly, the book income statement benefits do not arise from a carryover of the tax basis in a transfer of assets subject to Section 351.

The memo is separated into the three following parts: first, a basic discussion on financial accounting and its use in the business world; second, a summary of the cash flow tax benefits and accounting benefits under three scenarios; and third, an analysis of how the accounting benefits arise in each of the three scenarios.

Attached to this letter is the Section 2 - Summary of the Benefits under the three scenarios. As the summary attachment indicates, the transaction is a deal driven by the accounting benefits. If a client were interested in the tax benefit, other less expensive alternatives exist to generate equivalent tax benefits.

Sincerely,

Bill Boyle

Bill Boyle

cc: Tom Finley
Christine Levinson
Leon Kozak
Gregg Grauer
Brian McGuire

Section 2 - Summary of Benefits of Transactions

	Transaction #1 Base Case Basic Section 351 Transaction	Transaction #2 Section 351 with Recapitalization Provision	Transaction #3 Section 351 with Recapitalization Provision and Additional Asset Contributions by Co. B
Cash Tax Savings	$80 million when losses generated in Years 1-20 from REMICs are actually used	$80 million when losses generated in Years 1-20 from REMICs are actually used	$80 million when losses generated in Years 1-20 from REMICs are actually used
Pre-Tax Accounting Income (Above-the-Line)	None	$133 million income over Years 1-20 when losses from REMICs are generated	$133 million income over Years 1-5 *or sooner* if Leased Assets are sold
Accounting Tax Expense (Below-the-Line)	None	$53 million expense over Years 1-20 when losses from REMICs are generated	$53 million expense over Years 1-5 *or sooner* if Leased Assets are sold
Net Accounting Income	None	$80 million income over Years 1-20 when losses from REMICs are generated	$80 million income over Years 1-5 *or sooner* if Leased Assets are sold
Present Value of Pre-Tax Accounting Income	None	$65 million (assuming pre-tax income generated equally in Years 1-20) (*)	$106 million (assuming pre-tax income generated equally in Years 1-5) (*)

It is our professional opinion that a business entity would be willing to pay (1) little, if any, fee for Transaction #1, (2) a moderate fee for Transaction #2 and (3) a substantial fee for Transaction #3.

(*) Discounted at a target investment yield of 8%

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Overview of Financial Accounting for Joint Venture Transaction

Section 1 - Background

Financial accounting is often called the language of business as it is the primary method of communicating a business entity's activities. Most often, financial accounting information is provided to decision makers in the form of financial statements. In preparing these financial statements for a business entity, preparers must identify, quantify, analyze, interpret, and classify the numerous events that have occurred during the relevant period and their financial effects on the business entity.

Various parties use financial statements to assess an entity's financial performance. New and existing investors are the principal end users of a business entity's financial statements. The information provided in the financial statements help these investors to evaluate the performance of the entity in generating profits and to predict the ability of the entity to generate future profits. Thus, the financial statements allow investors to make informed decisions about whether to initially invest in a particular entity and whether to continue, decrease or increase an existing investment in a particular entity.

The executive officers of business entities also have significant interest in the financial statements of the entity which they manage. The compensation of such managing executives is usually dependent on the business entity's profitability. Most entities pay bonuses to their managing executives based directly on financial results reported in the entity's financial statements. Thus, the financial statements provide an objective benchmark for determining how successful executives have been in meeting their performance goals. Accordingly, operating, strategic and financial decisions of executives are largely based on predictions of the impact such decisions will have on an entity's financial statements.

Numerous other parties also rely on the information contained in a business entity's financial statements. Potential acquirers of a particular business entity will place great importance on information contained in the financial statements in making their acquisition decision and in determining an appropriate price for the entity. Lenders rely on financial statements in order to determine whether to grant loans to an entity and to determine the appropriate lending terms. Regulatory agencies, such as the Securities and Exchange Commission (SEC), review a listed business entity's financial statements to determine whether an entity conforms with regulatory requirements.

Financial accounting relies on and integrates raw data from diverse economic and legal disciplines. However, a distinction is made between reporting for financial accounting purposes and reporting for these other disciplines. For example, financial statement reporting to shareholders of a corporation must abide by Generally Accepted Accounting Principles (GAAP) while reports to income tax authorities must be made in accordance

with the law set forth in the Internal Revenue Code and the various regulations and administrative pronouncements issued by the U.S. Treasury and the Internal Revenue Service (IRS). While the income tax rules are often consistent with GAAP, they are in many instances distinctive and inconsistent with GAAP. Though there is nothing inconsistent or inappropriate about having two sets of rules, often the different approaches can lead to somewhat anomalous results.

Financial statements are required to be prepared in accordance with a common set of measurement principles and practices. GAAP provides the applicable rules and is composed of all the conventions, rules and procedures that comprise accepted accounting practice at a given point in time. Accounting principles become "generally accepted" through agreement by practitioners. Such agreement is not solely dependent on a static set of rules. These principles and practices continuously evolve to represent current GAAP. In addition, experience, custom, industry factors and practical necessity contribute to determining which accounting principles become generally accepted. Accordingly, these principles are not necessarily the product of airtight logic.

The United States Congress has granted the SEC the ultimate responsibility for authorizing the generally accepted accounting principles for companies with publicly-held stock. However, the SEC has delegated such power to the Financial Accounting Standards Board (FASB) and its predecessor, the Accounting Principles Board (APB). The FASB is a private-sector organization which is financed by various professional accounting associations. While the SEC retains the authority to overrule the FASB, Congress can overrule both the SEC and the FASB. Congress and the SEC rarely exercise their authority to overrule a particular accounting principal. Nonetheless, the evolution of GAAP is largely dependent upon, and balanced by, the regulatory interests of Congress, the SEC and the FASB, in addition to the practical interests of investors, lenders and public corporations. Thus, the determination of GAAP can be a complex process and the resulting accounting principles can be somewhat arbitrary due to the number of parties involved and their varied and often conflicting interests.

One of the significant financial statements is the balance sheet, which illustrates the financial status of an entity at a particular point in time. The balance sheet has two sections: one section lists assets, which represent the resources of the entity that are expected to provide future benefits to the entity; the other section lists liabilities and stockholders' equity, which collectively represent the entity's third party and ownership claims against the entity's resources. Another major financial statement is the income statement which measures an entity's performance for a particular time span. Specifically, the income statement presents the revenue and expense transactions recorded by the entity during a particular period of time.

In the following discussion, a number of important financial accounting principles and concepts will be used. These are defined below:

- **"Purchase Accounting"** - This is a method of accounting for a business acquisition. Under Purchase Accounting, the acquiring corporation records the net assets acquired at their fair market values. Any excess of the purchase price over the fair market value of the net identifiable assets is recorded as goodwill, while negative goodwill is recorded if the purchase price is less than the fair market value of the acquired identifiable assets (e.g., where a "Bargain Purchase" occurs).

- **"Deferred Credit"** - An item recorded in the liability section of a balance sheet which represents an amount of deferred revenue for financial statement purposes. Over time, as the deferred revenue is actually recognized in the income statement, the Deferred Credit disappears. A Deferred Credit can be created as a result of certain business acquisitions where a bargain purchase is made (i.e., a Deferred Credit may be the equivalent of negative goodwill discussed above).

- **"Above-the-Line/Below-the-Line"** - An income statement presents an entity's revenues less its expenses. The presentation of such amounts on the income statement is *Revenues* first and *Expenses (other than income taxes)* second. The subtotal of these two items is "Pre-Tax Income". Anything which is included in this Pre-tax total is considered **"Above-the-Line"** in accounting lingo.

  The "Tax Expense" is then deducted from the Pre-Tax Income line, leaving "Net Income" as the last entry on the Income Statement. Amounts in the Tax Expense are commonly referred to as **"Below-the-Line"**. Thus, there is an imaginary "Line" between Pre-Tax Income and Tax Expense on the Income Statement.

  The distinction between Above-the-Line and Below-the-Line is critically important in a number of respects. Most significantly, stock analysts and valuation specialists utilize this concept when analyzing a particular corporate business entity and determining the appropriate value and stock price for the corporation. Commonly, such analysis relies heavily on Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) (rather than a multiple based on Net Income). For example, a company with 1996 EBITDA of $100 might be valued at $800 million based on a multiple of 8 times EBITDA. Thus, stock analysts and valuation specialists generally ignore the tax expense line of an income statement (along with other items such as interest and depreciation) in determining a corporation's true market or trading value. Accordingly, since the compensation of a business entity's executive officers is often tied to the market or trading value of the entity, such executives place much greater priority on increasing Pre-Tax Income and are generally less concerned about the entity's Net Income.

- "Gross-Up" - Generally, this term is used in situations where an item of income is included in the Net Income line of the income statement without a related tax cost being recorded in the Tax Expense line. For example, a tax-free municipal bond providing $60 of Net Income is said to be "Grossed-Up" to $100 (assuming a 40% effective tax rate). In other words, a "Gross-Up" provides the amount of Pre-Tax income that would have to exist to provide the same amount of Net Income if a tax cost were actually recorded on the item.

- "Temporary Differences" - Whenever revenue or expense items are recognized in one time period for tax purposes and in another time period for GAAP reporting purposes, "Temporary Differences" are created. Temporary Differences "originate" in one period and subsequently "reverse" in another. The differences result from the following four types of transactions: (1) revenue included in taxable income after being included in accounting income (e.g., installment sales); (2) expenses deducted from taxable income subsequent to accounting income (e.g., warranty expense deducted for book purposes in the year of sale but when paid for tax purposes); (3) income recognized for tax purposes prior to being included for accounting purposes (e.g., rental received in advance); and (4) expenses subtracted for taxable income before being deducted for accounting purposes (e.g., accelerated depreciation method utilized in determining taxable income while straight-line depreciation used for book purposes).

- "Interperiod Tax Accounting" - Where Temporary Differences exist, "Interperiod Tax Accounting" requires that accounting income be reported as if it were subject to the full current tax rate even though a different income recognition method was used for tax purposes.

- "Deferred Tax Assets and Liabilities" - As a result of Interperiod Tax Accounting, Deferred Tax Assets and Deferred Tax liabilities may be recorded. Where either income is deferred or expenses are accelerated for tax reporting purposes, a Deferred Tax Liability must be recorded in the financial statements. Where income is accelerated or expenses deferred for tax reporting purposes, a Deferred Tax Asset is recorded.

  Generally, GAAP requires that assets and liabilities be recorded in the financial statements at fair market values. Usually, such fair market values incorporate applicable present value concepts. Thus, the value of an asset or the amount of a liability is discounted under present value concepts based on the expected timing of the asset or liability being realized. However, Deferred Tax Assets and Deferred Tax Liabilities are recorded *based on their gross amounts and do not incorporate any present value concepts.* Accordingly, such Deferred Tax Assets and Deferred Tax Liabilities are originally recorded on the balance sheet at the same amount regardless of when they are expected to be realized.

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Section 2 - Summary of Benefits of Transactions

	Transaction #1 Base Case Basic Section 351 Transaction	Transaction #2 Section 351 with Recapitalization Provision	Transaction #3 Section 351 with Recapitalization Provision and Additional Asset Contributions by Co. B
Cash Tax Savings	$80 million when losses generated in Years 1-20 from REMICs are actually used	$80 million when losses generated in Years 1-20 from REMICs are actually used	$80 million when losses generated in Years 1-20 from REMICs are actually used
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Net Accounting Income	None	$80 million income over Years 1-20 when losses from REMICs are generated	$80 million income over Years 1-5 *or sooner* if Leased Assets are sold
Present Value of Pre-Tax Accounting Income	None	$65 million (assuming pre-tax income generated equally in Years 1-20) (*)	$106 million (assuming pre-tax income generated equally in Years 1-5) (*)

It is our professional opinion that a business entity would be willing to pay (1) little, if any, fee for Transaction #1, (2) a moderate fee for Transaction #2 and (3) a substantial fee for Transaction #3.

(*) Discounted at a target investment yield of 8%

Section 3 - Analysis of the Transactions

The goals of the proposed joint investment transaction (the "Transaction") are two-fold. First, it will provide the joint investment entity (the "JIE") with a market rate return. Second, it will allow the JIE to record the benefits of the transaction in a manner which is unusually attractive from a financial accounting point of view. Specifically, the JIE, after identifying the benefits of the transaction, will: (i) ***gross-up*** the amount of the benefit to a pre-tax equivalent number; (ii) record the benefit ***above-the-tax-line***; and (iii) capture the above-described benefits on an ***accelerated*** basis.

Publicly-traded corporations are particularly attracted to making investments which provide, "grossed-up", "above-the-line" and "accelerated" accounting benefits. Generally, as discussed previously, corporate business entities and their executive officers are primarily concerned with maintaining or increasing their stock price. In determining stock price, analysts typically give more importance to pre-tax earnings than to after-tax earnings. Therefore, the creation of pre-tax earnings will generally control whether an investment will be made. Tax benefits, without a corresponding accounting benefit, will not pursuade most publicly-traded companies to make an investment. In fact, in many cases, any significant tax benefits above a particular threshold lose their value because many companies target a specific effective tax rate and effectively manage earnings to maintain that tax rate. Generally, decision makers at these companies are not incentivized to lower their effective tax rates below this threshold level. Accordingly, it is the accounting benefits, and not the tax benefits, which will typically drive an investment decision.

In the Transaction, the REMIC Residual Interests ("RRIs") (with a tax basis in excess of its fair market value) and certain other assets are contributed by Co. B to the JIE in a Section 351 transaction. The assets contributed carry with them a carryover tax basis under Section 362. Co. B, as one of the transferors, receives cash and a debt obligation (i.e., boot) plus stock. The RRIs will not generate substantial cash flow. However, they will generate ordinary losses for Federal income tax purposes. Because of the nature of the RRIs and because of SRLY limitations and other restrictions, these ordinary losses will not, in large measure, give rise to cash tax benefits until the out years of the Transaction (i.e., years 11-20).

Application of Purchase Accounting Rules - Although the Transaction is a carryover basis transaction for tax purposes, it is characterized differently for financial accounting purposes. Under purchase accounting rules, the JIE is treated as having purchased the assets contributed in the Section 351 transaction in exchange for stock and boot (i.e., debt and cash). The purchase price (i.e., the fair market value of the stock and debt and the

amount of cash distributed) is allocated the among the contributed assets to the extent of their relative fair market values. Any excess of purchase price over the fair market value of the contributed assets is treated as goodwill. Any excess of the fair market value of the assets over purchase price results in negative goodwill.

The Instant Transaction provides substantial accounting benefits solely as a result of the application of these Purchase Accounting Rules and the creation of negative goodwill. The following examples illustrate this conclusion:

Example #1 - No Bargain Purchase Recorded :

Assume Co. B contributes to JIE, in a Section 351 exchange, mortgages with a fair market value and of tax basis of $135 and RRIs with a fair market value of $1 (not counting the potential tax benefits) and a tax basis of $201. The RRIs generate a $200 loss in the current year and the JIE could utilize the entire loss currently to shelter income. The JIE issues to Co. B $10 of stock, $5 of debt and $201 of cash, totaling $216 of fair market value consideration in the exchange, ($135 for the mortgages, $1 for the RRI and $80 for the tax benefits attributable to the RRI (i.e., the $200 tax loss benefited at 40%)).

One possible method that could be required under the applicable accounting rules would be for this JIE would make the following accounting entries to record the transaction:

Debit:		Credit:	
Mortgages	$135	Cash	$201
REMIC Residuals	$1	Debt	$5
Deferred Tax Asset	$80	Equity	$10

In this case, JIE allocates the $216 purchase price first to the mortgages and RRIs based upon their fair market values. The accounting rules also require the JIE to record a Deferred Tax Asset to the extent of the excess of tax basis over book basis. The Deferred Tax Asset of $80 represents the book-tax basis difference in the RRI (i.e., $201 tax basis less $1 book basis multiplied by the 40% tax rate). Essentially, no bargain purchase would arise because the JIE would be treated as paying $216 in exchange for assets with a value and book basis of $216.

Example #2 - Creation of Bargain Purchase:

However, application of the Purchase Accounting rules to this transaction require different accounting for the transaction. The acquisition entry required under the applicable accounting is as follows:

Debit:		Credit:	
Mortgages	$135	Cash	$201
REMIC Residuals	$81	Debt	$5
Deferred Tax Asset	$48	Equity	$10
		Negative Goodwill	$48

Since the JIE is paying $80 of consideration for tax benefits to be derived from the RRIs, purchase accounting principles require that this consideration be recorded as part of the book basis of the RRIs. Since the JIE would then have a book basis in the RRIs of only $81 and continues to have a tax basis of $201 in the RRIs, a difference continues to exist between the book and tax bases. The applicable accounting continues to require that a Deferred Tax Asset be recorded for this $120 basis difference ($201 tax basis less $81 book basis). Thus, with a 40% tax rate, a Deferred Tax Asset of $48 must be recorded.

As a result, the JIE is treated as acquiring $264 worth of assets ($135 Mortgages, $81 RRIs and a $48 Deferred Tax Asset), while still paying only $216 of consideration. Thus, the JIE pays the same consideration as Example #1 above, but records additional assets on its balance sheet as a result of the application of the accounting rules. Accordingly, the JIE is treated as having made a Bargain Purchase *solely for accounting purposes*. As a result, the JIE would record negative goodwill of $48.

In economic terms, there is no Bargain Purchase in Example #2 since JIE is paying consideration equal to the present fair market value of the acquired assets. It is significant to note that JIE pays a full $80 for the tax benefits associated with the RRIs in Example #2. Arguably, this is the highest purchase price possible for the RRIs as it assumes that the tax losses will be generated and used in Year 1. Therefore, it is clear that a Bargain Purchase will always be deemed to occur for financial accounting purposes in this transaction since the Deferred Tax Asset must be recorded based on the gross difference between the book and tax bases of the RRIs.

Accordingly, the Bargain Purchase and the resulting accounting benefit is solely a creation of the accounting rules and the lack of a present value concept in the recording of the Deferred Tax Asset. In other words, the Bargain Purchase arises, not because the tax basis in the RRI carries over, but because the portion of the purchase price consideration paid for the tax benefits reflects their expected fair market value benefit, while the accounting rules require recording the Deferred Tax Asset based upon the gross difference between the tax basis and the book basis.

In isolation, a bargain purchase will arise for accounting purposes any time that the consideration attributable to a tax benefit reflects a discount to the gross Deferred Tax Asset.

Transaction Scenarios:

Below are a series of scenarios which illustrate the financial accounting impact of the bargain purchase and the related effect, if any, upon the income statement. In all these transactions, Co. A and Co. B contribute assets to the JIE, which is referred to as "Subco", in a Section 351 transaction. The base case scenario ("Transaction #1") illustrates the impact of Co. B receiving solely stock in the Section 351 transaction in exchange solely for the RRI. In the base case scenario, the benefit of the bargain purchase from the tax basis in the RRI does not flow through the income statement, but rather results in a direct increase in stockholder's equity. **Subco does not derive any income statement benefit from the tax basis in the RRIs.**

In the second scenario ("Transaction #2"), Co. B receives stock and debt of Subco in exchange for the RRIs. In addition, any shareholder with a 4% voting interest may force a recapitalization of Co. B's stock and debt investment into solely a debt instrument of Subco. This provision enables the JIE to record a deferred credit as a result of a "bargain purchase" for accounting purposes (rather than booking the amount directly to equity). This deferred credit is grossed up and reverses into "other income" above the tax line on a grossed-up basis as the RRI losses are recorded. In other words, the recapitalization provides two accounting benefits: (1) the amortization of the deferred credit through pre-tax income and (2) the recording of a gross-up of the deferred credit.

The third scenario ("Transaction #3"), includes a contribution of "other assets" by Co. B in exchange for cash and debt as a part of the Section 351 transfer. The contribution of the "other assets" enables Subco to accelerate a substantial portion of the accounting benefits related to the reversal of the deferred credit over a significantly shorter period of time than in the second scenario.

I. ***Transaction #1 Base Case Scenario - Basic Section 351 Transaction***

Net Impact: ***No Income Statement Accounting Benefits***

Description of Transaction

- Unrelated companies, Co. A and Co. B, will enter into a venture for the purpose of making investments in various assets. The entity to be used for this venture is an existing wholly-owned subsidiary of Co. A ("Subco").

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- Co. A will contribute $135 million of cash in exchange for common stock representing 95.1% of the vote and approximately 90% of the value of Subco.

  In exchange for all of the voting preferred stock of Subco representing 4.9% of the voting power and approximately 10% of the value of Subco, Co. B will contribute RRIs to Subco. The RRIs have been held by Co. B for 5 years and generated a total of $215 million of income in those years. As a result of this income recognition, the RRIs have a current tax basis of $215 million. The RRIs are expected to start generating losses in the year of contribution and are expected to continue to generate losses for the next 20 years. The total of such losses is expected to equal the current tax basis of $215 million. Assuming a 40% effective tax rate, the recognition of $215 million of tax losses will provide a cash tax benefit of approximately $86 million. However, the realization of these losses will be spread over the next 20 years and the actual use of some of these losses against taxable income will likely occur beyond 20 years into the future. Accordingly, the present value of the anticipated $80 million cash benefit is only $15 million. Thus, Co. B contributes RRIs with a fair market value and book basis of $15 million and a tax basis of $215 million.

- Subco will invest the $135 million of cash received from Co. A in income generating assets (i.e., mortgages, leased assets).

Financial Accounting Discussion

- Since Company A will hold stock with a majority of the voting power and value of Subco, Subco will continue to be consolidated with Co. A for financial accounting purposes.

- Certain "Purchase Accounting" rules apply to combinations of business enterprises. The RRIs acquired by Subco will likely not meet the definition of a business. Thus, as a technical matter these rules do not directly apply. However, the Purchase Accounting rules will still be looked to by analogy as they constitute the best guidance for the purchase of a pool of assets.

- Under these Purchase Accounting rules, Subco records the acquired assets at their respective fair market values. In addition, where differences exist between the book basis and the tax basis in the acquired assets, Deferred Tax Assets and/or Deferred Tax Liabilities must be recorded by Subco.

- As a result of applying these Purchase Accounting rules, Subco initially records an accounting entry for the acquisition of the RRIs as follows (assuming a 40% effective tax rate):

REMIC Residual	15	
Deferred Tax Asset (*)	80	
Minority Interest (Co. B Equity)		15
Stockholders' Equity		80

(*) $215 tax basis less $15 book basis times 40% effective tax rate

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- **In effect, due to the application of the accounting rules, Subco is treated as having made a *Bargain Purchase*. In other words, for accounting purposes, the transaction is viewed as an acquisition of a pool of assets worth $95 (RRIs of $15 and a Deferred Tax Asset of $80) for only $15 of consideration. However, since Subco is treated as having issued *solely* stock as consideration in this acquisition, the Purchase Accounting rules require that the benefit of this $80 Bargain Purchase be recorded as a direct increase in stockholders' equity (i.e. it does not flow through the income statement) rather than creating a Deferred Credit which would reverse over time as earnings in the income statement.**

Net Impact of Transaction

- The Deferred Tax Asset of $80 will reverse over time as the RRIs generate tax losses. The use of such tax losses will effectively provide cash flow to Subco. Accordingly, the Deferred Tax Asset will provide $80 of cash tax benefits to Subco in the future. However, due to the Purchase Accounting rules, there would be no income statement benefit to such cash tax benefits. As indicated above, the benefit of the cash flow is added to stockholders' equity at the date of contribution of the RRIs to Subco and is not included in the income statement. Accordingly, while Subco would receive a cash benefit from acquiring the RRIs, there would be no income statement accounting benefit to the acquisition.

- **It is also significant to note that Subco is not securing a benefit from tax deductions that would otherwise be unusable by Co. B.** In fact, Co. B would be able to use the losses to be generated by the RRIs and could accelerate the usable loss by simply selling the RRIs outright. This conclusion is also applicable to Transactions #2 and #3 below.

- **The $80 Deferred Tax Asset is recorded based upon the book-tax basis differences in the RRIs. As discussed, the Deferred Tax Asset reverses as the losses from the RRIs are generated. The recording and reversal of the Deferred Tax Asset attributable to the book-tax differences, and the lack of an impact upon the income statement, is the same in all three transactions because the tax basis in the RRIs carries over in all three transactions. Therefore, the differences in the three transactions solely relates to: (1) the recording of the "Deferred Credit" in Transactions #2 and #3; (2) the grossing-up of the Deferred Credit; and (3) the timing of the reversal of the Deferred Credit into book earnings.**

- **It is our professional opinion that our corporate clients would either not enter into this Base Case Transaction or would pay very little for the cash benefits associated with this Base Case Transaction.**

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II. *Transaction #2 - Base Case With Addition of Recapitalization Provision*

Net Impact: Income Statement Benefits Created ("Above-the-Line" & "Grossed-up")

Description of Transaction

Same Facts as in the Base Case Transaction, except that:

- Co. A will contribute $135 million of cash to Subco in exchange for common stock representing 95.1% of the vote and approximately 94% of the value of Subco.
- Co. B will contribute RRIs to Subco with a fair market value and book basis (to Subco) of $15 million and tax basis of $215 million in exchange for all of the voting preferred stock of Subco representing 4.9% of the voting power and approximately 6% of the value of Subco and a $7 million Subco debt security (the "Original Debt").
- The corporate charter of Subco will contain a provision (the "Recapitalization Provision") which will allow any shareholder with a 4% voting interest to force a recapitalization of Co. B's preferred stock interest and original debt security into a new debt security any time after five years from the date of the formation of Subco.

Financial Accounting Discussion

Same as in the Base Case Transaction, except that:

- As a result this transaction, Subco's initial accounting entry for the acquisition of RRIs would instead be as follows:

REMIC Residual	15	
Deferred Tax Asset (*)	80	
Original Debt		7
Minority Interest (Co. B Equity)		8
Deferred Credit		80

(*) $215 tax basis less $15 book basis times 40% effective tax rate

- Subco still is treated as having made a Bargain Purchase since $95 of assets (RRIs of $15 and the $80 Deferred Tax Asset) are acquired for only $15 of consideration ($7 of debt and $8 of equity), creating an $80 Bargain Purchase. As in Transaction #1, the net worth of Subco is enhanced by the accounting value of the Bargain Purchase. However, in contrast to Transaction #1, special accounting rules applicable in Transaction #2 substantially alter how the Subco accounts for the Bargain Purchase element.
- The Recapitalization Provision allows any shareholder with a 4% or more voting interest to force a recapitalization of Co. B's preferred stock interest into a debt instrument. For financial accounting purposes, the likelihood of exercise of the Recapitalization Provision enables Subco to treat the contribution of the RRIs as a purchase by Subco for cash and debt

rather than stock. **Under the Purchase Accounting rules, the benefit of the Bargain Purchase in an acquisition using either cash or debt should not go directly to Subco's equity (as in the Base Case Transaction); instead, an $80 Deferred Credit is initially booked as a liability on Subco's balance sheet to represent the Bargain Purchase.**

- There is a bias in the financial accounting rules against recording Deferred Credits. Generally, the governing bodies would prefer a business entity to reduce the book basis of the acquired assets rather than record a Deferred Credit. However, certain accounting rules prevent the reduction of the book basis in the RRI. Under the facts in Transaction #2, no other assets exist which Subco could reduce prior to the recording of a Deferred Credit. Accordingly, the Deferred Credit would be recorded instead of a direct increase in stockholders' equity.

- The initial recording of the $80 Deferred Credit causes a book-tax basis difference to exist in the Deferred Credit itself (the tax basis in the Deferred Credit or liability is zero). In turn, the book-tax difference in the Deferred Credit requires the recording of an additional Deferred Tax Asset, thus creating an additional Bargain Purchase element and a corresponding additional Deferred Credit. The new Deferred Credit would again require the recording of a Deferred Tax Asset and so forth on an iterative basis. Accordingly, the net result would be an additional acquisition entry of:

Deferred Tax Asset	53	
Deferred Credit		53

This accounting rule results in a "Gross-Up" of the accounting benefit related to the Bargain Purchase of assets. In other words, the accounting rules cause the original Deferred Credit of $80 to be "grossed up" by Subco's effective tax rate so that the total Deferred Credit is $133 ($80 divided by (1-40% tax rate)). The above entry for $53 ($133 less $80) is recorded as a result of this Gross-Up.

Net Impact of Transaction

- The Deferred Credit will be amortized over time, creating $133 of accounting income. Specifically, this accounting income is recorded in pre-tax earnings as "Other Income." Thus, the additional income is recognized "Above-the-Tax-Line" in Subco's and Co. A's income statements. Accounting rules require that the amortization would occur over the life of the acquired assets, based on a "rational and systematic" methodology. One acceptable methodology is based on the gross returns provided by the acquired assets. Since the RRIs are the only "acquired" assets, the Deferred Credit is amortized in Years 1 through 20 as the RRIs provide economic returns.

It should be noted that the difference between the Base Case and Transaction #2 does not result from securing cash tax benefits that would not otherwise exist. Instead, the difference between the two scenarios is due solely to the differing application of the financial accounting rules where the Recapitalization Provision exists. In the Base Case and Transaction #2, the cash tax benefits remain the same.

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- As in the Base Case Transaction, the Deferred Tax Asset of $80 recorded in the original acquisition entry will reverse over time as tax losses are recognized from the RRI. There will be no net impact to the income statement, however, as Subco will recognize a current tax benefit when those losses are recognized which will offset the deferred tax cost from the reversal of the Deferred Tax Asset.

- The Deferred Tax Asset of $53 recorded in the second acquisition entry will reverse in proportion with the reversal of the related Deferred Credit. Since this Deferred Tax Asset will not generate actual current tax losses, the reversal of the asset will generate a net Tax Expense to Subco. Thus, a $53 Tax Expense will be recognized in Subco's and Co. A's income statements over years 1 through 20. (Note: As a result, the Gross-Up does not result in an overall increase in Net Book Income because the $53 of "Above-the-Line" income is offset by the $53 increase in the Tax Expense. However, as discussed earlier, the increase in Pre-Tax Earnings is valuable to many corporations, even if such amount is offset by an additional Tax Expense.)

- **It is important to note that the same Federal income tax principals apply in both the Base Case Transaction and in Transaction #2 and the cash tax consequences under both transactions are identical. The addition of the Recapitalization Provision in Transaction #2 provides the following substantial and qualitative accounting benefits to Subco: (1) a Deferred Credit of $80 is recorded, (2) the Deferred Credit is grossed-up from $80 to $133; and (3) the Deferred Credit is reversed into book income as compared to the base case scenario which had no income statement benefit.**

- **It is our professional opinion that our corporate clients would be interested in Transaction #2 and would pay a moderate fee for the financial accounting benefits associated with Transaction #2.**

III. Transaction #3 - Same as Transaction #2 With Additional Assets Contributed by Co. B

Net Impact: Income Statement Benefits Accelerated

Description of Transaction

Same Facts as in Transaction #2, except that:

- Co. A will contribute $135 million of cash to Subco in exchange for common stock representing 95.1% of the vote and approximately 90% of the value of Subco.

- In exchange for cash in the amount of $135, all of the voting preferred stock representing 4.9% of the voting power and approximately 6% of the value of Subco and the $7 million Subco Original Debt security, Co. B will contribute to Subco:
    1. a portfolio of leased assets with a 5 year economic life and a fair market value of $135 million; and
    2. RRIs with a fair market value and book basis (to Subco) of $15 million and tax basis of $215 million (collectively, the "Co. B Assets")

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Financial Accounting Discussion

Same as in Transaction #2, except that:

- As a result this transaction, Subco's initial accounting entry for the acquisition of the Co. B assets would instead be as follows:

REMIC Residual	15	
Leased Assets	135	
Deferred Tax Asset (*)	80	
Cash		135
Original Debt		7
Minority Interest (Co. B Equity)		8
Deferred Credit		80

(*) $215 tax basis less $15 book basis times 40% effective tax rate

- Due to the strict application of the accounting rules, Subco is again treated as having made a Bargain Purchase of the Co. B assets. In other words, $230 of assets (RRIs of $15, Leased Assets of $135 and the Deferred Tax Asset of $80) are acquired for only $150 of consideration (cash of $135, debt of $7 and equity of $8), again creating an $80 Bargain Purchase.

- As indicated above, as a result of the bias in the financial accounting rules against recording Deferred Credits, the governing accounting bodies would prefer to reduce the book basis of the acquired assets. Certain rules prevent reduction of the book basis in the RRIs. However, these rules would not prevent a reduction in the book basis of the Leased Assets. Such a reduction would create a book-tax basis difference in the Leased Assets, and in turn would require the recording of a Deferred Tax Asset and a corresponding additional Deferred Credit. The new Deferred Credit would again reduce the book basis of the Leased Assets and so forth on an iterative basis. Accordingly, the net result would be an additional acquisition entry of:

Deferred Tax Asset	53	
Deferred Credit	80	
Leased Assets		133

- As a result, the net acquisition entry would be as follows:

REMIC Residual	15	
Leased Assets	2	
Deferred Tax Asset	133	
Cash		135
Original Debt		7
Minority Interest (Co. B Equity)		8
Deferred Credit		0

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Net Financial Impact of Transaction

- Assuming the value of the Leased Assets remains constant, Subco will recognize $133 of pre-tax operating income upon the sale of the Leased Assets (e.g., a sale for $135 of proceeds less book basis of $2). Alternatively, Subco could recognize higher pre-tax earnings via lower book depreciation expense on the Leased Assets over their 5 year economic life (e.g., only $2 of depreciation rather than $135).

  Thus, Subco would accelerate the "Above-the-Line" & "Grossed-Up" Accounting benefit in Transaction #3. Instead of recognizing the accounting benefit in years 1-20 as in Transaction #2, the accounting income would be recognized no later than years 1-5 (as the Leased Assets are depreciated for book purposes) and could be recognized even earlier if the assets are sold. This acceleration is solely the result of the special application of the Purchase Accounting rules in the case where Co. B contributes assets to Subco in addition to the RRIs. There is no difference in the cash tax benefits between the Base Case Transaction, Transaction #2 and Transaction #3.

- As in the Base Case and Transaction #2, the Deferred Tax Asset of $80 recorded in the original acquisition entry will reverse over time as tax losses are recognized from the RRI. There will be no net impact to the income statement, however, as Subco will recognize a current tax benefit when those losses are recognized which will offset the deferred tax cost from the reversal of the Deferred Tax Asset.

- As in Transaction #2, the Deferred Tax Asset of $53 recorded in the second acquisition entry will create a tax expense on Subco's and Co. A's income statements. The reversal of this Deferred Tax Asset should occur at the same time that the basis reduction in the Leased Assets is reversed (e.g., at the time the Leased Assets are sold or over the 5 year depreciable period if the Leased Assets continue to be held by Subco).

- **It is our professional opinion that our corporate clients would be extremely interested in Transaction #3 and would pay a substantial fee for the financial accounting benefits associated with Transaction #3.**

Summary

In summary, it should be apparent from the above discussion that the Transaction is a deal driven by the accounting benefits. If a client were interested in the tax benefits, other less expensive alternatives exist to generate equivalent tax benefits. Moreover, it is our professional opinion that a business entity would be willing to pay (1) little, if any, fee for Transaction #1, (2) a moderate fee for Transaction #2 and (3) a substantial fee for Transaction #3.

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