

IX. TAX OPINION LETTERS

RELATING TO

PROJECT APACHE

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WRITER'S DIRECT NUMBER:

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Enron Corp.
1400 Smith Street
Houston, TX 77002

Preferred Units Financing

Ladies and Gentlemen:

This letter sets forth our opinion with respect to certain United States federal income and withholding tax ("U.S. tax") aspects of the transactions described below (collectively, the "Transaction") under the Internal Revenue Code of 1986, as amended (the "Code").¹

We understand that Enron Corp. ("Company") and its affiliates are engaging in the Transaction to accomplish the objectives of factoring receivables, raising capital for their business operations and to retire existing indebtedness.

TRANSACTION

For U.S. tax purposes, Company is the common parent of an affiliated group that files a consolidated U.S. tax return on a calendar basis and uses the accrual method of accounting.

Company will transfer \$748.5 million² to Seminole Capital L.L.C., a newly-formed Delaware limited liability company ("Company LLC"), in exchange for 99.8 percent of the member interests in Company LLC, and The Lucelia Foundation, a New York not-for-profit

¹ Unless otherwise indicated, all "Section" references are to the Code and all "Treas. Reg." references are to the Treasury Regulations promulgated thereunder.

² All numerical amounts used herein are approximations.

corporation which is unrelated to Company ("TLF", and together with Company, the "Company LLC Members") will transfer \$1.5 million to Company LLC in exchange for 0.2 percent of the member interests in Company LLC.

Company LLC will contribute \$20,000 to Cheyenne Finance S.a r.l., a newly-formed Luxembourg company ("SARL"), in exchange for all of its outstanding common stock, and will transfer \$749.98 million to SARL in exchange for Subordinated Convertible Equity Certificates (the "Certificates"). Payments on the Certificates will be made if, as and when declared by SARL's board of managers. The Certificates will have a term of 99 years and will be subordinate to all present and future obligations and interests in SARL other than its common stock.

Rabo Merchant Bank N.V., a Dutch limited liability company ("Rabo"), will organize Choctaw Investors B.V., a Dutch company ("Investor BV"), and will contribute \$15 million to Investor BV in exchange for all of its common stock. Investor BV will borrow \$485 million from various lenders.

SARL and Investor BV will organize Cherokee Finance V.O.F., a general partnership (*vennootschap onder firma*) organized under the laws of the Netherlands ("Dutch VOF"). Dutch VOF will have two classes of outstanding units, common and preferred, as described below.

SARL will contribute \$750 million to Dutch VOF in exchange for 100 percent of the common units of Dutch VOF (the "Common Units"). SARL will be the common general partner of Dutch VOF. The Common Units will have: (i) no final maturity, and (ii) no right to distributions while the Preferred Units (as defined below) remain outstanding. In addition, the holder of the Common Units will elect two of the three members of the board of directors of Dutch VOF (the "Board"). A ruling issued by the Luxembourg tax inspectorate (the "Luxembourg Tax Ruling") states that SARL will be required, on an annual basis, to include in its gross income, for Luxembourg tax purposes, its allocable share of income derived by Dutch VOF.

Investor BV will contribute \$500 million to Dutch VOF in exchange for 100 percent of the preferred units of Dutch VOF (the "Preferred Units"), which will be placed with Investor BV by Chase Securities, Inc. ("Chase"). The Preferred Units will have: (i) the right to a floating rate, cumulative distribution equal to a formula percentage multiplied by the liquidation preference of such units if, as and when declared by the Board (the "Preferred Distribution") out of retained earnings (as determined for U.S. GAAP purposes), (ii) an initial liquidation preference of \$500 million, which will thereafter be increased by any accrued but unpaid Preferred Distributions, and reduced by the amount of any Redemption Proceeds (as defined below) received with respect to the Preferred Units, and (iii) a ten-year stated redemption date, at which time the Preferred Units will be redeemed for their liquidation preference at that time. In addition, the Preferred Units generally will be redeemable in whole or in part at any time at the option of Dutch VOF. (Amounts paid by Dutch VOF to Investor BV in an optional redemption of Preferred Units will be referred to hereinafter as "Redemption Proceeds.")

The holder of the Preferred Units will elect one of the three Board members. In addition, without the affirmative vote of the holders of more than 50 percent of the Preferred Units, Dutch VOF will not undertake any of a number of actions, including (i) entering into any transaction of merger or consolidation, (ii) liquidating, winding up or dissolving itself, or commencing a voluntary case, action or proceeding under any bankruptcy or insolvency laws, or (iii) conveying, selling, leasing, transferring or otherwise disposing of, in one transaction or a series of transactions, all or substantially all of the property of Dutch VOF.

At the end of five years, the Preferred Units holder, at its option, will be permitted to hold the Preferred Units at the then current Preferred Distribution rate for the subsequent five-year period. If the holder elects not to continue to hold the Preferred Units at the then current Preferred Distribution rate, the holder and Dutch VOF may agree to a new distribution rate for Preferred Distributions. If the holder of the Preferred Units and Dutch VOF cannot agree on a new distribution rate, the holder may tender its shares to a security agent, who will attempt to set such dividend rate, using a "Dutch auction rate" mechanism, at the lowest possible rate which would allow the units to be sold for an amount equal to their liquidation preference. If the holder opts to tender all or any portion of its Preferred Units, and the security agent cannot place the Preferred Units, the holder will be required to hold the Preferred Units at a "default rate." In the case of a failed placement of the Preferred Units, a new auction will be conducted each month until the Preferred Units have been successfully placed by the security agent. A ruling issued by the Dutch tax inspectorate (the "Dutch Tax Ruling") states that Investor BV will be required, on an annual basis, to include in its income, for Dutch tax purposes, its allocable share of income derived by Dutch VOF.

Pursuant to an agreement between Company LLC and Rabo, Company LLC will have an option to purchase all of the outstanding shares of Investor BV. This option will terminate after nine and one-half years (*i.e.*, six months prior to the ten-year stated redemption date).

Dutch VOF (i) will have its books and records maintained outside of the United States; (ii) will have its activities conducted by its own officers, employees and/or agents hired by Dutch VOF and not those of Company or its affiliates (although such officers, employees and/or agents may be employed by both Dutch VOF and Company or one of its affiliates); (iii) will pay all of its own expenses, including taxes, from the earnings on its investments (other than organizational expenses, which will be paid out of the capital contributed by SARL); and (iv) will engage in all transactions on an arm's-length basis, including compensating on an arm's-length basis any related or unrelated person for services provided to Dutch VOF. Interest paid on any loans made by Dutch VOF to Company (or an affiliate of Company) will be within the range of market interest rates, taking into account all the terms and conditions of the loans. Dutch VOF's books of account, trial balances and tax returns will be prepared by outside accountants. Board meetings will be held outside of the United States, at which time any investment or lending decision for Dutch VOF for the succeeding period will be made and certified by the Board.

Dutch VOF generally will be permitted to invest its capital and earnings in the following: (i) cash equivalents; (ii) debt securities of any U.S. corporation rated "A" or better by

S&P or "A2" or better by Moody's; (iii) indebtedness of Company; (iv) indebtedness of any affiliate of Company, provided that such indebtedness is guaranteed by Company and (v) regular interests ("FASIT Interests") in entities which elect to be treated as fixed asset securitization investment trusts ("FASITs") for U.S. tax purposes (the assets collectively described in clauses (i) through (v) shall be known as "Core Permitted Assets").³ It is anticipated that Dutch VOF will initially use most of the cash it receives to purchase FASIT Interests. Dutch VOF also may invest in any other debt securities ("Other Permitted Assets") so long as (i) the ratio of Core Permitted Assets (subject to certain other limitations such as duration of investment) to the current liquidation preference of the Preferred Units equals or exceeds 1.5 to 1, and (ii) the ratio of the sum of Core Permitted Assets and Other Permitted Assets to the current liquidation preference of the Preferred Units equals or exceeds 2.5 to 1.

ASSUMPTIONS

In rendering the opinions set forth below, we have relied, with your permission and without independent investigation or verification, on the following assumptions:

1. Under U.S. GAAP, Dutch VOF will be consolidated with Company for financial accounting purposes, and the Preferred Units will be reflected as a "minority interest in subsidiary" on the balance sheet of Company.
2. SARL will not elect, pursuant to Treas. Reg. § 301.7701-2, to be disregarded as an entity separate from Company LLC for U.S. tax purposes.
3. Dutch VOF will elect, pursuant to Treas. Reg. § 301.7701-2, to be classified as an association taxable as a corporation for U.S. tax purposes.
4. Investor BV will not elect, pursuant to Treas. Reg. § 301.7701-2, to be disregarded as an entity separate from Rabo for U.S. tax purposes.
5. Company LLC will not elect, pursuant to Treas. Reg. § 301.7701-2, to be classified as an association taxable as a corporation for U.S. tax purposes.
6. The general partnership agreement of Dutch VOF will provide for rights and remedies to the holder of the Preferred Units upon a default in the payment of any Preferred Distribution that are customary and consistent with the rights and remedies set forth in other privately placed preferred stock.
7. Investor BV and its direct and indirect owners will treat the Preferred Units as equity for U.S. tax purposes and will not take any action that is inconsistent with such treatment.

³ Certain U.S. tax issues relating to the FASIT Interests are discussed in a separate opinion letter to you dated the date hereof.

8. The business of Dutch VOF largely will consist of holding FASIT Interests, lending funds to Company and its affiliates and purchasing, selling and investing in Core Permitted Assets and Other Permitted Assets. Dutch VOF will conduct this business outside of the United States and will not have a place of management, branch or office in the United States.

9. Any loans made by Dutch VOF to Company or any Company affiliate will constitute valid indebtedness for U.S. tax purposes.

10. More than 70 percent of Dutch VOF's gross income will consist of income with respect to FASIT Interests and interest paid by Company or Company Affiliates with respect to loans made by Dutch VOF to Company or its affiliates.

11. The Company affiliated group will have current and accumulated earnings and profits for each year in which the Preferred Units are outstanding in excess of the aggregate amount of distributions that may reasonably be anticipated to be made to shareholders of Company for such year, and Dutch VOF, therefore, is not being formed and will not be availed of with a view to permit the Company affiliated group to avoid making dividend distributions to Company's shareholders.

12. The shareholders of Investor BV will not be at least ten percent related through ownership with Company.

13. More than 50 percent of the stock of Investor BV (by vote and value) will be owned, directly or indirectly, by persons who are entitled to the benefits of the Dutch Treaty (as defined below) under paragraph 1 of Article 26 of the Dutch Treaty.

14. Either (i) less than 50 percent of the gross income of Investor BV will be used, directly or indirectly, to make payments that are deductible for Netherlands income tax purposes in a given taxable year to persons that are not entitled to the benefits of the Dutch Treaty under paragraph 1 of Article 26 of the Dutch Treaty, or (ii) both (A) less than 70 percent of the gross income of Investor BV will be used, directly or indirectly, to make payments that are deductible for Netherlands income tax purposes in a given taxable year to persons that are not entitled to the benefits of the Dutch Treaty under paragraph 1 of Article 26 of the Dutch Treaty and (B) less than 30 percent of the gross income of Investor BV will be used, directly or indirectly, to make payments that are deductible for Netherlands income tax purposes in a given taxable year to persons that are neither entitled to the benefits of the Dutch Treaty under paragraph 1 of Article 26 of the Dutch Treaty nor "residents of member states of the European Communities" (as such term is defined in the Dutch Treaty).

15. The aggregate number of shares in the principal class of Company shares that are traded on a recognized stock exchange (as defined in the Dutch Treaty) per year has exceeded and is expected to continue to exceed 6 percent of the average number of shares outstanding in such class during that taxable year.

16. Less than 50 percent of the income of SARL will be used, directly or indirectly, to make payments that are deductible for Luxembourg income tax purposes in a given taxable year to persons that are not entitled to the benefits of the New Luxembourg Treaty (as defined below) under paragraph 2 of Article 24 of the New Luxembourg Treaty.

17. The placement fees paid by Company and Dutch VOF to Chase in connection with the issuance of the Preferred Units are reasonable and consistent with fees charged for other quasi-equity financing transactions in the market, such as "MIPS" and "TOPrS."

18. The aggregate fair market value of the assets contributed to Dutch VOF by SARL is not in excess of what would be reasonably necessary to secure the lowest possible Preferred Distribution rate on the Preferred Units in light of the assets of Dutch VOF following such contribution and the terms of the Preferred Units.

19. At least \$5 million of Dutch VOF's assets will be invested at all times in instruments that are not issued or guaranteed by Company or a Company affiliate.

20. A realistic possibility exists that Company would let the Preferred Units be auctioned, rather than call such stock, in the event that the holder of the Preferred Units chose to tender such stock for auction.

21. The default rates associated with a defaulted auction are commercially reasonable in light of other auction rate preferred equity interests issued out of companies with similar credit quality.

22. Company LLC might, based on objective economic factors (and ignoring tax considerations), exercise its option to acquire the shares of Investor BV.

23. No side letters (inconsistent with any of the foregoing assumptions or facts) or unwritten understandings exist relating to the Transaction.

24. Investor BV will not engage in any activities that will cause Investor BV to be considered as engaged in the conduct of a trade or business in the United States.

Assumptions 6, 17, 18, 20, 21 and 22 will be confirmed through representations made in writing by The Chase Manhattan Bank. Assumption 13 will be confirmed through a representation made in writing by Rabo.

SUMMARY OF OPINIONS

The conclusions expressed herein are based upon our interpretations of current U.S. tax law, such law being subject to change both prospectively and retroactively, and upon the facts, statements and assumptions discussed herein. In addition, we have relied on the opinion of

Dutch counsel to the effect that the provisions of the Dutch VOF agreement are effective under local law.

Based upon and subject to the analysis set forth below and the assumptions and statements referred to herein, it is our opinion that for U.S. tax purposes:

1. Dutch VOF should be treated as a corporation.
2. The Preferred Units should be characterized as equity, not debt.
3. The Certificates should be characterized as equity, not debt.
4. For each taxable year, subpart F income (as defined in Section 952(a)) of Dutch VOF equal to the sum of (i) the Preferred Distributions made or accrued in such year and (ii) the outstanding liquidation preference of the Preferred Units on the last day of such year should be taken into account by the holder of the Preferred Units. Any remaining subpart F income should be taken into account by Company LLC as indirect holder of the Common Units.
5. Dutch VOF should not be classified as a passive foreign investment company with respect to the holders of the Common Units.
6. The direct and indirect holders of the Common Units should have no inclusion of income under the foreign personal holding company rules with respect to the Common Units.
7. Dutch VOF should not be subject to the accumulated earnings tax.
8. The form of the Transaction should be respected and not disregarded on the grounds that it constitutes an economic sham.
9. Dutch VOF's initial issuance of the Preferred Units should not be treated as creating a "fast-pay arrangement" within the meaning of Prop. Reg. § 1.7701(i)-3(b)(1).
10. Section 269 should not be applied to reallocate subpart F income to Company.

In rendering the opinions contained herein, we have relied on the accuracy and completeness of the facts, information, covenants, statements and representations contained in (1) the General Partnership Agreement of Dutch VOF, (2) the Option Agreement between Company LLC and Rabo, (3) the Contribution Agreements between Investor BV and Dutch VOF and between SARM and Dutch VOF, (4) the \$485 million Credit Agreement of Investor BV (the "Investor BV Credit Agreement"), (5) the limited liability company agreement of Company LLC, (6) statements and information provided to us by Company, Chase and Rabo, and (7) such other statements, information and documents as we have deemed relevant. We have assumed that such statements and documents reflect all material facts regarding the formation and operation of Dutch VOF and all related transactions. In addition, we have assumed that the Transaction has been and will be carried out in accordance with such statements and documents, that all

statements (whether or not set forth in a document) were true and correct when made and continue to be true and correct and that none of the material terms contained in any document have been or will be waived or modified. In our examination of the documents, we have assumed that all documents submitted to us are authentic and have been duly executed by appropriate and authorized parties.

We have not considered and do not express any opinion as to any U.S. tax consequences of the Transaction other than those expressly stated above. Specifically, we do not address compliance issues and form filing requirements (including the filing of Form 5471 and forms required in order to secure any treaty exemption) except as otherwise noted. We also have not considered and do not express any opinion with respect to the tax consequences of the Transaction under any state, local or foreign tax law.

The opinions set forth above are based upon current U.S. tax law and administrative practice as in effect on the date hereof. In rendering such opinions, we have considered the pertinent facts and circumstances and the current U.S. tax law and administrative practice as it relates to such facts and circumstances. We do not undertake to advise you as to future changes in U.S. tax law that may affect the opinions contained herein.

This opinion is being furnished to you solely for your use in regard to the Transaction and is not to be used, relied upon, circulated, quoted or otherwise referred to for any other purpose without our prior written consent.

An opinion of counsel is not binding on the Internal Revenue Service (the "IRS") or the courts. There can be no assurance that the IRS will not take a contrary position with respect to the conclusions set forth above or as to how a court would decide the issues discussed herein.

DISCUSSION

I. STATUS OF SARL, INVESTOR BV AND DUTCH VOF FOR U.S. TAX PURPOSES

We have been advised to assume that SARL will not elect to be disregarded as an entity separate from Company LLC for U.S. tax purposes. A foreign entity that does not elect otherwise is generally treated as an association if all of the entity's members have limited liability.⁴ Based on the opinion of Luxembourg counsel that members of an SARL have limited liability, and assuming no election is made, SARL should be treated as an association taxable as a corporation for U.S. tax purposes.

We have also been advised to assume that Investor BV will not elect to be disregarded as an entity separate from Rabo for U.S. tax purposes. Based on the opinion of

⁴ Treas. Reg. § 301.7701-3(b)(2)(i)(B).

Dutch counsel that members of a BV have limited liability, and assuming no election is made, Investor BV should be treated as an association taxable as a corporation for U.S. tax purposes.

We have also been advised to assume that Dutch VOF will elect to be treated as an association taxable as a corporation for U.S. tax purposes. Accordingly, Dutch VOF should be classified as a foreign corporation for U.S. tax purposes, and the interests held by each of SARL and Investor BV should be treated as stock interests in Dutch VOF.⁵

II. DUTCH VOF SHOULD BE RESPECTED AS A SEPARATE ENTITY FOR U.S. TAX PURPOSES

Although the existence of an entity (such as Dutch VOF) can, under certain circumstances, be ignored for U.S. tax purposes if necessary to reflect the true substance of a transaction, this result would not be appropriate with respect to Dutch VOF's participation in the Transaction. In *Moline Properties, Inc. v. Commissioner*,⁶ the Supreme Court applied the substance over form doctrine for the purpose of determining whether an entity should be respected for U.S. tax purposes. In *Moline Properties*, the taxpayer, who was the sole shareholder of a corporation, attempted to characterize gain from the sale of real property, title to which was held by the corporation, as gain to the sole shareholder individually, and to declare the existence of the corporation "merely fictitious" for U.S. tax purposes. The Supreme Court held that the taxpayer could not disregard the corporate form of his business organization unless such form was a "sham."

In so holding, the Supreme Court stated:

Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.⁷

This standard has been consistently applied by courts in determining whether corporations should be respected as separate entities.⁸

⁵ Treas. Reg. § 301.7701-3(a).

⁶ 319 U.S. 436 (1942).

⁷ *Id.* at 438-39.

⁸ See, e.g., *Bollinger v. Commissioner*, 485 U.S. 340 (1988); *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945); *Nutt v. Commissioner*, 39 T.C. 231 (1962), *rem'd on another issue*, 351 F.2d 452 (9th Cir. 1965), *cert. denied*, 384 U.S. 918 (1966), *acq.* 1964-2 C.B. 5; *Siegel v. Commissioner*, 45 T.C. 566 (1966), *acq.* 1966-2 C.B. 7; *Bass v. Commissioner*, 50 T.C. 595 (1968).

The Supreme Court in *Moline Properties* explicitly established a two-prong disjunctive test for determining whether an entity should be disregarded. The first prong is a subjective standard requiring the taxpayer to demonstrate a legitimate, non-tax business purpose that is served by the selection of the corporate form as a separate and independent vehicle for owning and conducting the subject activity. The second prong is an objective standard merely requiring a demonstration that the entity has engaged in sufficient business activity to warrant its recognition as that particular type of entity. If either prong of the test is satisfied, the organization will be recognized as a separate entity.⁹

In *Moline Properties*, the corporation's only business activity was to lease a portion of land held by it prior to sale. The corporation transacted no other business, kept no books of account and maintained no bank account for the deposit of the rental funds, yet the form of the corporation was respected. In *Rogers v. Commissioner*,¹⁰ the absence of an office, employees, books and records did not result in finding a lack of business activity. The entity's negotiation and renegotiation of loans, use of bank accounts, payment of state taxes and filing of certain reports and statements were found to constitute sufficient activity to satisfy the active business test.

The primary business purpose for the formation of Dutch VOF, and the Transaction in general, is to raise capital. The form permits Company to characterize the transaction as quasi-equity "minority" interest for accounting purposes. That there may be some alternative structure available to the parties to undertake the financing which would result in an increased tax liability to the parties is not relevant because, as stated in *Gregory v. Helvering*,¹¹ taxpayers are free to structure a transaction in a form that minimizes or eliminates taxes that would arise under any other structure.

The second prong of the *Moline* test should also be satisfied because Dutch VOF's business activities will include substantial investments. Dutch VOF will receive [\$750 million] from Company LLC and [\$500 million] from Investor BV. Dutch VOF will (i) invest in FASIT Interests, (ii) make loans to Company and Company affiliates, (iii) have the authority to lend to third parties, (iv) maintain books and records, and (v) file local tax returns. In addition, it is expected that Dutch VOF will accumulate significant funds on an annual basis which it will reinvest in "permitted assets." Therefore, Dutch VOF should have sufficient business activity to assure separate corporate recognition under the second prong of the *Moline* test.

III. DEBT/EQUITY ANALYSIS

A. Characterization of the Preferred Units

⁹ See, e.g., *Rogers v. Commissioner*, 34 T.C.M. (CCH) 1254, 1256 (1975) ("*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity [citations omitted]. Business purpose or business activity are alternative requirements").

¹⁰ 34 T.C.M. (CCH) 1254 (1975).

¹¹ 293 U.S. 465 (1935).

The vast majority of the cases that analyze the characterization of an instrument as debt or equity for U.S. tax purposes focus on whether investments in a corporation that are structured in the form of debt are, in substance, debt or, instead, are equity in the corporation. Under these cases, the characterization of an instrument as debt or equity for U.S. tax purposes depends on all the facts and circumstances surrounding the issuance and operation of a particular instrument. For example, the Third Circuit Court of Appeals, in *Fin Hay Realty Co. v. United States*,¹² listed 16 factors to be used to judge whether an investment which is in the form of a debt is, in fact, equity:

(1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal [subordination]; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments [out of earnings or out of all assets]; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.¹³

Courts, in determining whether a particular instrument evidences a debtor-creditor or equity ownership relationship, must rank and weigh the relative importance of the various factors present in an instrument. The Supreme Court has stated that "[t]here is no one characteristic . . . which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."¹⁴

Although the preponderance of authorities involving debt/equity characterization involve the issue of whether an instrument structured, in form, as debt should be recharacterized, in substance, as equity, there are a limited number of authorities which discuss the attempted recharacterization of an instrument structured in form as equity as debt. These authorities, in testing the economic substance of the security, generally apply the same *Fin Hay* factors that have been applied in the more traditional cases involving the recharacterization of debt as equity.¹⁵

¹² 398 F.2d 694 (3d Cir. 1968).

¹³ *Id.* at 696.

¹⁴ See *John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946).

¹⁵ See, e.g., *Zilkha & Sons v. Commissioner*, 52 T.C. 607 (1969), *acq.* 1970-2 C.B. xxi (court concluded that preferred interests were dependent upon success of business and that, notwithstanding various protections designed to minimize risk, preferred interests were equity for U.S. tax purposes); *Ragland Investment Company v. Commissioner*, 52 T.C. 867 (1969), *aff'd*, 435 F.2d 118 (6th Cir. 1970) (same); G.C.M. 34529 (June 18, 1971); G.C.M. 39187 (Mar. 13, 1984).

The intention of the issuing entity (*i.e.*, Dutch VOF) that the Preferred Units issued to Investor BV constitute equity is evidenced by the following: (1) the Preferred Units will be issued under the Dutch VOF partnership agreement and (2) Dutch VOF will at all times treat transactions involving the shares in a manner consistent with their characterization as preferred equity, including for accounting purposes and for purposes of filings with any regulatory bodies. Thus, the formal documentation and the intent of the issuer and the interest holders reflected in that documentation will support the treatment of the Preferred Units as equity interests.

The Preferred Units contain a stated preferential distribution. Periodic distributions on the Preferred Units issued by Dutch VOF, however, are solely out of Dutch VOF's retained earnings and only if, as and when declared by the Board. The sole source, therefore, of Investor BV's Preferred Distribution is Dutch VOF's retained earnings. A creditor would require payment on its instrument in all events and such payment could be made out of the company's capital funding.

Although, in form, Dutch VOF will be organized as a general partnership, the equity interest holders in Dutch VOF have agreed that Dutch VOF will be managed by a Board. The holder of the Dutch VOF Preferred Units will be entitled to elect, on a cumulative basis, [two] of the [five] Dutch VOF directors with 40 percent of Dutch VOF's total voting power. Accordingly, the Preferred Units will possess the equity characteristic of voting rights.

Investor BV, as an equity holder in Dutch VOF, will be subordinated to all creditors of Dutch VOF. This is a significant characteristic of an equity instrument. In fact, since the Preferred Units are dependent upon Dutch VOF's retained earnings for a return on investment, and are dependent upon sufficient remaining equity for a return of investment, Investor BV is even subordinated to ordinary trade creditors of Dutch VOF. Generally, the presence of subordination, as a legal matter, is significant regardless of whether the parties to the transaction contemplate at the outset the incurrence of meaningful liabilities. In the instant case, however, we note that Dutch VOF is contractually prohibited from borrowing money other than unsecured indebtedness in an amount not to exceed \$1 million. Thus, the potential for incurring meaningful liabilities, even unanticipated liabilities, is somewhat limited. Nevertheless, if Dutch VOF breached the provisions set forth under the Dutch VOF agreement, Investor BV would be subordinated to the claims of those creditors vis-à-vis their rights to the assets of Dutch VOF.

Finally, the Preferred Units do not grant Investor BV any traditional creditor remedies, such as the right to accelerate payment on default. In addition, it has been represented to us that the rights and remedies contained in the Dutch VOF agreement which are available to holders of the Preferred Units upon a default are customary and consistent with those of other privately placed preferred equity instruments that serve as collateral for bank loans.

Although the Preferred Units will have a fixed maturity date, we view this factor as neutral in the debt/equity analysis. While the absence of a fixed maturity date is often conclusive of a determination that an instrument constitutes equity, "it is not unusual for preferred stock to have a

maturity or retirement date."¹⁶ Furthermore, the IRS has publicly ruled that five-year mandatorily redeemable preferred stock qualifies as equity in the context of a reorganization.¹⁷ We have also considered how the auction rate mechanism embedded in the Dutch VOF Preferred Units will affect the debt/equity nature of the Dutch VOF Preferred Units. More specifically, we have considered whether the presence of such feature could lead one to conclude that the Preferred Units have a redemption date which is earlier than the ten-year stated redemption date.

We note that Company will indemnify Investor BV for possible breaches of fiduciary duties by Dutch VOF directors appointed by it and for a limited number of possible breaches of the constituent documents of Dutch VOF that are within the control of such directors. In addition, certain breaches of constituent documents will trigger the right of Investor BV to have its Preferred Units redeemed. We believe that on balance the rights provided to Investor BV do not represent significant creditors' rights, and are sufficiently discrete and remote that they should not negate our conclusion that the Preferred Units should be respected as equity in Dutch VOF for U.S. tax purposes.

The Preferred Units issued to Investor BV in the Transaction are quite similar in their terms to the "Dutch-auction rate preferred stock" which were the subject of Revenue Ruling 90-27.¹⁸ The IRS ruled in Revenue Ruling 90-27 that certain types of Dutch-auction rate preferred stock are treated as equity for tax purposes and can qualify for the intercorporate dividends received deduction under certain circumstances. In Revenue Ruling 90-27, a publicly-held domestic corporation issued 1,000 shares of Dutch-auction rate preferred stock with a liquidation preference of \$100,000 per share. Each prospective purchaser was required to execute a purchaser's letter agreeing to sell the shares only through a Dutch-auction proceeding to an authorized broker-dealer or to a purchaser that has executed a similar purchaser's letter. In each auction, potential holders (and existing holders wishing to increase the number of shares held) bid to purchase shares offered for sale. The stock traded at its liquidation preference so each bid consisted of a proposed dividend rate at which the bidder was willing to purchase the offered shares at a price equal to the liquidation preference.

At each auction looked at in Revenue Ruling 90-27, (1) an existing holder could choose to hold its shares at whatever rate was set for the next dividend period, (2) it could place a bid order to hold its shares if the rate for the next dividend period was not below the rate specified in the bid (which was treated as a sell order if the dividend rate was lower), or (3) it could place a sell order regardless of the applicable dividend rate. If all existing holders chose to hold their shares, the dividend rate was set at 59 percent of the AA Composite Commercial Paper Rate. If there were insufficient bids, the auction "failed" and the dividend rate was set at the applicable maximum bid rate for that auction (expressed as a percentage of the AA Composite Commercial Paper Rate, ranging anywhere from 110 to 250 percent). There were no express or implied agreements that would

¹⁶ *Huisking & Co. v. Commissioner*, 4 T.C. 595, 599 (1945) (subordinated debentures held to be "more nearly like preferred stock than indebtedness" and recast as equity, notwithstanding form and fixed maturity date where interest was payable at the discretion of the company, and where debentures were unsecured and subordinated to claims of all creditors).

¹⁷ Rev. Rul. 78-142, 1978-1 C.B. 111.

¹⁸ 1990-1 C.B. 50.

guarantee any holder the right to sell, and the holders could not compel the issuer to redeem the shares. Dividends were cumulative and were required to be declared by the board of directors out of legally available funds. The IRS concluded that such stock should be treated as equity, not debt.

In the instant case, we have been advised to assume that there is a realistic possibility that Company would let the Dutch VOF Preferred Units be auctioned, rather than call such stock, in the event that the holder of the Dutch VOF Preferred Units chose to tender such stock for auction. We have been informed that the default rates associated with a defaulted auction are commercially reasonable in light of other auction rate preferred equity interests issued out of companies with similar credit quality. Most importantly, however, is the fact that the holders of the Dutch VOF Preferred Units cannot require the units to be redeemed prior to the ten-year redemption date, even in the event of a defaulted auction. The presence of the auction rate mechanism in the Dutch VOF Preferred Units, therefore, should not be viewed as creating a fixed maturity date prior to the ten-year redemption date.

We believe of the most significant factors applied in distinguishing between debt and equity, a preponderance of such factors favors an equity characterization of the Preferred Units. Thus, we believe the Preferred Units should be characterized for U.S. tax purposes as equity, not debt.¹⁹

B. Characterization of the Certificates

Based on the characteristics distinguishing debt from equity described above, the Certificates should, subject to the discussion of Section 385(c) below, be characterized as equity for U.S. tax purposes. Section 385(c)(1) provides that "[t]he characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)." This provision does not apply, however, where the holder of an interest discloses on its return that it is treating the interest in a manner inconsistent with the issuer's characterization.²⁰

The Certificates are instruments which, while treated as debt for Luxembourg tax purposes, are labeled on their face as equity. In addition, the Certificates provide by their terms that they will be characterized (within the meaning of Section 385(c)) as equity rather than indebtedness of SARL. Consequently, Company LLC may characterize the Certificates as equity for U.S. tax purposes. In addition, because this characterization by Company LLC would be consistent with SARL's characterization of the Certificates, no disclosure would be required under Section 385(c)(2).

¹⁹ We note that the legislative history of Section 351(g), enacted as part of the Taxpayer Relief Act of 1997, states that the "Treasury Secretary has regulatory authority to . . . prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., secs. 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code." H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. (1997). Although the Preferred Units fall within the scope of Section 351(g), no regulations have been issued thereunder. Moreover, there is no indication that, were regulations issued, such regulations would characterize the Preferred Units as debt rather than equity.

²⁰ I.R.C. § 385(c)(2).

Similarly, Company LLC should not be prevented from treating the Certificates as equity for U.S. tax purposes under the so-called "Danielson rule" because the U.S. tax treatment of the Certificates by Company LLC and will be consistent with both the form of the Certificates and the treatment of the Certificates by the issuer.

IV. U.S. TAXATION OF INCOME RECEIVED BY DUTCH VOF

A. General

A foreign corporation that is engaged in a trade or business in the United States (a "U.S. trade or business") generally is subject to income tax on its income that is effectively connected with the U.S. trade or business at the same graduated rates of taxation as a U.S. corporation (*i.e.*, up to 35 percent). Income derived from U.S. sources that is not effectively connected with a U.S. trade or business generally is subject to a flat 30 percent U.S. income tax and the related U.S. withholding tax if the income is "fixed or determinable annual or periodical" ("FDAP income"),²¹ such as interest, dividends, rents and royalties. As such, Dutch VOF could be subject to tax on income derived from its investment in FASIT Interests or its lending activities if such income is (i) effectively connected with the conduct by Dutch VOF of a U.S. trade or business or (ii) non-effectively connected U.S. source FDAP income. However, income derived with respect to the FASIT Interests should generally qualify for the "portfolio interest exemption."²² In addition, (i) the income tax treaty between the United States and the Netherlands (the "Dutch Treaty"),²³ (ii) the income tax treaty between the United States and Luxembourg that is currently in force (the "Current Luxembourg Treaty"),²⁴ and (iii) the income tax treaty between the United States and Luxembourg that has been signed, but has not yet entered into force (the "New Luxembourg Treaty"),²⁵ each provides that interest arising in the United States that is derived by a resident of the Netherlands and Luxembourg, respectively, that is not attributable to a "permanent establishment" of such resident in the United States, is not subject to U.S. tax, irrespective of whether such interest is effectively connected with a U.S. trade or business. Accordingly, so long as Dutch VOF does not maintain a permanent establishment in the United States, Dutch VOF will not be subject to tax on U.S. source interest paid to Dutch VOF regardless of whether such income is treated

²¹ I.R.C. §§ 881, 1441(a), 1442; Treas. Reg. § 1.1441-4(a).

²² I.R.C. § 881(c); Treas. Reg. § 1.871-14(d).

²³ Convention Between Netherlands and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, which was signed on December 18, 1992 and entered into force on December 31, 1993.

²⁴ Convention Between the United States of America and the Grand Duchy of Luxembourg with Respect to Taxes on Income and Property, which was signed on December 18, 1962 and entered into force on January 1, 1964.

²⁵ Convention Between the Government of the Grand Duchy of Luxembourg and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, which was signed on April 3, 1996 and has not yet entered into force.

as effectively connected with a U.S. trade or business or as non-effectively connected U.S. source FDAP income.

B. U.S. Trade or Business

Whether a foreign corporation is engaged in a U.S. trade or business is a question of fact. However, Treas. Reg. § 1.864-4(c)(5)(i) provides that a "foreign corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation or any other person who would be a related person within the meaning of Section 954(d)(3) if such foreign corporation were a controlled foreign corporation shall not be considered to be engaged in the active conduct of a banking, financing or similar business in the United States." Also, investing or trading in stocks and debt securities for the taxpayer's own account will not constitute a U.S. trade or business.²⁶ These provisions support the conclusion that Dutch VOF's investing in FASIT Interests, lending to Company and its affiliates and investing in public debt of U.S. issuers would not cause Dutch VOF to be engaged in a U.S. trade or business.

In Rev. Rul. 73-227,²⁷ the Service held that a foreign corporation ("X") with its principal office in the United States was engaged in a trade or business in the United States by reason of its activity of borrowing funds and relending them to its domestic parent ("M") and parent affiliates. The ruling stated that "X's trade or business consists of the borrowing of funds and the relending of such funds to M and M's domestic and foreign subsidiaries or affiliates. The activities incident to this trade or business are virtually all carried on in the United States through X's United States office. Accordingly, X is engaged in the active conduct of a trade or business in the United States." The conclusion in Rev. Rul. 73-227 appeared inconsistent with Treas. Reg. § 1.864-4(c)(5)(i) by finding a U.S. trade or business where the regulations specifically provided that none existed.

Revenue Ruling 88-3²⁸ revoked Revenue Ruling 73-227, stating that the conclusion contained therein may be "unsound" because the ruling did not discuss and apply the proper legal standard for making the highly factual determination of whether X was engaged in a United States trade or business. Thus, Revenue Ruling 88-3 may be read to create a negative inference that where a foreign person's activities are limited to borrowing money and lending such money to affiliates, it does not have a trade or business and, therefore, cannot be engaged in a U.S. trade or business. In any case, however, so long as Dutch VOF's activities are conducted outside the United States, we believe that Dutch VOF should not be viewed as being engaged in a U.S. trade or business.

The case of *Scottish American Investment Co., Ltd. v. Commissioner*²⁹ provides helpful authority in this regard. In *Scottish American*, a foreign corporation was in the business of

²⁶ I.R.C. § 864(c)(2)(A)(ii).

²⁷ 1973-1 C.B. 338.

²⁸ 1988-1 C.B. 268.

²⁹ 12 T.C. 49 (1949).

investing in securities and maintained a U.S. office through which it monitored its investments. All business decisions relating to such investments, however, were made from outside of the United States. The Tax Court held that the corporation was not engaged in a U.S. trade or business because the U.S. office was simply a "helpful adjunct" to the corporation's business.

Further, as stated above, the Dutch Treaty and the Current and New Luxembourg Treaties provide that, so long as Dutch VOF does not maintain a U.S. permanent establishment, Dutch VOF will not be subject to U.S. tax on its interest income.

In addition to any tax imposed on a foreign corporation under Section 882, such foreign corporation may be subject to the 30 percent branch profits tax imposed under Section 884. If Dutch VOF is deemed to be engaged in a trade or business within the United States, Dutch VOF may be subject to the branch profits tax on its dividend equivalent amount.³⁰ The dividend equivalent amount generally means the foreign corporation's effectively connected earnings and profits adjusted for reductions and increases in U.S. net equity.³¹ Under Article 11 of the Dutch Treaty, U.S. branch profits tax may only be imposed to the extent that the business profits of a Dutch company are effectively connected with the conduct of a U.S. trade or business and are attributable to a permanent establishment in the United States. The branch profits tax of a foreign corporation may not be eliminated under a U.S. tax treaty unless the subject foreign corporation is a "qualified resident" of such foreign country under the branch profits tax rules.³² A foreign corporation will be considered a qualified resident of a foreign country for these purposes unless (i) 50 percent or more of its stock (by value) is owned directly or indirectly by individuals who are neither U.S. citizens or resident aliens nor residents of such foreign country, or (ii) 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are neither U.S. citizens or residents nor residents of such foreign country.³³ Because U.S. citizens or residents will indirectly own more than 50 percent of Dutch VOF's stock and less than 50 percent of Dutch VOF's income will be used to meet liabilities of persons who are neither U.S. nor Dutch, Dutch VOF should be considered a qualified resident of the Netherlands for purposes of the branch profits tax rules and, therefore, should not be subject to the branch profits tax even if it is deemed to have a U.S. permanent establishment.

³⁰ I.R.C. § 882(a).

³¹ I.R.C. § 884(b).

³² I.R.C. § 884(e)(1).

³³ I.R.C. § 884(e)(4).

C. Qualification for Treaty Benefits

1. Application of Section 894

Temp. Reg. § 1.894-1T(d)(1)³⁴ provides that the tax imposed by Section 881(a) on a payment made by a U.S. resident to a foreign person is eligible for exemption or reduction under a U.S. income tax treaty if (i) such payment is treated as derived by a resident of an applicable treaty jurisdiction, (ii) such resident is a beneficial owner of the payment, and (iii) all other applicable requirements for benefits under the treaty are satisfied.³⁵ A payment received by an entity is treated as derived by a resident of an applicable treaty jurisdiction only to the extent the payment is subject to tax in the hands of a resident of such jurisdiction.³⁶ A payment received by an entity that is treated as fiscally transparent by an applicable treaty jurisdiction is considered a payment subject to tax in the hands of a resident of the jurisdiction to the extent that the interest holders in the entity are residents of the jurisdiction.³⁷ An entity is treated as fiscally transparent by a jurisdiction to the extent the jurisdiction requires interest holders in the entity to take into account separately on a current basis their respective shares of the items of income paid to the entity and to determine the character of such items as if such items were realized directly from the source from which realized by the entity (for purposes of the tax laws of the jurisdiction).³⁸

Based on the opinion of Luxembourg and Dutch tax advisors to SARL and Investor BV that SARL and Investor BV will be required to take into account separately on a current basis their respective shares of the items of income paid to Dutch VOF and to determine the character of such items as if such items were realized directly from the source from which realized by the entity (for purposes of the tax laws of Luxembourg and the Netherlands, respectively), Dutch VOF should constitute a fiscally transparent entity under the laws of both Luxembourg and the Netherlands. In addition, Luxembourg and Dutch tax advisors have opined that each of SARL and Investor BV will be liable for Luxembourg and Dutch corporate income taxes, respectively, as residents of such

³⁴ The temporary regulations promulgated under Section 894 are effective with respect to amounts paid on or after January 1, 1998. Temp. Treas. Reg. § 1.894-1T(d)(7). The rules contained in Temp. Treas. Reg. § 1.894-1T(d) apply in respect of all income tax treaties to which the United States is a party unless the applicable treaty partner would not grant a reduced rate under the treaty to a U.S. resident in similar circumstances, as evidenced by a mutual agreement between the competent authorities or by a public notice of the treaty partner, which mutual agreement or notice shall be announced by the IRS. Temp. Treas. Reg. § 1.894-1T(d)(5). No such announcement has been made.

³⁵ The term "entity" is defined as a person that is treated by the United States or the applicable treaty jurisdiction as other than an individual. Temp. Treas. Reg. § 1.894-1T(d)(4)(i). The term resident has the meaning assigned to such term in the applicable treaty. Temp. Treas. Reg. § 1.894-1T(d)(4)(iv). The determination of whether a person is a beneficial owner of a payment shall be made under U.S. tax laws. Temp. Treas. Reg. § 1.894-1T(d)(2)(ii)(B).

³⁶ Temp. Treas. Reg. § 1.894-1T(d)(1).

³⁷ *Id.*

³⁸ Temp. Treas. Reg. § 1.894-1T(d)(4)(ii).

jurisdictions on their respective shares of Dutch VOF's income. Accordingly, for purposes of Section 894, the interest paid by Company to Dutch VOF should be treated as subject to tax in the hands of a resident of Luxembourg to the extent allocable to SARL and as subject to tax in the hands of a resident of the Netherlands to the extent allocable to Investor BV.

A resident of an applicable treaty jurisdiction that derives a payment received by an entity that is fiscally transparent under the laws of the applicable tax jurisdiction shall be treated as the beneficial owner of the payment unless (i) such resident would not have been treated as the beneficial owner of the payment had such payment been received directly by the resident or (ii) the entity receiving the payment is not treated as a beneficial owner of the payment.³⁹ For instance, SARL and Investor BV would not be considered the beneficial owners of interest received by Dutch VOF from Company if either they or Dutch VOF were viewed as acting either as a nominee or a conduit for another person.⁴⁰ Under U.S. tax principles, Dutch VOF should be viewed as the beneficial owner of any interest payment actually made by Company to Dutch VOF, and each of SARL and Investor BV would be viewed as the beneficial owner of any payment made by Company had such payment been made directly to it.⁴¹ Accordingly, for purposes of these regulations, SARL and Investor BV should be viewed as the beneficial owners of the interest payments received by Dutch VOF from Company.

Because (i) income received by Dutch VOF should be considered as having been received by residents of the Netherlands (with respect to Investor BV's interest) and Luxembourg (with respect to SARL's interest), and (ii) Dutch VOF should be viewed as the beneficial owner of income received by Dutch VOF, the income tax imposed by Section 881(a) (and the withholding tax imposed by Section 1442) on U.S.-source interest paid to a foreign corporation should not apply to interest received by Dutch VOF so long as such interest is entitled to an exemption under a bilateral income tax treaty to which the United States is a party.⁴²

³⁹ Temp. Treas. Reg. § 1.894-1T(d)(2)(ii)(A).

⁴⁰ See Temp. Treas. Reg. § 1.894-1T(d)(2)(ii)(B).

⁴¹ In *Aiken Industries v. Commissioner*, 56 T.C. 925 (1971) *acq.* 1972-2 C.B. 1, discussed in detail below, an intermediate entity in a back-to-back loan arrangement was disregarded for purposes of determining whether U.S. withholding tax should be imposed on interest paid to a foreign lender. The court in *Aiken* stated that the intermediate entity lacked dominion and control over the funds it received as it was required to pay out as interest all of the interest payments it received. As such, the court found that it could not be said that the interest was in fact "received by" the intermediate entity. In contrast, SARL will not be required to pay (and in fact is not expected to pay) any amounts on the Certificates until maturity. Further, unlike the situation in *Aiken*, SARL's return on the Common Units is expected to exceed the yield on the Certificates, such that SARL will generate a profit from its investment in the Common Units. See *Northern Indiana Public Service Company*, *infra*.

⁴² See Temp. Treas. Reg. § 1.894-1T(d)(6), Ex. 9.

2. Treaty Analysis

As described above, payments received by Dutch VOF from U.S. sources may be entitled to an exemption from U.S. withholding tax under the Dutch Treaty to the extent attributable to Investor BV's interest in Dutch VOF, and, under the Current Luxembourg Treaty (or under the New Luxembourg Treaty with respect to payments made after such treaty enters into force), to the extent attributable to SARL's interest in Dutch VOF. We analyze below whether Investor BV is entitled to benefits under the Dutch Treaty and whether SARL is entitled to benefits under the Current and New Luxembourg Treaties.

a. Dutch Treaty

Article 12 of the Dutch Treaty provides an exemption from U.S. withholding tax on interest derived by a resident of the Netherlands from U.S. sources. For purposes of the Dutch Treaty, a resident of a state means any person who, under the laws of that state, is liable to tax therein by reason of, among other things, place of incorporation.⁴³ We have been advised by Dutch tax advisors that Investor BV is subject to tax in the Netherlands based on its place of incorporation and is therefore a resident of the Netherlands for purposes of the Dutch Treaty.

A resident of a contracting state is entitled to benefits under the Dutch Treaty only if such person qualifies for such benefits under the Treaty's "Limitation on Benefits" provision (a "qualified resident").⁴⁴ A person is considered a qualified resident for purposes of the Dutch Treaty if, among other things, it is a person (i) more than 50 percent of the beneficial interest in which (or, in the case of a company, more than 50 percent of the aggregate vote and value of all of its shares, and more than 50 percent of the shares of any "disproportionate class of shares") is owned, directly or indirectly, by qualified residents (the "Stock Ownership Test") and (ii) which meets the base reduction test described in Article 26 paragraph 5 (the "Base Erosion Test").⁴⁵

More than 50 percent of the stock of Investor BV will be owned by Rabo, which will represent to Dutch VOF that it is a person described in paragraph 1 of Article 26 of the Dutch Treaty.

The Base Erosion Test will be met if either (i) less than 50 percent of such person's gross income is used, directly or indirectly, to make deductible payments in the current year to persons that are not qualified residents, or (ii) in the case of a person resident in The Netherlands, (A) less than 70 percent of such gross income is used, directly or indirectly, to make deductible payments to persons that are not qualified residents, and (B) less than 30 percent of such gross income is used, directly or indirectly, to make deductible payments to persons that are neither qualified residents nor residents of the member states of the European Communities. Based on assumption 14 above, the initial lenders to Investor BV under the Investor BV Credit Agreement will satisfy the Base Erosion Test. In addition,

⁴³ Dutch Treaty, art. 4.

⁴⁴ Dutch Treaty, art. 26(1).

⁴⁵ Dutch Treaty, art. 26(1)(d).

under Section 11.6(f) of the Investor BV Credit Agreement, each lender is not permitted to assign its rights and obligations under the Investor BV Credit Agreement if such assignment would cause Investor BV to fail the Base Erosion Test. Therefore, Investor BV should satisfy the Base Erosion Test of the Dutch Treaty and, consequently, should be a qualified resident under the Dutch Treaty.

As stated above, the Dutch Treaty provides that no tax will be imposed on interest paid to a qualified resident unless such interest income is attributable to a "permanent establishment" in the source country.⁴⁶ A "permanent establishment" is a "fixed place of business through which the business of the enterprise is wholly or partly carried on," and includes especially a place of management, a branch and an office.⁴⁷ Because all of Dutch VOF's business will be carried on outside the United States, and it will not have a place of management, a branch or an office in the United States, Dutch VOF should not be deemed to have a "permanent establishment" in the United States. Accordingly, any interest derived by Dutch VOF from U.S. sources (and attributable to Investor BV's interest) should not be subject to U.S. tax.

b. Luxembourg Treaties

i. Current Luxembourg Treaty

Under Article VIII of the Current Luxembourg Treaty, interest received by a Luxembourg corporation or resident that does not have a U.S. permanent establishment is exempt from U.S. tax. The term "resident corporation" means a juridical person that has its business management or seat in Luxembourg.⁴⁸ We have been advised by Luxembourg counsel that SARL is a juridical person for Luxembourg purposes that will have its seat in Luxembourg.⁴⁹ Accordingly, interest paid to Dutch VOF attributable to SARL's interest will be exempt from U.S. tax under the Current Luxembourg Treaty so long as SARL does not have a U.S. permanent establishment.

Under the Current Luxembourg Treaty, a "permanent establishment" is a "fixed place of business in which the business of the enterprise is wholly or partly carried on," and includes especially a place of management, a branch and an office.⁵⁰ Notwithstanding this definition, an enterprise will be treated as having a permanent establishment in a state if a person (other than an independent contractor) acts on behalf of the enterprise and has, and habitually exercises, in the state an authority to conclude contracts in the name of the enterprise.⁵¹ No person will have the authority to conclude contracts on behalf of SARL in the United States. While SARL's directors will be U.S.

⁴⁶ Dutch Treaty, art. 12.

⁴⁷ Dutch Treaty, art. 5(2).

⁴⁸ Current Luxembourg Treaty, art. II(e).

⁴⁹ The Current Luxembourg Treaty contains no limitation on benefits provision.

⁵⁰ Dutch Treaty, art. II(f).

⁵¹ Current Luxembourg Treaty, art. II(f)(iv).

citizens and residents, its directors will be specifically precluded from concluding any contract on behalf of SARL and from making any management decisions in the United States. Accordingly, SARL should not have a U.S. permanent establishment.

ii. New Luxembourg Treaty

Under Article 12 of the New Luxembourg Treaty, interest arising in the United States and paid to a resident of Luxembourg that does not have a U.S. permanent establishment is exempt from U.S. tax. A Luxembourg resident includes any person who is liable to tax in Luxembourg by reason of its place of incorporation.⁵² The Luxembourg Tax Ruling provides that SARL is subject to tax in Luxembourg based on its place of incorporation.⁵³ Accordingly, SARL should be considered a resident of Luxembourg for purposes of the New Luxembourg Treaty.

Under the New Luxembourg Treaty's Limitation on Benefits provision, a resident of a contracting state is entitled to benefits of the treaty only if such person is a "qualified resident" as defined in that provision. A Luxembourg company will be a qualified resident if, among other things, (i) at least 50 percent of the principal class of shares in the company is ultimately owned by persons that are qualified residents or U.S. citizens (the "Stock Ownership Requirement"), and (ii) deductible amounts paid or accrued by the company during its taxable year to persons that are neither qualified residents nor U.S. citizens do not exceed 50 percent of the gross income of the company for that year (the "Base Erosion Requirement").⁵⁴ Thus, SARL will be considered a qualified person (and thus entitled to benefits under the New Treaty) so long as Company is a qualified person, because in such case (i) at least 50 percent of SARL's shares would be owned ultimately by a qualified resident (Company), and (ii) SARL's only deductible amounts would be accrued with respect to Company LLC, which by virtue of being wholly-owned by Company, would be at least 50 percent owned by a qualified resident under the New Luxembourg Treaty.⁵⁵

Company will be considered a qualified resident if its principal class of shares is substantially and regularly traded on one or more recognized stock exchanges.⁵⁶ While the New Treaty does not define the term "principal class of shares," the treaty's technical explanation states that such term is understood to mean the company's ordinary or common shares, but only if such shares possess a majority of the company's voting power and value. Company's common stock represents more than 50 percent of its vote and value and, therefore, is considered its principal class of shares.

⁵² New Luxembourg Treaty, art. 4(1).

⁵³ We note that Company LLC will not receive any U.S. foreign tax credits for Luxembourg taxes paid by SARL.

⁵⁴ New Luxembourg Treaty, art. 24(2)(c).

⁵⁵ New Luxembourg Treaty, art. 25(2)(c).

⁵⁶ New Luxembourg Treaty, art. 25(2)(d).

Shares in a class are considered to be substantially and regularly traded if the aggregate number of shares of that class traded during the previous taxable year is at least 6 percent of the average number of shares outstanding in that class during that taxable year. Based on assumption 15 above, Company should be considered a qualified resident of Luxembourg because its principal class of shares is substantially and regularly traded on one or more recognized stock exchanges. Accordingly, Company should be considered a qualified person for purposes of the New Luxembourg Treaty. Consequently, for the reasons discussed above, SARL will satisfy the Stock Ownership and Base Erosion Requirements and, therefore, will be considered a qualified person under the New Luxembourg Treaty.

Further, SARL will not make any deductible payments to persons that are not qualified residents. Accordingly, SARL will meet the Base Erosion Test and, therefore, SARL should be treated as a qualified resident under the Dutch Treaty.

The definition of "permanent establishment" in the New Luxembourg Treaty is substantially the same as that in the Current Luxembourg Treaty. As stated above, because no person will have the authority to conclude contracts on behalf of SARL in the United States, SARL should not have a U.S. permanent establishment.

Based on the foregoing, because (i) the income derived by Dutch VOF will be treated as derived by residents of The Netherlands and Luxembourg, (ii) each of the members of Dutch VOF should be treated as beneficial owners of the payments made by Company to Dutch VOF, and (iii) Investor BV and SARL are qualified residents of the Netherlands and Luxembourg, respectively, Dutch VOF should be entitled to the benefits of the Dutch Treaty and either the Current Luxembourg Treaty or the New Luxembourg Treaty (whichever shall apply) with respect to payments made by Company.

3. Disclosure of Treaty-Based Return Positions

Section 6114 provides that, unless waived by the IRS, any taxpayer who takes the position that a U.S. treaty overrules or otherwise modifies a U.S. internal revenue law with respect to any tax imposed under the Code must disclose such position in the manner prescribed by the IRS. With respect to interest payments made prior to January 1, 2000, the IRS has waived (except in limited circumstances not applicable here) the reporting requirement for treaty exemptions from U.S. withholding tax.⁵⁷ For interest payments made after December 31, 1999, however, a taxpayer must disclose that it is claiming an exemption from U.S. withholding tax under a treaty that contains a limitation on benefits article where (i) the recipient of the interest income is related to the person obligated to pay the income, (ii) the income exceeds \$500,000, and (iii) a foreign person (other than an individual or State) meets the requirements of the limitation on benefits article of the treaty.⁵⁸ No disclosure will be required with respect to payments received by Dutch VOF on FASIT Interests it holds because the Dutch VOF and the FASIT should not be treated as related persons. However,

⁵⁷ Treas. Reg. § 301.6114-1(c)(1)(ii) (prior to amendment by T.D. 8733, 1997-43 I.R.B. 8).

⁵⁸ Treas. Reg. § 301.6114-1(b)(4)(ii)(C) (as amended by T.D. 8733, *supra*).

Dutch VOF must disclose that is relying on an exemption from U.S. withholding tax under the Dutch Treaty (and, if applicable, the New Luxembourg Treaty) with respect to payments under any loan made by Dutch VOF to Company or a U.S. affiliate of Company (so long as the income element of such payment is at least \$500,000) unless such payments are otherwise exempt from U.S. withholding tax absent application of such treaties.⁵⁹

V. ALLOCATION OF SUBPART F INCOME UNDER THE MULTIPLE CLASS OF STOCK RULES

A. General Allocation Rules

Section 957(a) defines a controlled foreign corporation ("CFC") as any foreign corporation if more than 50 percent of either the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such corporation is owned, or treated as owned under certain constructive ownership rules, by "U.S. shareholders." A "U.S. shareholder" is a U.S. person who owns, or is treated as owning, 10 percent or more of the combined voting power of stock entitled to vote in the corporation.⁶⁰ Because Company LLC (a U.S. person by virtue of being organized in the United States) should be viewed as owning stock in Dutch VOF with at least a ten percent vote, and such stock in the aggregate constitutes more than 50 percent of the value of Dutch VOF, Dutch VOF should be classified as a CFC.

A U.S. shareholder of a CFC generally must include in income its pro rata share of certain types of income and earnings, referred to as subpart F income, of the CFC,⁶¹ regardless of whether the U.S. shareholder receives a distribution of cash or property from the CFC.⁶² Subpart F income includes foreign base company income, which includes foreign personal holding company income, which in turn generally includes interest income. Subject to certain exceptions not relevant here, if a corporation's foreign base company income for a taxable year exceeds 70 percent of its gross income, the corporation's entire gross income is treated as foreign base company income.⁶³ Because more than 70 percent of Dutch VOF's gross income will consist of interest income, all of Dutch VOF's income will be treated as subpart F income.

As stated above, a U.S. shareholder of a CFC must include in income its pro rata share of the CFC's subpart F income for the year. Therefore, each Dutch VOF shareholder's pro rata share of Dutch VOF's subpart F income must be determined. A shareholder's pro rata share of subpart F

⁵⁹ Where required, disclosure of a treaty-based return position must be made on a Foreign Return Position Disclosure Under Section 6114 or 7701(b)).

⁶⁰ I.R.C. § 951(b).

⁶¹ I.R.C. § 951(a)(1)(A)(i).

⁶² I.R.C. § 951(a).

⁶³ I.R.C. § 954(b)(3)(B).

income is generally equal to the amount which would have been distributed to the shareholder if the corporation's subpart F income was distributed on the last day of the year. (For this purpose, actual distributions do not reduce the amount of subpart F income subject to inclusion. Such distributions, however, may be excluded from gross income under Section 959 as previously taxed income to the extent they represent amounts that have been subject to tax under the subpart F provisions.)

Treas. Reg. § 1.951-1(e)(2) provides the following special rule for determining a U.S. shareholder's pro rata share of subpart F income where there are multiple classes of stock outstanding:

If a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of such corporation's subpart F income, withdrawal, or increase in investment, for the taxable year which shall be taken into account with respect to any one class of such stock . . . shall be that amount which bears the same ratio to the total of such subpart F income, withdrawal, or increase in investment for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation bear to the total earnings and profits of such corporation for such taxable year.

The examples further illustrate how such allocation is made where the corporation has classes of common and preferred stock outstanding. The examples illustrate that a determination of the earnings and profits which would have been distributed to the preferred shareholders is first made.⁶⁴ Such determination is based on the dividend payable with respect to such preferred shares.⁶⁵ The remaining earnings and profits would then be deemed distributed to the holders of the common shares. Once such ratios have been established, the subpart F income of a CFC is allocated in accordance with such ratios.

The Dutch VOF agreement provides that the holders of the Common Units cannot receive dividends while any Preferred Units remain outstanding. It further provides that at any time Dutch VOF may redeem, in whole or in part, the Preferred Units through the payment of Redemption Proceeds up to an amount equal to the remainder of the retained earnings (after payment of the Preferred Distribution) of Dutch VOF. Thus, to the extent earnings are distributed, they must (to the extent the earnings remaining after payment of the Preferred Distribution do not exceed the liquidation preference of the Preferred Units) be paid to holders of the Preferred Units while such units remains outstanding. As analyzed below, any Redemption Proceeds paid in full or partial redemption of the Preferred Units should be considered a distribution (and hence a dividend to the extent of current and accumulated earnings and profits) so long as Company LLC's option to purchase the stock of Investor BV remains outstanding. Accordingly, pursuant to Treas. Reg. § 1.951-1(e)(2), as long as Dutch VOF's earnings and profits for any taxable year do not exceed the sum of the Preferred Distribution and the current outstanding liquidation preference on the Preferred Units, all of Dutch VOF's subpart F

⁶⁴ See Treas. Reg. § 1.951-1(e)(4), Ex. 1.

⁶⁵ Special rules may apply if an arrearage in dividends for prior taxable years exists.

income should be allocated to the holders of the Preferred Units and Company LLC's pro rata share of Dutch VOF's subpart F income should be zero.⁶⁶

We also note the potential application of Treas. Reg. § 1.951-1(e)(3), which provides that where two or more classes of stock are outstanding, and a body of persons has discretion as to how dividends should be distributed among the classes in a taxable year, the allocation for subpart F purposes will be made as if there were only one class of stock in which each share had the same rights to dividends as any other share. This regulation will not apply to Dutch VOF because no body of persons has discretion to make a distribution with respect to the Common Units while the Preferred Units are outstanding.

B. Case Law

The facts and conclusions set forth in *Barnette v. Commissioner*⁶⁷ also provide support for the allocation of subpart F income as described above. In *Barnette*, the taxpayer owned in excess of 95 percent of the stock of Allied Corporation, a Delaware corporation that had its principal office in Florida at all times during the taxable years 1976 through 1986. J.E.T.S. and Jets Services, both incorporated in Florida, were wholly owned subsidiaries of Allied. Allied was in the business of government contracting. Allied would bid for and perform the contracts through J.E.T.S. and Jets Services. In May 1976, J.E.T.S. submitted a bid to operate certain laundry and dry cleaning plants in West Germany. In order to qualify to do business in West Germany, J.E.T.S. formed a wholly owned GmbH, J.E.T.S. Wascherei. The contracts were awarded to J.E.T.S. Wascherei on May 1, 1977.

The taxpayer acquired control of a Panamanian corporation, Old Dominion, in March 1977. In 1977, J.E.T.S. sold J.E.T.S. Wascherei to Old Dominion. Old Dominion was to earn license income from J.E.T.S. Wascherei. In December of 1980, Old Dominion amended its Articles of Incorporation to authorize a class of preferred stock that provided for the payment of dividends at a fixed percentage of the stock's liquidation preference. The terms of the preferred stock also provided that any dividends paid to preferred shareholders in excess of the stated fixed rate would reduce the preferred stock's liquidation preference and that no dividends could be paid on the common stock while the preferred stock remained outstanding. Between December 24th and December 26th, the following occurred. Taxpayer caused Old Dominion to issue a stock warrant to taxpayer for 3,000 shares of preferred stock at \$1 per share. The shares subject to the warrant had a liquidation preference of \$1,000 per share. Taxpayer exercised the warrant and acquired the 3,000 shares of Old Dominion preferred stock. It then transferred all 3,000 shares of the Old Dominion preferred stock and 10 percent of its Common Units to Allied. Allied then transferred those shares to Jets Services.

⁶⁶ We also note that the loans to Company and its domestic affiliates will result in an investment of earnings in U.S. property within the meaning of Section 956. In general, a U.S. shareholder of a CFC must include its pro rata share of the CFC's increase in investment of earnings in U.S. property during the taxable year. I.R.C. § 951(a)(1)(B). However, Treas. Reg. § 1.951-1(e)(4) applies to determine a U.S. shareholder's pro rata portion of a CFC's investment in U.S. property as well as the CFC's subpart F income. Accordingly, Dutch VOF's investment in U.S. property should not result in an inclusion to Company LLC under Section 951(a)(1)(B).

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

As a result of these transaction, Jets Services owned 10 percent of the common stock of Old Dominion and all of the preferred shares from December 1980 until they were redeemed in January 1985.

For the years in question, *i.e.*, 1980 through 1985, the foreign personal holding company rules took precedence over the subpart F rules.⁶⁸ Nevertheless, for the years in question the income of Old Dominion constituted either subpart F income or income subject to inclusion under the foreign personal holding company regime. Treas. Reg. § 1.551-2(c), relating to foreign personal holding company income, provides that:

The amount which each United States shareholder must return is that amount which he would have received as a dividend if the above-specified portion of the undistributed foreign personal holding company income had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year on which the required United States group existed. Such amount is determined, therefore, by the interest of the United States shareholder in the foreign personal holding company, that is, by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders, then the assumed distribution of the stated portion of the undistributed foreign personal holding company income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

The preferred stock in Old Dominion was issued purposely to deflect away foreign personal holding company income from the taxpayer. The court assumed, and the petitioners conceded, that the issuance of the preferred stock was tax-motivated. The court stated, however, that even if the "only purpose for the creating of the preferred stock was tax avoidance, we fail to see how the existence of the preferred stock can be ignored."⁶⁹ The court noted that the taxpayer did not need a business purpose to issue the stock, because the business purpose doctrine "covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally."⁷⁰ Moreover, the court found that the taxpayer's financial position was in fact changed because, notwithstanding the fact that the taxpayer owned 98 percent of the corporation that ultimately held the preferred stock, the evidence did not support a finding that the corporation could be disregarded under *Moline Properties*. The court ruled for the taxpayer, respecting the rights of the stock as set forth in the corporate charter.

⁶⁸ Section 951(d) was amended, effective for taxable years beginning after July 18, 1984, to provide that, if an amount would be includible under both the subpart F rules and the foreign personal holding company rules of Section 551, such amount shall be included in the gross income of the shareholder solely under the subpart F rules.

⁶⁹ 63 T.C.M. at 3201-18.

⁷⁰ *Id.* (citation omitted).

Having concluded that the preferred stock should be respected as being outstanding for U.S. tax purposes, the Tax Court concluded that the holder of such stock was properly taxable on all subpart F income and undistributed foreign personal holding company income during the years in question. Most notably, even though Jets Services was only entitled to a first preference of \$240,714 and \$241,966 for the taxable years ended 1983 and 1984, respectively, it was allocated undistributed foreign personal holding company income of \$426,708 and \$1,140,237 for those years, respectively. In fact, the aggregate cash distributions (current and liquidating) eventually received by Jets Services amounted to \$3,707,573. Even though Jets Services only received approximately \$700,000 in cash over the liquidation preference of the preferred shares, it was allocated substantially more income under the subpart F and foreign personal holding company rules.

We note that the Preferred Units provide Dutch VOF the right to redeem some or all of the units by paying Redemption Proceeds, in contrast to the *Barnette* case in which the issuer was merely accorded the right to pay additional dividends to the preferred shareholders. Nevertheless, the redemption right with respect to the Preferred Units is substantially identical to the right to pay additional dividends in *Barnette* in both an economic and a tax sense, because any amounts paid by the issuer would reduce the stock's liquidation preference and would represent the payment of a dividend for tax purposes.

Dutch VOF's earnings and profits should be wholly allocable to the holder of the Preferred Units under the multiple class of stock regulations and the *Barnette* case so long as such earnings and profits do not exceed the sum of (i) the Preferred Distribution and (ii) the current outstanding liquidation preference on the Preferred Units. Notwithstanding this, however, the IRS may argue that the Redemption Proceeds, if paid, would not constitute a dividend distribution and thus should not result in an allocation of earnings and profits, but rather would result in a constructive redemption of a portion of the Preferred Units.

In addition, in the context of the Transaction, Company LLC will be granted an option to purchase the stock of Investor BV at its then current fair market value. This option will expire six months prior to the ten-year stated redemption date of the Preferred Units.⁷¹

A redemption of stock is taxable to the redeemed shareholder as a distribution potentially taxable as a dividend under Section 301, rather than as a sale or exchange of the redeemed shares, unless the redemption is either (i) not essentially equivalent to a dividend under Section 302(b)(1), (ii) a substantially disproportionate redemption under Section 302(b)(2) or (iii) a complete termination of the shareholder's interest in the corporation.

In determining whether a redemption qualifies as a sale or exchange under Section 302(b) or a distribution potentially taxable as a dividend under Section 301, the constructive

⁷¹ Neither Section 318 nor the Treasury Regulations thereunder define the term "option." However, the IRS has ruled that an option that is "exercisable only after the lapse of a fixed period of time . . . is an option within the meaning of Section 318(a)(4) of the Code." Rev. Rul. 89-64, 1989-1 C.B. 91, 92.

ownership rules of Section 318(a) must be taken into account.⁷² Section 318(a)(4) provides that "[i]f any person has an option to acquire stock, such stock shall be considered as owned by such person." Because Company LLC will have an option to acquire the stock of Investor BV, Company LLC should be treated as the constructive owner of 100 percent of Investor BV under Section 318(a)(4). Section 318(a)(5)(A) provides (with exceptions not relevant here) that stock constructively owned by a person under Section 318(a)(4) shall be considered as actually owned for purposes of applying Section 318(a)(2). Section 318(a)(2)(C) provides that if a person owns 50 percent or more of the value of stock in a corporation, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.⁷³ Therefore, since Company LLC is treated as owning all of the stock of Investor BV, Investor BV should be viewed as owning all of the Dutch VOF Common Units held by Company LLC (through SARL), and thus should be treated as owning 100 percent of the stock of Dutch VOF at all times prior to the expiration of the option.

A redemption of stock will qualify for sale or exchange treatment as "substantially disproportionate" within the meaning of Section 302(b)(2) if immediately after the redemption (i) the shareholder whose stock is redeemed owns less than 50 percent of the total voting power of the redeeming corporation and (ii) such shareholder's percentage interest in voting stock of the corporation is less than 80 percent of the shareholder's percentage interest in such stock immediately before the redemption. Because under the constructive attribution rules discussed above, Investor BV, at all times, should be viewed as owning 100 percent of the stock of Dutch VOF, any redemption, whether deemed or actual, should not qualify as "substantially disproportionate." In addition, such redemption should not qualify as a complete termination of its interest in Dutch VOF for the same reason.

Section 302(b)(1) also provides for sale or exchange treatment if a redemption is not "essentially equivalent to a dividend." Neither the Code nor the regulations define the phrase "essentially equivalent to a dividend." The regulations provide a facts and circumstances test and specifically require the Section 318(a) constructive ownership of the redeemed shareholder to be "one of the facts" considered in determining whether the redemption proceeds are the equivalent of a dividend.⁷⁴

In *United States v. Davis*,⁷⁵ the Supreme Court held that a redemption must always be viewed as essentially equivalent to a dividend unless it results "in a meaningful reduction of the shareholder's proportionate interest in the corporation."⁷⁶ In determining whether a redemption effects a meaningful reduction in the shareholder's interest, the Court held that all shares constructively owned as a result of Section 318 attribution must be treated as actually owned by such shareholder.

⁷² I.R.C. § 302(c).

⁷³ I.R.C. § 318(a)(3)(C).

⁷⁴ Treas. Reg. § 1.302-2(b).

⁷⁵ 397 U.S. 301 (1970), *reh'g denied*, 397 U.S. 1071 (1970).

⁷⁶ *Id.* at 313.

The IRS and the courts have interpreted *Davis* as requiring the shareholder to be treated as receiving a Section 301 distribution unless the proportionate interest of a redeemed shareholder, after taking into account the attribution rules, has been reduced as a result of the redemption.⁷⁷ Again, because under the constructive attribution rules discussed above Investor BV should be viewed at all times as owning 100 percent of the stock of Dutch VOF, the redemption should be viewed as essentially equivalent to a dividend.⁷⁸

VI. TREATMENT OF DUTCH VOF AS A PASSIVE FOREIGN INVESTMENT COMPANY (A "PFIC")

A foreign corporation will be classified as a PFIC if either (i) 75 percent or more of its gross income for a taxable year is passive income,⁷⁹ or (ii) the average percentage of assets (by value)⁸⁰ held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent.⁸¹ Section 1297(b)(1) provides that passive income generally means foreign personal holding company income as defined in Section 954(c),⁸² unless an exception applies. Because foreign personal holding company income generally includes interest income, Dutch VOF will satisfy the income test and be classified as a PFIC unless an exception

⁷⁷ See *Metzger Trust v. Commissioner*, 76 T.C. 42, 61 (1981), *aff'd*, 693 F.2d 459 (5th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983); *Cerone v. Commissioner*, 87 T.C. 1, 22 (1986) (notwithstanding family hostility); Rev. Rul. 78-60, 1978-1 C.B. 81 (shareholder could elect not to participate in future serial redemptions); Rev. Rul. 77-427, 1977-2 C.B. 100 (subsidiary sold to corporation owning 10 percent of seller); Rev. Rul. 77-218, 1977-1 C.B. 81 (controlled corporation sold to related controlled corporation); Rev. Rul. 71-261, 1971-1 C.B. 108 (redemption of stock from estate where beneficiaries owned remaining stock); Priv. Ltr. Rul. 9131059; Priv. Ltr. Rul. 8651026; Tech. Adv. Mem. 8552009; Priv. Ltr. Rul. 7933038 (actual ownership reduced to zero). At least one court has accepted the view that family hostility can be taken into account in applying the constructive ownership rules of Section 318(a)(1). See *Haft Trust v. Commissioner*, 510 F.2d 43 (1st Cir. 1975). The IRS, however, rejected the First Circuit's decision in *Haft Trust* and indicated that it will apply the Section 318 attribution rules mechanically. See Rev. Rul. 80-26, 1980-1 C.B. 66.

⁷⁸ Section 305(c) and Treasury Regulations promulgated thereunder provide that a change in the redemption price of stock may give rise to a deemed distribution if the change has the result of the receipt of property by some shareholders and an increase in the proportionate interests of the other shareholders in the assets or earnings and profits of the corporation. Any reduction in the liquidation preference of the Preferred Units as a result of payment of Redemption Proceeds should not be treated as giving rise to a deemed distribution under the above rule because the proportionate interest in the assets and earnings and profits of the corporation of the holders of the Common Units remains the same irrespective of whether any Redemption Proceeds are paid.

⁷⁹ I.R.C. § 1297(a)(1).

⁸⁰ In the case of a CFC (or any other foreign corporation if such foreign corporation so elects), the determination is made based on the adjusted bases of property.

⁸¹ I.R.C. § 1297(a)(2).

⁸² I.R.C. § 1297(b)(1). Under Section 954(c), foreign personal holding company income generally includes (but is not limited to) dividends, interest, rents and royalty income.

applies. Because Dutch VOF's assets will consist solely of interest-producing assets, Dutch VOF will also satisfy the asset test unless an exception applies.

Notwithstanding the fact that Dutch VOF may be a PFIC, the Taxpayer Relief Act of 1997 enacted Section 1297(e), which provides that for taxable years of U.S. persons beginning after December 31, 1997 and for taxable years of foreign corporations ending on or within such years, a corporation that is a CFC will not be treated as a PFIC with respect to any U.S. shareholder. Thus, Dutch VOF should not be a PFIC with respect to Company LLC.⁸³

VII. TREATMENT OF DUTCH VOF AS A FOREIGN PERSONAL HOLDING COMPANY (AN "FPHC")

Under the FPHC rules,⁸⁴ citizens or residents of the United States, domestic corporations, and partnerships and estates or trusts (other than foreign estates or trusts) who are direct or indirect shareholders of an FPHC must include in income their pro rata share of the FPHC's undistributed foreign personal holding company income ("UFPHCI").

Section 552 generally provides that an FPHC is any foreign corporation that satisfies a gross income requirement and a stock ownership requirement. A corporation satisfies the gross income requirement if at least 50 percent of its income is foreign personal holding company income. It satisfies the stock ownership requirement if, at any time during the taxable year, not more than five individuals who are citizens or residents of the United States own, directly or indirectly, more than 50 percent of either the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such corporation. As discussed above, Dutch VOF's income will be interest income that qualifies as foreign personal holding company income. Therefore, Dutch VOF will satisfy the gross income requirement. Section 554 sets forth constructive ownership rules used to determine

⁸³ Dutch VOF will also be a "foreign investment company" (a "FIC"). A foreign corporation will be a FIC if it satisfies an investment business test and a stock ownership test. Section 1246(b). The investment business test is satisfied if a corporation is either (i) registered under the Investment Company Act of 1940, or (ii) engages, or holds itself out as engaging, primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest in securities or commodities. The stock ownership test is satisfied if U.S. persons own, directly or indirectly, 50 percent or more of the stock of the foreign corporation by vote or value. Because Dutch VOF will be engaged in the business of investing in securities, which include notes and any evidence of indebtedness, Dutch VOF will satisfy the investment business test. Because Company LLC is a U.S. person and indirectly owns more than 50 percent of the stock of Dutch VOF, Dutch VOF will be treated as a FIC. As such, some or all of the gain recognized by Dutch VOF's U.S. shareholders (*i.e.*, Company LLC) on a taxable sale or exchange of the FIC stock may be characterized as ordinary income. While not stated explicitly, the FIC rules should not apply to gain realized, but not recognized, in a nonrecognition transfer, such as a complete liquidation of the FIC under Section 332. See Kuntz & Peroni, *U.S. International Taxation*, ¶ B2.07[3][a].

⁸⁴ We note that Dutch VOF will not be a personal holding company, as defined in Section 542, because a company that meets the requirements to be treated as an FPHC cannot be a "personal holding company." I.R.C. § 542(c). Thus, to the extent the tests of Sections 542 and 552 were both met, Dutch VOF should be classified as an FPHC and not a PHC.

whether a corporation satisfies the stock ownership requirement. Based on our understanding of the facts, Dutch VOF would not satisfy the stock ownership test.

Assuming, however, that Dutch VOF is an FPHC, U.S. shareholders would have to include in income their pro-rata share of Dutch VOF's UFPHCI. These pro-rata shares, however, would be determined under the method described in the discussion of *Barnette* in Part V.B above, although the CFC rules achieve the result under a different regulation. As discussed above, the Tax Court considered Treas. Reg. § 1.551-2(c) in *Barnette*⁸⁵ and concluded that the preferred shareholders should be allocated all of the UFPHCI under facts similar to the Transaction. Therefore, under the reasoning of *Barnette*, Company LLC should have no inclusion under the FPHC rules since all of Dutch VOF's UFPHCI should be allocated to Investor BV.

VIII. THE ACCUMULATED EARNINGS TAX

Assuming that Dutch VOF declares and pays only Preferred Distributions with respect to the Preferred Units, it will accumulate substantial earnings and profits each year. Section 531 imposes an accumulated earnings tax equal to 39.6 percent of accumulated taxable income on any corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders, or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being distributed.⁸⁶ The fact that a corporation is a mere holding or investment company is prima facie evidence of the purpose to avoid the income tax with respect to shareholders.⁸⁷ Based on the activities we understand Dutch VOF will engage in, it should be a holding or investment company within the meaning of Section 533(b). Accordingly, Dutch VOF would have the burden of going forward with evidence relating to the tax avoidance purpose, or lack thereof, for its accumulation of earnings and profits.

The purpose that is prescribed in Section 532 is an intent to avoid the imposition of the individual income tax on the ultimate individual shareholders of the corporation.⁸⁸ Under the governing documents, any distribution of retained earnings must be made to Investor BV. Accordingly, we believe that the accumulated earnings tax should not be applied to Dutch VOF's accumulation of its earnings and profits. In addition, even if the IRS could successfully argue that a portion of the accumulated earnings and profits were allocable to Company, we have assumed that the Company affiliated group will have current and accumulated earnings and profits for each year in which the Preferred Units are outstanding in excess of the aggregate amount of distributions that may reasonably be anticipated to be made to shareholders of Company for such year. Dutch VOF, therefore, is not being formed and will not be availed of with a view to permit the Company affiliated

⁸⁵ 63 T.C.M. (CCH) 3201 (1992).

⁸⁶ I.R.C. § 532(a).

⁸⁷ I.R.C. § 533(b).

⁸⁸ See Treas. Reg. § 1.532-1(a); Priv. Ltr. Rul. 9330011 (Apr. 28, 1993); Priv. Ltr. Rul. 9330010 (Apr. 28, 1993); Priv. Ltr. Rul. 9229025 (Apr. 21, 1992).

group to avoid making dividend distributions to Company's shareholders.⁸⁹ Accordingly, the accumulated earnings tax should not apply.

IX. THE FORM OF THE TRANSACTION SHOULD BE RESPECTED AND NOT DISREGARDED AS AN ECONOMIC SHAM

The IRS may attempt to alter the characterization of the Transaction on the grounds that it constitutes an economic sham. In *Frank Lyon Co. v. United States*,⁹⁰ the Supreme Court held that a transaction will be recognized for tax purposes only if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached . . ."⁹¹ *Frank Lyon* has been construed to create a two-prong test for determining whether a transaction is a "sham" to be disregarded for tax purposes entirely: "(1) has the taxpayer shown that it has a business purpose for engaging in the transaction other than tax avoidance? (2) has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits?"⁹²

The Fourth Circuit Court of Appeals in *Rice's Toyota World, Inc. v. Commissioner* has interpreted the two-prong inquiry set forth in *Frank Lyon* as follows: a tax-favored transaction may be treated as an economic sham and tax benefits denied where (i) the taxpayer has no business purpose other than obtaining tax benefits and (ii) the transaction lacks economic substance because no reasonable possibility of a pre-tax profit exists.⁹³ Other courts have avoided a rigid approach to these two criteria, preferring to view them as relevant inquiries to consider in applying the traditional sham transaction analysis.⁹⁴ It should be noted that, where the claimed business purpose of the taxpayer is to

⁸⁹ In addition, although Section 532(c) provides that the determination of whether the accumulated earnings tax applies is to be made without reference to the number of shareholders of the corporation, courts are loath to impose the tax on publicly held corporations. William L. Raby, *When Will Accumulated Earnings Tax be Imposed on Publicly Traded Corporations?*, 61 Tax Notes 1491 (1993). Company, Dutch VOF's ultimate parent, will be publicly held, and only at the Company shareholder level are there shareholders liable for the individual income tax. As such, Dutch VOF should be treated no differently than a publicly held corporation for accumulated earnings tax purposes.

⁹⁰ 435 U.S. 561, 583-84 (1978).

⁹¹ *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978). See also *United States v. Wexler*, 31 F.3d 117, 122 (3d Cir. 1994), cert. denied, 513 U.S. 1190 and cases cited; *Peerless Industries, Inc. v. United States*, 94-1 USTC ¶ 50,043 at 83,171 (E.D. Pa. 1994), aff'd in an unpublished opinion, 37 F.3d 1488 (3d Cir. 1994); *Seykota v. Commissioner*, 61 T.C.M. (CCH) 2706, 2721 and 2726 (1991).

⁹² *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990); *Rasmussen v. Commissioner*, 63 T.C.M. (CCH) 2710 (1992); see also *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1548-49 (9th Cir. 1987).

⁹³ 752 F.2d 89, 91-95 (4th Cir. 1985).

⁹⁴ *Shriver v. Commissioner*, 899 F.2d 724 (8th Cir. 1990); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990); *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988), cert. denied, 488 U.S. 824 (1988); *Cherin v. Commissioner*, 89 T.C. 986, 993 (1987).

earn a profit by entering into the transaction, unlike the transaction in *Frank Lyon* which was also guided by accounting and regulatory concerns, the two prongs of the test for determining whether an economic sham exists overlap to a large extent. A series of cases, discussed below, illustrate how the economic substance prong of the test for determining whether an economic sham exists has been the sole basis for the courts in disregarding the form of the transaction where the taxpayer's only claimed business purpose was to earn a profit.

In *Knetsch v. United States*,⁹⁵ the taxpayer purchased deferred savings annuity bonds from an insurance company, borrowing virtually the entire purchase price from the insurance company and then borrowing to pay the annual interest expense on the loan in a manner such that the taxpayer was assured of an economic loss each year. The taxpayer had a locked-in loss from the inception of the transaction. The Court said that the transaction "did not appreciably affect the taxpayer's beneficial interest except to reduce his tax" and that "it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."⁹⁶ Accordingly the transaction was "a sham," and the Supreme Court disallowed the taxpayer's interest expense deductions.

Similarly, in *Goldstein v. United States*,⁹⁷ the taxpayer borrowed money at a high interest rate to purchase Treasury securities bearing a low interest rate and then prepaid the interest on her borrowings. Similar to *Knetsch*, the taxpayer in *Goldstein* had locked in an economic loss from the inception of the transaction. The Second Circuit Court of Appeals disallowed the interest deduction claimed under Section 163 citing a lack of economic substance as well as a lack of a non-tax business purpose.

The Tax Court applied these principles in *Sheldon v. Commissioner*,⁹⁸ where in certain of the transactions before the court the taxpayer demonstrated that it could have made a profit. In *Sheldon*, a seller of Treasury Bills bought securities and obtained financing from the seller through a repurchase agreement. The petitioner and seller established through confirmation tickets that the petitioner had bought the securities and then placed them with the seller to collateralize the seller financing. However, the seller neither acquired nor delivered any securities to the petitioner. Because the Treasury Bills were purchased and sold to the same dealer, the transactions could be settled, as they would be in the Transaction, by "pair-offs." The court explicitly acknowledged that this method of settling the transactions permitted the petitioner to buy and finance Treasury Bills without any potential for delivery by himself or the seller. The purchases were therefore not fictitious or factual shams.

The court, however, denied the claimed deductions stating that "[i]n instances where intermediate repos could have or did generate some gain from the [positive] carry, these amounts were

⁹⁵ 364 U.S. 361 (1960).

⁹⁶ *Id.* at 366.

⁹⁷ 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

⁹⁸ 94 T.C. 738 (1990).

nominal, either fixed or short-term and stable and, in any event, merely reduced the fixed losses by relatively insignificant amounts." The Tax Court ultimately found that even what nominal profit there was in *Sheldon* was absorbed by losses on related and, arguably, integrated transactions.⁹⁹ It is unclear to what extent the majority opinion in *Sheldon* can be construed as authority for comparing the tax benefits of a transaction to the amount of pre-tax profit potential in determining its economic substance. Nevertheless, the insignificant profit potential which was found to exist provided the court with ample support to conclude that the taxpayer (i) lacked a non-tax business purpose and (ii) the transaction lacked economic substance under the test set forth in *Rice's Toyota World, Inc.* since no reasonable possibility of a pre-tax profit in excess of a de minimis amount existed.

Most recently, in *ACM Partnership v. Commissioner*,¹⁰⁰ the Tax Court disregarded transactions entered into by a partnership as lacking economic substance. In *ACM*, foreign affiliates of a foreign bank, Colgate-Palmolive ("Colgate") and Merrill Lynch formed a partnership. The partners received partnership interests of 82.63 percent, 17.07 percent and .029 percent, respectively. The partnership bought a debt instrument for \$205 million and then sold a significant portion of such debt instrument within a relatively short time period. The consideration received by the partnership included \$140 million in cash and installment notes which provided for payments based on LIBOR. The installment notes had a net present value of \$35 million and, based on their terms, qualified the transaction for contingent payment installment sale treatment. Under the contingent payment installment sale regulations, the partnership initially realized and recognized a large capital gain, attributable to the fact that it could only offset basis of \$29 million from the notes sold against the \$140 million of cash proceeds. The partnership allocated the income to the partners in accordance with the terms of the partnership agreement such that the foreign bank affiliates (with 82.63 percent) were allocated most of the capital gain. The partnership then allocated basis of \$146 million to the installment notes (in accordance with the Section 453 basis allocation rules). The notes thus had a net present value of \$35 million and a basis of \$146 million. The notes were then subsequently disposed of in a manner which yielded a capital loss that was substantially allocated to Colgate.

Colgate asserted that it had multiple business purposes for entering into the transaction. First, it argued that it had a non-tax economic profit motive for its overall ACM investment. Second, Colgate argued that the ACM investment structure allowed it to manage its debt financing costs. In connection with this second business purpose, it asserted that the partnership could be used to acquire Colgate long-term debt and such debt could then be exchanged for Colgate medium-term debt. In an extremely complex analysis, the Tax Court noted the subjective nature of the second business purpose, examined the facts to determine whether they were consistent with such subjective business purpose and concluded that they were not.

The Tax Court then focused on the non-tax economic profit motive of Colgate and whether the transaction had economic substance in light of such non-tax economic profit motive. In making the determination as to whether a transaction has economic substance, courts look to whether

⁹⁹ *Id.* at 768-69. See also *Estate of Baron v. Commissioner*, 83 T.C. 542, *aff'd*, 798 F.2d 65 (2d Cir. 1986).

¹⁰⁰ 73 T.C.M. (CCH) 2189 (1997).

the transaction is "rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions."¹⁰¹ Although a non-tax economic profit motive clearly existed without taking into account transaction costs, the Tax Court noted that the transaction had to be segregated into its multiple valid business purposes and transaction costs allocated to each business purpose. Having determined that the liability management business purpose was not valid since the facts were inconsistent with such business purpose, the Tax Court noted that the non-tax economic profit motive was the sole business purpose of the transaction. After allocating all transaction costs to such business purpose, the Tax Court concluded that (i) there was no reasonable potential for Colgate to have earned any pre-tax profit from its investment unless the notes either increased in credit quality or a 400 to 500 percent basis point increase occurred in the 3-month LIBOR interest rates, neither of which the court thought likely on the evidence presented, and (ii) therefore, Colgate's strategy was not "consistent with rational profit-motivated behavior on the bases of expected tax benefits." Accordingly, the court upheld the IRS's disallowance of the capital loss taken by Colgate.

In a recent decision, the Third Circuit Court of Appeals affirmed the Tax Court's decision. In doing so, the Court of Appeals emphasized that the "inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the objective economic substance of the transactions and the subjective business motivation behind them." Both of these "factors" inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. Nevertheless, the Court of Appeals noted that "it is well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations." The *ACM* court cited for this proposition *Northern Indiana Public Service*. The *ACM* court also noted that "in analyzing both the objective and subjective aspects of [the *ACM* transaction] where the objective attributes of an economically substantive transaction were lacking, we do not intend to suggest that a transaction which has actual, objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations."

As discussed above, *Knetsch*, *Goldstein*, *Sheldon* and *ACM* (based on the Tax Court's conclusion that the facts of the case were inconsistent with the liability management business purpose asserted by Colgate) all involve the courts' evaluation of the economic substance of a transaction in light of the taxpayer's ability to earn a pre-tax profit. In all of those cases, the courts either found a locked-in loss or a lack of a reasonable possibility to earn a pre-tax profit by more than a de minimis amount. We believe that the Transaction is distinguishable from those transactions, and more akin to the transaction described in *Frank Lyon*, in that it is imbued with significant non-tax attributes. Although the Transaction will be structured such that there is a reasonable possibility for Dutch VOF and Company to earn a pre-tax profit by more than a de minimis amount, the primary business purpose for the formation of Dutch VOF, and the Transaction in general, is to raise capital. With respect to Company, the form permits Company to characterize the financing as quasi-equity "minority" interest for accounting purposes. In addition, it has been represented to us that the transaction costs associated with the Transaction are reasonable and consistent with other quasi-equity financing structures in the market.

¹⁰¹ *ACM*, 23 T.C.M. at 2217.

It should also be noted that the Seventh Circuit Court of Appeals in *Northern Indiana Public Service Company* noted that even though the formation of the intermediate entity was heavily guided by tax considerations (*i.e.*, the ability of the taxpayer to reduce the withholding tax that would have otherwise been imposed on the foreign lenders had such lenders made loans directly to the taxpayer), such structure allowed the taxpayer to raise lower cost financing from foreign capital markets which it would not have been able to access without the benefit of the structure. In fact, the Seventh Circuit specifically discussed the application of *Knetsch* to that case and found that line of authority unpersuasive. The IRS had tried to argue that the transaction between the intermediate entity and its parent should be ignored and that, absent such transaction, the intermediate entity had no profit potential. The Seventh Circuit held that:

it is unnecessary, and we think inappropriate, for us to sever a corporation from its transactions in analyzing a case, such as this one, where the corporation was formed with the intent of structuring its economic transactions to take advantage of laws that afford tax savings. Finance's existence, its interest transactions with Taxpayer and its other economic activities are all relevant to our analysis. Moreover, *Knetsch* and the captive insurance company cases do not dictate the outcome the Commissioner desires. Those cases allow the Commissioner to disregard transactions which are designed to manipulate the Tax Code so as to create artificial deductions. They do not allow the Commissioner to disregard economic transactions, such as the transactions in this case, which result in actual, non-tax related changes in economic position.¹⁰²

Because the Transaction results in actual non-tax related changes in the economic position of Company and Dutch VOF and serves a significant business purpose, other than earning a pre-tax economic profit, the form of the Transaction should be respected and not disregarded as an economic sham or lacking economic substance.

X. SECTION 7701(l): PROPOSED "FAST PAY" REGULATIONS

Section 7701(l), which was enacted specifically to address what is described, in the legislative history, as "unwarranted" tax avoidance, provides as follows:

The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title.

Under proposed regulations recently promulgated under Section 7701(l), the IRS may recharacterize an arrangement in which a corporation has outstanding fast-pay stock (where tax avoidance is a principal purpose for the arrangement) as an arrangement directly between the non-fast-

¹⁰² *Northern Indiana Public Service Company*, 101 T.C. 294, *aff'd*, 115 F.3d 506 (7th Cir. 1997).

pay (or "benefited") shareholders and the fast-pay shareholders in which the benefited shareholders issue financial instruments directly to the fast-pay shareholders.¹⁰³

It should be noted that where a fast-pay arrangement is recharacterized, the nature of the financial instruments deemed issued (*i.e.*, as debt or equity) is determined under general income tax principles. If the Transaction were considered a fast-pay arrangement, it is unclear which direct or indirect holder of the Common Units would be deemed to issue financial instruments to Investor BV. Under such circumstances, we believe it is likely that SARL would not be treated as issuing such instruments because such a recharacterization would itself most likely constitute a fast-pay arrangement under the same reasoning. As a result, we believe the most likely recharacterization of the Transaction would be as an arrangement between Company LLC and Investor BV. Under this characterization, the classification of such instruments as debt or equity would likely have little U.S. tax effect to the Company group because classification as debt would provide Company LLC with an interest deduction and classification as equity would divert an equal amount of income away from the Company group and to Investor BV. Nonetheless, the subpart F income of Dutch BV for each taxable year in excess of the Preferred Distribution paid during such year would be taxable to the Company group.

Furthermore, if the IRS could successfully recharacterize the Transaction as an arrangement involving the issuance by the Company LLC Members of financial instruments to Investor BV (which recharacterization we think is unlikely), the classification of such financial instruments as debt or equity would become vitally important. (It is unclear under this recharacterization whether the financial instruments deemed issued would constitute debt or equity.) Under an equity classification, the Company group would be taxable on all of Dutch VOF's subpart F income, but would receive no deduction for Preferred Distributions paid by Dutch VOF to Investor BV. In contrast, debt classification would result in the Company group including in income all of Dutch VOF's subpart F income, which would be offset to the extent of the interest deduction for Preferred Distributions paid to Investor BV.

The regulations define fast-pay stock as follows:

Stock is fast-pay stock if it is structured so that the dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if --

(A) It is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant); or

¹⁰³ Prop. Reg. § 1.7701(l)-3(c)(2).

(B) It is issued for an amount that exceeds [parenthetical omitted] the amount at which the holder can be compelled to dispose of the stock.¹⁰⁴

The determination of whether stock is fast-pay stock is based on all of the facts and circumstances, including any related agreements such as options or forward contracts.¹⁰⁵ The determination is made when the stock is issued, when there is a modification, or when there is a significant change in the facts and circumstances.¹⁰⁶

Although both economically and in form a redemption, the payment of Redemption Proceeds would be treated as a dividend under Section 316 for tax purposes because (i) the amounts paid would be treated as a distribution on stock under Section 302 (through the option attribution rule in Sections 318(a)(4) and 318(a)(2)(C)) and (ii) the amounts would be paid out of earnings and profits.

As to presumption (A) of the regulations, the Preferred Units do not have a dividend rate that is reasonably expected to decline. Dutch VOF is expected to pay the Preferred Distribution (which distribution is LIBOR-based) while the Preferred Units are outstanding. The amount of the Preferred Distribution would be reduced in the event that Redemption Proceeds were transferred to Investor BV in partial redemption of the Preferred Units because the liquidation preference of the Preferred Units would be reduced. As a result, at the time of their issuance, the Preferred Units should not implicate presumption (A) of the fast-pay regulations.

However, in the event of a "significant change in the facts and circumstances," which might be considered to occur to the extent Redemption Proceeds were paid, the status of the stock as fast-pay stock would be retested. (The regulations do not specify whether such a recharacterization would be effective retroactively, or just from the time of the change in the facts and circumstances.) The Preferred Units could conceivably be recharacterized as a fast-pay arrangement to the extent that Redemption Proceeds reduced the liquidation preference of the Preferred Units, such that future Preferred Distributions were reduced. Nonetheless, we would argue that prepayment affects timing but not the effective dividend rate and thus even in these circumstances should not implicate presumption (A).

As to presumption (B), payment of Redemption Proceeds would give rise to a reduction in the liquidation preference of the outstanding Preferred Units. As such, it could be argued that, if such Redemption Proceeds were paid, Investor BV could then be forced to dispose of the Preferred Units for less than their original issue price, thus raising the issue of the application of presumption (B) above. This argument should not prevail because, on a per-share basis, Investor BV actually receives the issue price in redemption for each share of the Preferred Units. As such, it cannot be compelled to dispose of any Preferred Unit for less than that unit's issue price. Moreover, as with

¹⁰⁴ Prop. Reg. § 1.7701(l)-3(b)(2)(i).

¹⁰⁵ Prop. Reg. § 1.7701(l)-3(b)(2)(ii).

¹⁰⁶ *Id.*

presumption (A), such a reduction of the liquidation preference of the Preferred Units is not expected to occur. Although the regulations do not state that a dividend must be reasonably expected to be paid for it to be taken into account in applying the presumptions, we believe that such a requirement should be considered implicit in the regulation's use of the term "structured," a term that suggests purpose or expectation.

The question arises whether, apart from the two presumptions in the regulations, the Preferred Units are "structured so that the dividends (as defined in Section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on a holder's investment)." Any payment of Redemption Proceeds arguably will constitute a return of the holder's investment because such payment will result in a corresponding reduction in the liquidation preference of the Preferred Units. Moreover, the because the Transaction is structured to provide for two payments each of which constitutes a dividend under Section 316 and one of which would constitute a return of the holder's investment if actually paid, it could be argued that the Preferred Units should be treated as fast-pay stock. It could also be asserted that while the Redemption Proceeds need not be paid in order to achieve the intended result, the regulations do not, on their face, require such a causal connection. Nevertheless, we believe that an instrument cannot be "structured" to provide for dividends that are economically a return of the holder's investment where the only dividends that could create a return of the holder's investment are within the discretion of the issuer's board of directors and are not reasonably expected to be paid.

However, we believe that the regulations were aimed at transactions in which the dividends intended to be paid resulted in a return of the holder's investment, and that only where this intention exists should a transaction be considered to be "structured so that dividends paid" constitute a return of the holder's investment.

XI. SECTION 269 SHOULD NOT APPLY TO DISALLOW ANY DEDUCTION, CREDIT, OR ALLOWANCE ARISING FROM THE TRANSACTION

Section 269(a) provides in pertinent part that:

... if any person or persons acquire . . . directly or indirectly, control of a corporation . . . and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which such person . . . would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance . . . [C]ontrol means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

By acquiring at least 50 percent of the total value of Dutch VOF stock, Company will have acquired control for purposes of Section 269.¹⁰⁷ However, Company will not acquire control of

¹⁰⁷ *James Realty Co. v. United States*, 280 F.2d 394 (8th Cir. 1960) (acquisition of a controlling interest in a newly organized corporation is considered an acquisition of control in the corporation for purposes of

Dutch VOF with the principal purpose of tax evasion by securing a benefit "... which such corporation or person would not *otherwise* enjoy" (emphasis added). The Tax Court held in *Commodores Point Terminal Corp. v. Commissioner*¹⁰⁸ that a corporation acquiring 58 percent of a target corporation was not prohibited under the predecessor of Section 269 from utilizing the dividends-received deduction because the acquiring corporation could have enjoyed such deduction even if it had acquired stock that did not constitute control of the target. Specifically, the court held that "the word otherwise can only be interpreted to mean that the deduction, credit or allowance, if it is to be disallowed, must stem from the acquired control" ¹⁰⁹ In *Cromwell Corp. v. Commissioner*,¹¹⁰ the Tax Court refused to apply Section 269 because the taxpayer could have "otherwise enjoyed" the same tax benefit without acquiring control.¹¹¹

The allocation of subpart F income to Investor BV rather than Company LLC does not depend on Company LLC acquiring control of Dutch VOF, but rather depends on the rights of the holders of the Common Units and the Preferred Units to the earnings and profits of Dutch VOF. Accordingly, Section 269 should not apply to reallocate any of Dutch VOF's subpart F income to Company LLC.

Moreover, the reallocation of income from the holders of the Dutch VOF Preferred Units to the holders of the Dutch VOF Common Units should not be viewed as the denial of a "deduction, credit or other allowance" within the context of Section 269. The Treasury Regulations promulgated under Section 269 provide that "the term allowance refers to anything in the internal revenue laws which has the effect of diminishing tax liability."¹¹² The courts, however, have consistently held that the tax benefit at issue must fit within the accepted usage of one of the quoted terms.

Section 269); *see also Dillier v. Commissioner*, 41 T.C. 762 (1964), *aff'd sub nom, Made Rite Inv. Co. v. Commissioner*, 357 F.2d 647 (9th Cir. 1966); *Bobsee Corp. v. United States*, 411 F.2d 231 (5th Cir. 1969).

¹⁰⁸ 11 T.C. 411 (1948).

¹⁰⁹ *Id.* at 17.

¹¹⁰ 43 T.C. 313 (1964).

¹¹¹ In *Cromwell Corp. v. Commissioner*, 43 T.C. 313 (1964), four individuals formed a new corporation in order to effectuate a bootstrap acquisition of another corporation. The new corporation borrowed money and used the proceeds as part of the consideration. After the acquisition, the acquired corporation borrowed money and distributed the proceeds to the acquiring corporation, which in turn repaid its loan. The IRS sought to prevent the two corporations from enjoying the benefit of filing as a consolidated group. The Tax Court held for the taxpayer and indicated that "the course of action pursued did not result in securing a benefit not *otherwise obtainable* since similar methods of acquisition have been approved by the courts." 43 T.C. at 317 (emphasis added). The court held that "[w]e rest our decision upon the ground that, irrespective of purpose, there has been no securing of a benefit which *would not otherwise have been enjoyed*." 43 T.C. at 317 (emphasis added).

¹¹² Treas. Reg. § 1.269-1(a).

For example, in *Nutt v. Commissioner*,¹¹³ the taxpayer sold property to his wholly-owned corporation, which subsequently sold the property at a profit. The IRS asserted that Section 269 should be applied to reallocate income earned by the corporation to the corporation's shareholder because the IRS believed that, in substance, the income had been earned by the shareholder.¹¹⁴ Reasoning that the IRS was attempting to increase both the income and deductions claimed by taxpayer on its return rather than "to disallow to petitioners a deduction, credit, or other allowance claimed by them," the Tax Court held that "Section 269 of the Internal Revenue Code of 1954 is by its terms inapplicable."¹¹⁵

In *Siegel v. Commissioner*,¹¹⁶ a U.S. taxpayer formed a foreign corporation which, under then-current law, was not subject to current U.S. taxation on its foreign profits.¹¹⁷ Upon a liquidation or sale of the corporation, however, the taxpayer would have recognized capital gain. Similar to *Nutt*, the IRS challenged the nonrecognition of income at the shareholder level under Section 269. Specifically, the IRS asserted that a reallocation of income from the corporation to its shareholder was warranted under Section 269. The Tax Court first noted that the existence of a substantial business reason for forming the corporation (albeit a foreign corporation) goes far to render Section 269 inapplicable.¹¹⁸ The Tax Court also held that, in any event, similar to *Nutt*, Section 269 was inapplicable because the IRS did not seek to disallow any "deduction, credit or other allowance" claimed by the taxpayer. Rather, the IRS sought to utilize Section 269 to add to the taxpayer's reported income by disregarding the intervening corporation and treating the shareholder as if he owned the interest in the activity directly that earned the income.¹¹⁹

¹¹³ 39 T.C. 231 (1962), *acq.*, 1964-2 C.B. 5, *remanded on other issues*, 351 F.2d 452 (9th Cir. 1965), *cert. denied*, 384 U.S. 918 (1966), *on remand*, 48 T.C. 718 (1967), *remanded*, 69-2 USTC ¶ 9501 (9th Cir. 1969), *on remand*, 52 T.C. 484 (1969), *rev'd*, 447 F.2d 1109 (9th Cir. 1971).

¹¹⁴ Arguably, the economic value of the stock held by the subject taxpayers in the cases, discussed *infra*, had appreciated to the extent of the economic accrual of such income at the corporate level. Presumably, a sale or liquidation of the stock of the subject corporation would have resulted in recognition of capital gain by the shareholder. Thus, the IRS in these cases was attempting to preclude the taxpayer from deferring recognition of that gain and in some instances, converting ordinary income to capital gain.

¹¹⁵ See *Cherry v. United States*, 264 F. Supp. 969, 983 (C.D. Cal. 1967), where the court stated that the terms "deduction," "credit" and "allowance," as used in Section 269, are technical terms, each having their own precise meanings in the Code. The court, in *Cherry*, then cited *Nutt* for the proposition that a statutory provision dealing with the nonrecognition of gain is not a "deduction," "credit" or "allowance" so that Section 269 does not deal with nonrecognition concepts.

¹¹⁶ 45 T.C. 566 (1966), *acq.*, 1966-2 C.B. 7.

¹¹⁷ The years in question preceded the enactment of subpart F and Section 1248. Under these provisions, either the taxpayer would have been currently taxed on the ordinary income of the corporation or any capital gain on the sale or liquidation of the corporation would have been converted into ordinary income.

¹¹⁸ *Id.* at 577.

¹¹⁹ *Id.* at 578.

We also note that the Tax Court has refused to apply Section 269 in a series of cases where the nonrecognition of gain event was permanent. For example, in *Bijou Park Properties, Inc. v. Commissioner*,¹²⁰ the taxpayer formed Company A. Company A was in the business of developing and subdividing land. Company A then sold the parcels for long term installment notes. Approximately ten years later, Company B was formed by the taxpayer for purposes of buying all of the Company A stock. Subsequent to the purchase, Company A was liquidated into Company B. Under the Code as in effect at that time, where a corporation purchased all of the stock of another corporation and liquidated it within two years in a transaction to which Section 332 applied, the acquiring corporation was entitled to a stepped-up tax basis in the assets received from the acquired corporation under Section 334(b)(2). Company B, therefore, allocated a substantial portion of its cost basis in Company A stock to the installment notes (such notes representing substantially all the assets of Company A). The IRS argued that under Section 269, Company A had made a taxable disposition of the installment notes requiring recognition of any gain which had been deferred under Section 453.¹²¹ The Tax Court found that, as a factual matter, the acquisition of control of Company A did not have as its principal purpose the "evasion or avoidance of Federal income tax."¹²² Moreover, the Tax Court concluded that, as a matter of law, the benefit of the nonrecognition of gain by Company A was not a "deduction, credit or other allowance."¹²³ Under the provisions in existence at that time, however, the Tax Court concluded that Company B was related to Company A and was, therefore, not entitled to a basis step-up in the assets.

The court's refusal to apply Section 269 in *Bijou Park* is particularly relevant in analyzing the subsequent case, *Cherry v. United States*.¹²⁴ *Cherry* involved facts similar to those presented in *Bijou Park* except that the purchasing corporation was not deemed to already own the stock of the acquired corporation by virtue of the constructive ownership rules under Section 318. The IRS, however, did not contend that the acquired corporation should be treated as having disposed of its installment notes. Rather, the IRS limited its argument under Section 269 to precluding the acquiring corporation from the tax "allowance" under Section 334(b)(2), *i.e.*, the stepped-up tax basis of the installment notes. The District Court held that the acquiring corporation was entitled to a step-up in the tax basis of the installment obligations upon a liquidation of the acquired corporation. The Court further noted that:

It is true, as the Government points out, that the deferred profit on the installment obligations, not previously taxed to the predecessor corporations, will, in part, escape taxation at the corporate level once the successor, parent corporations acquire a new

¹²⁰ 47 T.C. 207 (1966).

¹²¹ The IRS did not challenge the existence of Company A under *Moline Properties*. This argument on its face, however, would have had no merit inasmuch as Company A had been in existence for ten years prior to its sale and had been engaged in substantial business activity during that period.

¹²² *Id.* at 214.

¹²³ *Id.*

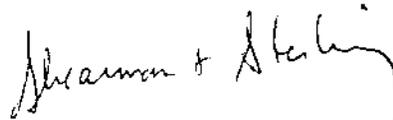
¹²⁴ 264 F. Supp. 969 (C.D. Cal. 1967).

basis determined by reference to the purchase price paid for the shares of stock acquired. But that is the inevitable result of the rule originally judicially fashioned by the courts and legislatively adopted by Congress in Section 334(b)(2) which treats the parent corporations as though they had purchased assets directly.¹²⁵

By contending that Company LLC should be allocated additional subpart F income, the IRS would be attempting to "increase" the income of the taxpayer as opposed to "disallowing" a deduction, credit or other allowance.

Based on the authorities discussed above, we do not believe that the IRS should be able to apply Section 269 in this manner.

Very truly yours,



RAR
ACG
MBS

¹²⁵ *Id.* at 981.

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Sequoia Financial Assets LLC

Ladies and Gentlemen:

We have acted as tax counsel to Enron Corp., an Oregon corporation ("Enron"), in connection with (i) the formation of Sequoia Financial Assets LLC (the "Company"), a Delaware limited liability company that will elect to be treated as a financial asset securitization trust (a "FASIT") for U.S. federal income tax purposes, (ii) the sale to the Company by U.S. subsidiaries of Enron (the "Sellers") of certain accounts receivable arising from the operations of the Sellers and certain debt of Enron issued to the Sellers (the "Enron Debt"), (iii) the sale to the Company by Enron of certain debt of the Sellers guaranteed by Enron (the "Seller Debt"), and (iv) the issuance and sale by the Company of the Class O Interest, the Class A Interests, and the Secured Notes (including each Monthly Note and each Interim Note). You have requested our opinions as to certain United States federal income tax consequences regarding the formation of the Company and the issuance and sale of the Class O Interest, the Class A Interests and the Secured Notes.

The Class O Interest and the Class A Interests are membership interests in the Company arising under the Sequoia Financial Assets LLC Company Agreement, dated as of May 28, 1999 (the "Company Agreement"), between Enron and the holder of the Class O Interest (the "Class O Interest Holder"). The Secured Notes will be issued by the Company in the form of debt instruments pursuant to the Security Agreement, dated as of May 28, 1999 (the "Security Agreement"), among the Company, Enron, Cherokee Finance V.O.F. ("Cherokee"), and the Class O Interest Holder and the Note Purchase Agreement, dated as of May 28, 1999 (the "Note Purchase Agreement"), between the Company and Cherokee as the Noteholder. The Company acquired, and will acquire, the accounts receivable, Enron Debt and Seller Debt from the Sellers and Enron pursuant to the Sale and Servicing Agreement, dated as of May 28, 1999 (the "Sale and Servicing Agreement"), among the Company, the Sellers and Enron, in its capacity as the Servicer. The Sale and Servicing Agreement, the Company Agreement, the Security Agreement and the Note Purchase Agreement together are hereinafter referred to as the "Transaction Documents." Capitalized terms used herein and not otherwise defined shall have the meaning given to such terms in the Transaction Documents.

In connection with your request, we have examined the Transaction Documents and such other materials relating to the transactions described therein as we have deemed necessary and appropriate. The opinions set forth are based on the following assumptions: (i) the Transaction Documents represent the entire legal documentation relevant to the formation and capitalization of the Company and all related transactions; (ii) all of the parties to the Transaction Documents will, at all times, comply with the provisions of the Transaction Documents; (iii) the facts and representations set forth in such Transaction Documents are accurate; and (iv) the Class O Interest, the Class A Interests, the Secured Notes and any other certificates or instruments issued by the Company will be issued and administered in a manner consistent with the descriptions contained in the Transaction Documents. In rendering our opinions, we have relied on the accuracy and completeness of the facts, information, covenants, statements and representations contained in the Transaction Documents and such other statements, information and documents as we have deemed relevant. To the extent that our opinions rest on matters set forth in the Transaction Documents or such other statements, information and documents as we have deemed relevant, our opinions are subject to the assumptions, qualifications, exceptions and limitations set forth in the Transaction Documents and any other statements or representation of facts with respect to such matters.

Based upon, and subject to, the analysis set forth below and the assumptions and statements referred to herein, having regard for such legal counterclaims as we have deemed relevant, and subject to the qualifications set forth herein, we are of the opinion that for U.S. federal income tax purposes:

- (1) The Company will qualify as a FASIT.
- (2) The Class O Interest will be a FASIT ownership interest.
- (3) Each Monthly Note, each Interim Note and each Class A Interest will be a FASIT regular interest.
- (4) The Class O Interest Holder will be able to deduct the discount on the FASIT regular interests and such deductions may offset its income on the Assets and its upfront gain (if any) from the transfer of the Assets to the Company.
- (5) The transfers of the accounts receivable by the Sellers should be respected as true sales.
- (6) Enron and the Sellers should not be denied, or required to defer, their deduction for interest paid or accrued on the Enron Debt or the Seller Debt sold to the Company by reason of section 163(j).
- (7) Based on the exception for portfolio debt investments and certain income tax treaties applicable to the holders of member interests in Cherokee,¹ the interest payments made by the Company to Cherokee on the regular interests held by Cherokee should not be subject to U.S. withholding tax.

Our opinions in this regard are based upon the Internal Revenue Code of 1986, as amended, the Treasury regulations promulgated thereunder, the relevant case law and administrative pronouncements of the Internal Revenue Service (the "IRS"), all as of the date hereof. Our opinions are limited to the federal income tax laws of the United States and we do not express any opinion herein as to any other law. In particular, we

¹ Convention Between Netherlands and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, which was signed on December 18, 1992 and entered into force on December 31, 1993; Convention Between the United States of America and the Grand Duchy of Luxembourg with Respect to Taxes on Income and Property, which was signed on December 18, 1962 and entered into force on January 1, 1964; Convention Between the Government of the Grand Duchy of Luxembourg and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, which was signed on April 3, 1996 and has not yet entered into force. Cherokee will rely on the exception for portfolio debt investments and will not take a treaty-based return position that it would have to disclose.

have not considered and do not express any opinion as to the consequences of the transactions under any state, local or foreign tax law.

The opinions expressed above are furnished by us as counsel to you, and are solely for your benefit in connection with the transactions described herein. Without our prior written consent, you shall not be entitled to rely on this letter for any other purpose or in any other capacity, and no other person shall be entitled to rely on this letter for any purpose whatsoever. The opinions expressed should not be accepted as guarantees that a court of law or an administrative agency will concur in the opinions. In particular, our analysis of the foregoing issues is not binding on the IRS or the courts. No assurance can be given that the IRS will not challenge our analysis of the tax treatment of certain matters discussed herein or, if it does, that it will not be successful. No rulings have been requested or received from the IRS as to any of the matters discussed herein.

This letter speaks only as of the date hereof. We do not undertake to advise you of any development or circumstance of any kind, including any change of law or fact that may occur after the date hereof, irrespective of whether such development, circumstance or change may affect the legal analysis, a legal conclusion, or any other matter set forth in or relating to this letter.

The comments set forth below are intended to provide you with additional analysis and information regarding certain of our opinions, as we have deemed appropriate.

(1) A tax is imposed on income earned by a FASIT on loans it originates. Section 860L(e)(2)(C). The Company is not an originator of the accounts receivable, which are originated by the Sellers in the ordinary courses of their businesses. A question may arise, however, as to whether the Company is the originator of the Enron Debt and the Seller Debt. While the Seller Debt will be originally issued by the Sellers to Enron and the Enron Debt originally issued by Enron to the Sellers, the Company may acquire the Enron Debt and the Seller Debt immediately following its issuance pursuant to an arrangement. We believe the prohibition against origination was intended to prevent FASITs from being engaged in an active lending business and was certainly not intended to preclude acquisitions of debt instruments shortly after their issuance. For example, credit card receivables are generally acquired by securitization vehicles immediately following their creation pursuant to a prearranged plan. Such arrangements are typical in revolving credit card receivable financings, which the FASIT rules are

intended to facilitate.² The Company's activities are consistent with those necessarily performed by a vehicle for revolving credit securitizations and are, furthermore, essentially passive. *Cf.* Treas. Reg. § 1.864-4(c)(5) (foreign entity acting merely as a financing vehicle for borrowing funds is not considered to be in the active conduct of the business of banking or financing in the U.S.). Given the passivity of the Company in the present situation, we believe that, while there is no official guidance regarding engaging in origination, the Company is not an originator of the Enron Debt or the Seller Debt.

(2) A FASIT regular interest is any interest issued by a FASIT, which is designated as a FASIT regular interest, if it meets certain requirements. Section 860L(b)(1)(A). In particular, a FASIT regular interest must unconditionally entitle the holder to receive a specified principal amount (or similar amount) and must not have a stated maturity (including options to renew) of more than 30 years. Section 860L(b)(1)(A)(i) and (ii).³

(a) The question may arise whether a member interest issued by a limited liability company, such as a Class A Interest, may be a FASIT regular interest. The definition of a "FASIT regular interest" clearly provides that it may be any interest issued by a FASIT meeting listed requirements so long as it is designated as a FASIT regular interest. Furthermore, for federal income tax purposes, a FASIT regular interest is treated as a debt instrument even if it is not otherwise a debt instrument. Section 860H(c)(1). Each Class A Interest issued by the Company will be designated as a FASIT regular interest and will meet all of the listed requirements for FASIT regular interests. Consequently, each Class A Interest will be a FASIT regular interest.

(b) The fact that the holders of the Secured Notes and the Class A Interests are expected to reinvest the proceeds of those interests upon maturity may raise the question of whether the requirement that a FASIT regular interest entitle the holder to receive a specified principle amount is met. Each Secured Note and each Class A Interest entitles the holder to payment of a specified principal amount and matures no later than the end of the month in which it was issued. While the holders are expected to reinvest such amounts, the holders have the

² See New York State Bar Report on Proposed Regulations to be Issued Under FASIT Provisions (1997).

³ Application of the FASIT anti-abuse rule, section 860L(h), is discussed below in relation to the discussion of section 163(j).

discretion to stop reinvesting and to receive the stated principal amount. The planned reinvestment does not, therefore, violate the unconditional entitlement requirement. *See* Rev. Rul. 81-238, 1981-2 C.B. 248 (dividend reinvestment plan merely creates agency relationship where investor has discretion to terminate reinvestments); P.L.R. 6407295200A (July 29, 1964) (dividends subject to reinvestment in regulated investment company pursuant to plan allowing investor to withdraw at any time are paid for purposes of dividends paid deductions). While the principal amount is not delivered to the holders, the holders have control over the principal amount and are paid for federal income tax purposes.

(c) Because the holders are expected to reinvest the amounts received on each Secured Note and each Class A Interest, the question might also arise whether the Secured Notes and the Class A Interests have stated maturities of less than 30 years. As noted, the holders are not required to reinvest and may stop reinvesting upon the maturity of a Secured Note or a Class A Interest. Because the Secured Notes and the Class A Interests mature each month and are paid at that time, they do not have terms to maturity of more than one month.

(3) The FASIT ownership interest is the interest issued by a FASIT that is designated as an ownership interest and that is not a FASIT regular interest. Section 860L(b)(2). The Class O Interest will be designated as the ownership interest in the Company and will not be designated or treated as a regular interest. The question may arise whether the form will be respected in this case where (i) the Class A Interests entitle the holder to control the Company, (ii) the holder of the Class A Interests is entitled to receive a fee for servicing the assets of the Company, and (iii) the holder of the Class A Interest has indemnified the Class O Interest Holder for any taxes imposed on the Class O Interest Holder as a consequence of holding the ownership interest. One of the purposes of the FASIT rules is to provide certainty as to the classification of interests for federal income tax purposes, regardless of traditional debt/equity analysis. Consequently, we believe that these factors will not cause the designation of the Class O Interest as the ownership interest to be disregarded or the Class A Interests to be treated as an ownership interest. First, as discussed above, the FASIT rules anticipate that a FASIT regular interest may be a membership interest in a limited liability company (or some other form of equity interest in a business entity). Since many securitization transactions are structured to make the ownership interest as small as possible, it was foreseeable that membership interests treated as debt for tax purposes might entitle the holders thereof to the right to control the entity. Consequently, it was foreseeable that the holder of the designated ownership interest in the FASIT might not have such control. Second, FASITs are intended to

be passive entities, as discussed with respect to origination. The need to pay a servicer is a consequence of the passive nature of a FASIT. Therefore, the fact that the Company pays an arms-length servicing fee to Enron, which happens to be the holder of the Class A Interest is not significant. Third, the FASIT rules require that the holder of the ownership interest, which must be a domestic, taxable corporation, take into account the tax items of the FASIT. The rule is intended to assure that certain income does not escape taxation at the corporate level. While the Class A Interest holder will indemnify the Class O Interest Holder for any taxes imposed that are attributable to the FASIT, the Class O Interest Holder is not relieved of its liability for such taxes. The indemnification is a separate contractual relationship between the Class A Interest Holder and the Class O Interest Holder that exists outside of the FASIT and does not affect the status of the Class A Interest as a regular interest or the Class O Interest as an ownership interest. *See* Treas. Reg. § 1.860G-2(i)(1) (form respected where contractual rights are coupled with real estate mortgage investment conduit ("REMIC") regular interests). The status of the Class O Interest as the ownership interest is also supported by the real economic investment by the Class O Interest Holder, the yield on which depends on the performance of the Company's assets.

(4) The income from the disposition of an asset by a FASIT is generally subject to the tax on prohibited transactions. Section 860L(e)(2)(B). Because the Company may dispose of an account receivable if it is not paid on the due date, the question may arise whether the Company would be subject to the tax on prohibited transactions. There is an exception to the rule for dispositions incident to foreclosure, default or imminent default on the debt instrument. Sections 860L(e)(3)(A)(i) and 860F(a)(2)(A)(iii). According to the Sale and Servicing Agreement, default occurs in the event that nonpayment of a scheduled payment is not cured within three days of receipt of written notice by the Seller and the Servicer. While "imminent default" is not defined in the Code, we believe that nonpayment of a scheduled payment gives rise to a situation where default is imminent. Therefore, the Company will not be subject to the tax on prohibited transactions upon a disposition of an account receivable upon non-payment.

(5) Property acquired by a FASIT from someone other than the holder of the ownership interest is treated (i) as having been acquired by the holder of the ownership interest for an amount equal to the FASIT's cost of acquiring the property and (ii) as having been sold to the FASIT by such holder at its value. Section 860I(a)(2). For this purpose, value is determined under special FASIT valuation rules. If the value of the property exceeds the ownership interest holder's

cost basis in the property, the holder of the ownership interest recognizes gain to the extent of such excess ("upfront gain"). Section 860I(a)(1).

For purposes of determining its taxable income, the holder of the ownership interest is treated as the direct owner of all assets acquired by the FASIT, and as the direct obligor on all liabilities (regular interests) issued by the FASIT. If the holder recognizes upfront gain, the holder's basis in the assets of the FASIT is increased by the amount of gain recognized. Consequently, the holder of the ownership interest will recognize a gain each month with respect to the receivables and other assets of the FASIT equal to the sum of (i) the upfront gain, if any, and (ii) the excess of (x) the face amount of the assets over (y) the holder's basis in the assets (adjusted for upfront gain, if any). That gain generally should equal the interest expense on the regular interests issued by the FASIT.⁴

The holder of the ownership interest will be entitled to offset its upfront gain (if any) with interest expense on the regular interests, even in the unlikely event that the upfront gain is treated as derived outside of the FASIT. The FASIT provisions do not prohibit the use of FASIT losses (*i.e.*, interest expense on the regular interests) from offsetting non-FASIT gains. The FASIT rules only prohibit using non-FASIT losses to offset FASIT gains. *See* section 860J(a).

(6) The transfer of accounts receivables to the Company is structured as a transfer of the right to collect the full amount of the accounts receivable owed by the Seller's customers. The Sellers have agreed with their customers to offset the amount owed by the customers on the accounts receivable against the amounts owed by the Sellers to the customers. It might be argued that when the Company acquires the accounts receivable from the Sellers, it is acquiring a net position. We understand that the netting arrangement relates only to the manner and method of payment of the accounts receivable; the netting arrangement does not alter the obligations of a customer to the respective Seller in any other manner. Consequently, based on the form of the accounts receivable, a customer is unconditionally obligated to pay the full amount of the account receivable and the Seller has a legally enforceable right to receive the full amount of the receivable. Furthermore, at the time a customer takes delivery and incurs its obligation the amount of the offset is not determinable. Regardless of the netting, therefore, the gross amount of the accounts receivable transferred by the Sellers should have

⁴ The holder of the ownership interest presumably will recognize some taxable income, however, reflecting at a minimum the economic income generated by the ownership interest.

economic significance. See, e.g., *Peracchi v. Comm'r*, 98-1 U.S.T.C. 84,009 (9th Cir. 1998). Consequently, while there is no authority directly on point, the customers' obligations should be respected as independent obligations for the full amount of the receivables. See e.g., *Sacks v. Comm'r*, 69 F.3d 982, 989-90 (9th Cir. 1995).

(7) If the transfers of the accounts receivable to the Company are not treated as sales, but as pledges of the assets to secure repayment of amounts advanced to the Sellers, the Company would be viewed as holding debt instruments issued by the Sellers. While such debt instruments should be good assets for purposes of the FASIT asset qualification tests under section 860L(c)(1)(B), this characterization would raise the origination issue⁵ and could result in the application of the anti-abuse rule relating to section 163(j), described in more detail below.

To determine whether a transfer constitutes a sale for federal income tax purposes, the courts and the IRS have adopted a multi-factor analysis to ascertain whether the "substantial incidents of ownership" have been relinquished in the transfer. See, e.g., *Mathers v. Comm'r*, 57 T.C. 666, 674 (1972), *acq.*, 1973-1 C.B. 1; PLR 8338043 (June 17, 1983); GCM 34602 (Sept. 9, 1971); GCM 38147 (Oct. 26, 1979); GCM 37848 (Feb. 5, 1979); see generally, TAM 9237004 (April 8, 1992). Two key factors clearly indicate that a sale has occurred. First, the Company acquires the accounts receivable from the Sellers for a price fixed upfront so that the Company enjoys all of the benefits, in the form of increased yield by reason of earlier than expected prepayment of the accounts receivable, and bears all of the burdens, in the form of decreased yield by reason of later than expected prepayments, of ownership of the accounts receivable. Second, the Company bears all of the credit risk associated with the accounts receivable. While Enron ultimately bears the risk of loss due to defaults up to a certain level, which includes all expected losses, it bears that risk in its capacity as the holder of the Class A Interests in the Company and not as owner of the assets of the Company.⁶ Neither Enron nor the Sellers act as guarantors of the accounts receivable, however, and the holders of interests in the Company bear all of the risk that the obligations of the Company will exceed the value of its assets. On the other hand, the Company lacks the power to dispose of the assets, except in the event of non-payment or other default, which is the third of three key indicia of a sale. The Sellers themselves,

⁵ As discussed above, the Company is not an originator.

⁶ Enron will also indirectly own a 60% interest in each Secured Note.

however, have no retained interest in the assets transferred to the Company and should not be viewed as having retained ownership of the assets, which tends to undermine the argument that they merely pledged the assets. On the basis of the transfer of credit risk and prepayment risk, therefore, the transfer should be viewed as a true sale of the assets to the Company.

(8) Under section 163(j), the deduction for interest paid on a debt obligation by a domestic taxpayer to a related foreign entity may be deferred and ultimately denied. The Secretary of the Treasury is directed to issue regulations under section 163(j) as appropriate to prevent avoidance of that section. The legislative history of section 163(j) indicates the regulations should be issued recharacterizing back-to-back loans through third parties as direct loans to related parties. H. R. Rep. No. 101-247, at 1246-47. If the Company were disregarded for federal income tax purposes, the FASIT regular interests might be treated as debt instruments issued by the Seller to Enron and Cherokee.

(a) No regulations have been issued in final form to date. The existence of the Company should not be disregarded under general conduit principles. *See, e.g., Addison International, Inc. v. Comm'r*, 90 T.C. 1207, 1221 (1988), *aff'd*, 887 F.2d 660 (6th Cir. 1989) (corporation formed to qualify as a domestic international sales corporation may not be disregarded as a conduit, even though disqualified, and is imbued with business purpose); *Jet Research, Inc. v. Comm'r*, 60 T.C.M. 613 (1990) (same).

(b) Under regulations proposed in 1991, the IRS may disregard entities created with a principal purpose of avoiding the rules of section 163(j). Prop. Reg. § 1.163(j)-1(f). The regulations would be retroactive to 1989 if finalized in their current form. The principal purpose of the arrangement is to create a revolving securitization vehicle for accounts receivable generated by the Sellers. The obligors on the accounts receivable are not related to Cherokee and section 163(j) would not apply if they were transferred directly to Cherokee and the income on the accounts receivable were treated as interest. Only the interest paid on the Enron Debt and the Seller Debt would be subject to section 163(j) if transferred directly to Cherokee. The Enron Debt and the Seller Debt is used only for the purpose of making up for shortfalls in the amount of accounts receivable, which primarily occur due to prepayments during the month. Under the expected economic scenarios, (i) in most months, no Enron Debt or Seller Debt will be acquired at the beginning of the month, and (ii) a substantial portion of the accounts receivable are expected to be paid on or about the 25th of such month. Consequently, the anti-abuse rule in the proposed regulations should not be

applicable to disregard the Company, because no principal purpose of the transaction is to avoid section 163(j).⁷

(c) The Secretary of the Treasury is instructed to issue regulations to prevent the abuse of the FASIT rules "through transactions which are not primarily related to securitization of debt instruments by a FASIT." Section 860L(h). No such regulations have yet been issued. More importantly, as noted above, the principal purpose of the arrangement is to securitize accounts receivable generated by the Sellers. Therefore, the existence of the Company will not be disregarded under the FASIT anti-abuse rule.

(d) For purposes of section 864 and 956, income from the acquisition of trade receivables from related parties is treated as if it were interest on a loan to the obligor on the receivable. Regulations suggest that if a FASIT were to acquire receivables and issue regular interests to a party related to the Seller, the FASIT would be disregarded. Treas. Reg. § 1.864-8T(c)(3)(iv), Example 2. The regulation is not applicable for purposes of section 163(j). Even if it were applicable, the obligors under the receivables are unrelated to Cherokee and section 163(j) would not apply to deny or defer a deduction for the deemed interest payments on the receivables.

(9) Under section 881(a), a withholding tax of 30% is imposed on certain income, including interest income, of foreign corporations received from sources within the United States. If this rule were applicable to the payments on the Secured Notes to Cherokee,⁸ the "interest" paid would be subject to a 30% tax, unless otherwise excluded.⁹ For the reasons set forth below and in paragraph 10, the interest payments on the Secured Notes should not be subject to withholding tax.

⁷ As noted above, if the transfer of the accounts receivable were not respected as a sale to the Company, the Company might be viewed as holding debt issued by the Sellers and secured by the accounts receivable. In that event, the section 163(j) anti-abuse rule might apply. Even in that event, however, the principal purpose for the arrangement was to securitize the accounts receivable.

⁸ Cherokee is a corporation for U.S. federal income tax purposes.

⁹ The Secured Notes are principal only regular interests and therefore do not provide for payments of "interest." References to interest payments herein relate to the discount on the Secured Notes that is deductible to the FASIT or the holder of the ownership interest.

(a) As discussed above, the Secured Notes have terms to maturity of less than one month and are FASIT regular interests. For U.S. federal income tax purposes, a FASIT regular interest is treated as a debt instrument. Section 860H(c)(1). Because the terms of the Secured Notes are less than one year, all of the interest payable on the Secured Notes will be original issue discount. *See* Treas. Reg. § 1.1273-1(c)(5). Original issue discount is subject to withholding tax only to the extent provided in section 881(a)(3). For purposes of section 881, however, original issue discount on obligations with terms to maturity of less than 183 days are not subject to withholding tax. Section 871(g)(1)(B). Consequently, the interest income on the Secured Notes should not be subject to withholding tax.

(b) Even if the interest on the Secured Notes were not excepted from the withholding tax under the short-term obligation exception, "portfolio interest" -- including interest on obligations issued in registered form such as the Secured Notes¹⁰ -- is generally not subject to withholding tax unless it is received by a "10-percent shareholder" or unless it is received by a controlled foreign corporation from a related person. Section 881(c).

(i) In the case of an obligation issued by a corporation, a 10-percent shareholder is any person that owns 10 percent or more of the total combined voting power of all classes of stock of such corporation. Section 871(h)(3)(B)(i). In the case of an obligation issued by a partnership, a 10-percent shareholder is any person that owns 10 percent or more of the capital or profits interest in such partnership. Section 871(h)(3)(B)(ii). It is not clear whether the owner of the FASIT ownership interest or the FASIT itself is the issuer of the regular interests for federal income tax purposes. If the Secured Notes are treated as issued by the ownership interest holder, a corporation, Cherokee is not a 10-percent shareholder. The rules, however, provide only that the FASIT regular interests will be treated as liabilities of the holder of the ownership interest for purposes of determining the holder's taxable income. Section 860H(b)(1). It might be argued that the FASIT is the issuer of the Secured Notes. In that case it is not clear how the 10-percent shareholder rule would be applied. A FASIT is not treated as a corporation or a partnership for federal income tax purposes, section 860H(a), so the definition set forth in section 871(h)(3)(B) is not directly applicable. That provision suggests that a 10-percent shareholder has some form of

¹⁰ The portfolio interest exception applies to interest paid on certain obligations in registered form with respect to which the issuer receives a statement that the holder is not a United States person. Section 881(c)(2)(B).

ownership interest in the issuer. The FASIT rules themselves were intended to provide a statutory securitization vehicle to provide tax certainty in situations where it was difficult under the traditional tax analysis to clearly identify interests in the securitization vehicle as debt or equity. Under the FASIT rules, all interests designated as regular interests are treated as debt for all purposes, section 860H(c)(1), and only a single interest is treated as an ownership interest, section 860L(a)(1)(C), which is subject to specific tax accounting rules. Section 860H(b). On the basis of this statutory scheme, Cherokee should not be viewed as having an equity interest in the Company and should not be a 10-percent shareholder.

(ii) As stated above, the portfolio interest exception also does not apply to interest received by a controlled foreign corporation from a related person, as defined in section 864(d)(4). Section 881(c)(3)(C). Cherokee is a controlled foreign corporation. Section 864(d), in general, deals with certain related party factoring transactions and section 864(d)(4) provides a definition of related parties. Under that definition of a related person, this exception to the portfolio interest exception should not apply to Cherokee and the FASIT or the ownership interest holder.¹¹

(10) The exception from withholding tax for portfolio interest may not be applicable to payments of interest to the FASIT regular interest holders if the FASIT regular interests were treated as debt issued by the Sellers. *See* section 881(c)(3). Certain intermediate entities in back-to-back financing arrangements may be disregarded as conduits. Treas. Reg. § 1.881-3.

(a) An intermediate entity will not be treated as a conduit, however, unless its participation in the financing arrangement “reduces the tax imposed by section 881 (determined by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangements with the tax that would have been imposed under [Treas. Reg. § 1.881-3(d)]).”¹² Treas. Reg. § 1.881-3(a)(4)(i)(A). For purposes of determining

¹¹ The regulations under section 864(d)(4) provide authority to disregard certain intermediate parties, discussed in paragraph 8(d) above. Treas. Reg. § 1.864-8T(c)(3)(iv). The cross reference to section 864(d)(4) in section 881(c)(3)(C) should not make these regulations applicable to the Company. The regulations deal with the meaning of indirect acquisitions and not the meaning of “related persons,” which is defined in a different section of the regulations, at Treas. Reg. § 1.864-8T(b)(2).

¹² The participation of the intermediate entity must also be pursuant to a “tax avoidance plan.” Treas. Reg. (footnote continued on next page...)

the amount of tax reduction, the "financing entity" (Cherokee in this case) may "claim the benefits of any income tax treaty under which it is entitled to benefits." Treas. Reg. § 1.881-3(d)(2) cross-referencing Treas. Reg. § 1.881-3(a)(3)(ii)(C). Because Cherokee is entitled to an exemption from withholding tax under the U.S.-Netherlands treaty, the interposition of the Company does not reduce withholding taxes that would otherwise be payable and the Company is not a conduit. Therefore, the existence of the Company will not be disregarded under section 881.

(b) If a taxpayer takes a return position that any treaty of the United States overrules or modifies any provision of the Code to reduce the amount of tax owed, the taxpayer must disclose such return position. Treas. Reg. § 301.6114-1(a). Because Cherokee will not be relying primarily on a treaty-based exception from withholding, it will not file such a disclosure.

(i) It might be argued that a taxpayer is not entitled to a treaty benefit unless it files such disclosure. We do not view this requirement as affecting a taxpayer's entitlement to a benefit under a treaty as a matter of law, but rather as a mechanism for claiming the benefit. The benefit of the treaty is not being claimed in this case, and will not be claimed unless the Company is disregarded under section 881. We believe that Cherokee is entitled to the benefit of the treaty under the terms of the treaty, and could have claimed such benefit by filing the required disclosure, so that, under the regulations, the Company is not a conduit.

(ii) It might also be argued that the taxpayer is taking a return position, that the Company is not a conduit, on the basis of a treaty and must, therefore, disclose the return position to claim the benefit. Because, however, the regulations under section 881 give the IRS discretion to disregard an entity, reliance on the treaty is contingent on the assertion of the authority to disregard the Company by the IRS. Furthermore, assuming that the terms of the transfers of assets to the Company and of the FASIT regular interests are at the market, the Company might have participated in the arrangement without the purchase by Enron or Cherokee of FASIT regular interests and is therefore, on that basis, not a conduit. *See* Treas. Reg. § 1.881-3(a)(4)(i)(C)(2). This position is

¹²(...footnote continued from preceding page)

§ 1.881-3(a)(4)(i)(B). The existence of a tax avoidance plan is determined by considering all of the facts and circumstances, including whether there is a significant reduction in tax, as determined above. Treas. Reg. § 1.881-3(b)(2)(i).

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independent of any treaty benefit to the Company. Consequently, based on the contingent nature of the conduit assertion and the independent authority for avoiding conduit status, the taxpayer should not be viewed as taking a treaty-based return position and need not file a disclosure under section 6114.

Very truly yours,

Shearman & Sterling