XI. TAX OPINION LETTERS

RELATING TO

PROJECT VALHALLA

AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

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To:

Enron Corp.
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May 2, 2000

Project Valhalla

Ladies and Gentlemen,

We have acted as German legal advisers to Enron Corp. ("**Enron**") in connection with the promissory note issued by Deutsche Bank AG ("**Deutsche Bank**") to Enron (the "**Promissory Note**"), the financing of Rheingold GmbH ("**Rheingold**") by Enron and Deutsche Bank and the purchase of preferred shares (the "**Preferred Shares**") in Risk Management & Trading Corp. ("**RMT**") by Rheingold (the "**Transaction**") with effect as of May 2, 2000 (the "**Closing**").

Scope

This opinion is given as to German law (not including unpublished case law) as in effect, enforced and interpreted as of the day hereof only.

In giving this opinion we have examined copies of the documents listed in the annex to this letter (the "**Transaction Documents**"), together with such other documents as we have considered necessary or desirable in order to give this opinion.

Capitalized terms used in this letter and not defined in it are defined in the annex to this letter.

Assumptions

In rendering this opinion, we have relied upon, without independent verification, the following assumptions:

(A) the capacity, power and authority of each party to enter into and perform under the Transaction Documents;

(B) the due execution and delivery of the Transaction Documents by each party thereto;

(C) that those of the Transaction Documents which are not expressed by their terms to be governed by German law, and the rights and obligations created thereby, are valid and binding under the laws by which they are expressed to be governed;

(D) that in such cases where the execution of a document by a natural person acting for and on behalf of a legal person affects the disposition of property, the power to make such disposition is not limited by applicable public or private law other than applicable German public or private law;

(E) the authenticity of all documents submitted to us as originals;

(F) the conformity with their respective original documents of all documents submitted to us as photocopies and the authenticity of the originals of such photocopied documents;

(G) that all filings necessary for the valid and enforceable creation and / or maintenance of rights have been or will be duly made;

(H) that there are no other agreements between the parties to the Transaction which would expand, modify or otherwise affect the respective rights, duties and obligations of all parties set forth in the Transaction Documents which would have an effect on the opinions rendered herewith;

(I) that all Transaction Documents available to us in draft form only have been or will be executed in all material respects in the same form as presented to us;

(J) dividends on the Preferred Shares will qualify for the participation exemption under the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes (the "**Treaty**");

(K) that the activities of RMT consist of various hedging transactions with other group companies, such as entering into options, futures, financial futures, foreign exchange transactions, etc., as well as inter-company loans in order to use excess cash;

(L) that for U.S. tax purposes, RMT is part of a consolidated group with Enron and other Enron subsidiaries; that in the process of the group consolidation, RMT's income is set-off in part by the elimination of certain inter-company charges within the group, and in part by losses or loss carry-forwards of Enron or other group companies; and that RMT will become a party to a tax allocation agreement (the form of which is used by the Enron consolidated group) which provides for compensation payments for the differences in the tax effects for each group company caused by the consolidation;

(M) that there are no other exemptions or other special tax effects applicable for the U.S. taxation of RMT;

(N) that Rheingold will have no income other than the distributions on the Preferred Shares, potential capital gains from the sale of the Preferred Shares and a small amount of investment income;

(O) that Valhalla will engage in no other activities than those contemplated under the Transaction Documents; and

(P) that the Transaction will be unwound by

- Rheingold exercising a put option over the Preferred Shares (the "**Rheingold Put Option**"), thereby selling the Preferred Shares to Valkyrie for the original U.S. Dollar ("**USD**") issue price or the current USD amount which is equivalent to the original Euro issue price, whichever is higher,
- Rheingold redeeming the Note for the original USD issue price or the current USD amount which is equivalent to the original Euro issue price, whichever is higher,
- Deutsche Bank exercising the put option under the Put Option Agreement, or Valkyrie exercising the call option under the Call Option Agreement,
- Rheingold being merged into Valhalla, and
- Valhalla liquidating at a time after Valkyrie either actually, or, by reason of having a single owner and no longer qualifying as a partnership for U.S. tax purposes, has been dissolved

(the "**Unwind**").

We have reviewed the Transaction Documents for Enron. In rendering the opinions expressed herein, we have relied solely upon our review of these Documents and have made no independent verification of the factual matters set forth in such Documents. Accordingly, save as expressly provided in this opinion, no opinion is given as to matters of fact and it is assumed that there are no facts which would affect the conclusions in this opinion.

Opinion

Based upon and subject to the foregoing, and subject to our reservations and qualifications stated below, we are of the opinion that:

1. The profit share of Rheingold from the distributions of RMT on the Preferred Shares should not be subject to German taxation based on the German foreign controlled corporation rules in the German Foreign Transactions Tax Act (*Aussensteuergesetz* – "**AStG**").

2. Rheingold should have no income subject to German trade tax other than income from the investment of its equity before the Closing or of dividends received on the Preferred Shares and not distributed as dividends on the Participation Rights ("**Investment Income**"). However, it cannot be entirely excluded that trade tax may be assessed on 50 % of the interest paid on the Note minus any other deductible expenses incurred by Rheingold.

3. The Unwind will not cause any German income tax to be imposed on Rheingold or Valhalla other than withholding tax on retained Investment Income. In the case that the Euro depreciates against the USD between the Closing and the Unwind, withholding tax of 5 % will be incurred on any cash distributed to Enron in excess of the Euro amount of Valhalla's registered share capital.

4. Rheingold will be a German resident for German tax purposes as long as it maintains its seat or principal place of management in Germany.

5. The Preferred Shares should be treated as equity for German tax purposes.

Reservations and qualifications

1. German controlled foreign corporation rules

1.1 Foreign controlled corporation

For German tax purposes, the profits of a foreign corporation are attributed to a German shareholder irrespective of whether such profits are distributed or retained if:

- (a) German shareholders hold more than 50 % of the share capital or the voting rights of a foreign corporation which earns passive income, or

  (b) one German shareholder holds 10 % or more of the share capital or the voting rights in a foreign corporation which earns passive investment income, and

- the passive income or passive investment income, respectively, exceeds certain *de minimis* thresholds and

- such passive income or passive investment income, respectively, is subject to a low tax burden in the country of the foreign corporation.

A German shareholder is protected by the Treaty against German taxation if the foreign corporation is located in the United States, if the German shareholder holds 10 % or more of the shares in the foreign corporation and if the distributions of the foreign corporation are treated as dividends in the United States as the country of residence of such foreign corporation. However, this protection does not apply with regard to

- passive investment income,

- which is more than 10 % of the total passive revenues of the foreign corporation or more than DM 120,000 and,

- subject to a low tax burden in the country of the foreign corporation.

As a consequence, the share of Rheingold in the profits of RMT will be subject to German taxation with no participation exemption available if and to the extent that

- 10 % or more (or more than DM 120,000) of RMT's passive income is passive investment income, and

- such income is subject to a low U.S. tax burden.

1.2 Passive investment income

Passive investment income is income from holding, administration, maintenance or appreciation in value of cash, receivables, securities, share or similar assets, unless the taxpayer proves that such income is

- connected to activities which generate active income, or

- received from a subsidiary in which the foreign corporation holds a share of 10 % or more, or

- remuneration for services rendered by the foreign corporation which is considered an arm's length price under German transfer pricing rules.

According to a public ruling of the German tax administration, passive investment income includes interest and dividend income as well as income from financing leases, factoring, "financial innovations" (structured financial products), futures and financial futures. Although the application of the AStG to some of these activities is disputed in the legal literature, all German tax officers are bound by the ruling. Therefore, although disputable in court, for planning purposes it must be assumed that the tax administration will treat all income from the financing activities listed in the ruling as passive investment income.

As a consequence, most, if not all, of RMT's income may be treated as passive investment income. Based on the information available to us, we are not able to determine the exact amount of such passive investment income.

1.3 Low tax burden

A foreign company's income is subject to a low tax burden if it is subject to income tax in the country of its seat or management at an overall rate of less than 30 %.

The relevant tax burden is not necessarily the actual tax paid. In principle, the tax administration considers first the general corporate income tax rate applicable in the

particular country, state and local community, and any tax exemption or rate reduction for any relevant kind of income or corporation. The current U.S. corporate income tax rate of 35 % (plus state tax and local tax, if any) is principally sufficient to provide for a tax burden which is not a low tax burden for this purpose.

Even if the general corporate income tax burden is 30 % or higher and no specific exemption applies, but there is an indication that under the relevant foreign tax laws the amount of income included in the tax base is significantly smaller than it would be under the equivalent German tax laws, then an individual calculation of the tax base according to German corporate income tax laws is made. For this determination it is disregarded if the tax base is decreased by losses from other sources or by a loss carry-forward or loss carry-back. It is also disregarded if the foreign tax burden was decreased by a third country foreign tax credit or the deduction of a third country foreign tax imposed on the relevant foreign corporation. On the other hand, dividend income which is tax exempt based on a participation exemption or for which the foreign corporation can claim a tax credit for taxes imposed on the entity making the distribution (indirect tax credit) is automatically considered to be subject to a low tax burden. In the case that the foreign corporation receives different classes of income, only some of which are eligible for an exemption or tax reduction, the tax burden must be determined for each class of income separately.

There is no specific statutory rule nor administrative guidance regarding the effects of the consolidation within a group of companies. To our knowledge, there is also no case law regarding this question. However, it is the tax burden which is principally applicable to the relevant kind of income in the country of the foreign corporation, which is decisive for the application of the AStG. The set-off between income and losses from different sources is to be ignored. Although the statute does not provide explicitly whether this applies also to income and losses within a group of companies, consolidation is a concept which is also used in German tax law in the case of a so-called "*Organschaft*" which is different in detail from the U.S. consolidated group but which still uses similar concepts. One difference is that of the treatment of minority shareholders which, under U.S. consolidation rules, can participate in the tax benefits provided by losses with regard to losses which they do not have to bear. However, these potential benefits are normally, and specifically in the case of the Enron group, excluded by the compensation under the tax allocation arrangements within the group. Therefore, economically, each group company bears the tax burden attributable to its own income. In particular, in cases where income and losses are set off between group

companies within the same country which are subject to the same general level of tax burden, there should be no basis for the application of the AStG in these circumstances.

The same reasoning applies for the reduction of the tax base for U.S. tax purposes caused by the elimination of certain inter-company income. As the German consolidation within an *Organschaft* follows similar rules, it can be expected that the German tax administration will accept these corrections as resulting from consolidation procedures sufficiently similar to German rules that they will not decrease the tax burden.

Therefore, we consider it unlikely that the German tax administration will consider the income of RMT as subject to a low tax burden based on the effects of the group consolidation. However, as there is no explicit guidance by the statute, the tax administration or the tax courts, it cannot be entirely excluded that the German tax administration will treat the effects of the consolidation as a reduction in the tax burden. However, in view of the compensation under the tax allocation arrangements within the Enron group, we consider this unlikely and believe that there is a very good chance to win any potential argument about this issue.

2. <u>German trade tax</u>

2.1 General rules on exempt dividends and interest deduction

As a German corporation, Rheingold is subject to German trade tax, a local income tax which is administered by the same authorities as the corporate income tax, but the tax rate of which is set by the municipality in which the business premises are located. The tax base is in principle the net income of each fiscal year as determined for corporate income tax purposes but with some additional items to be deducted from or added to the tax base.

One of the items added to the tax base is 50 % of any interest paid on long term loans and previously deducted from the tax base. If an interest payment is non-deductible as expense directly connected to exempt dividends, then the add-back of 50 % of such interest does not apply. This is expressly stated in the German trade tax regulations (*Gewerbesteuer-richtlinien*). Although German tax regulations do not have the force of law and do, therefore, not bind the courts, they are official guidelines for the tax administration and must be followed by all tax officers.

2.2 Deemed non-deductible expenses

As it has been disputed for some time in which circumstances expenses can be considered as directly connected to exempt dividends, a new provision was added to the German corporate income tax act last year, which stipulates that for all exempt foreign source dividends an amount equivalent to 5 % of the dividends received is deemed to be the amount of expenses directly connected to the exempt dividends (Sec. 8b para. 7). The German Federal Ministry of Finance has recently issued a public ruling which outlines its interpretation of this new section (the "**Ruling**"). The Ruling, like tax regulations, does not have the force of law but must be followed by all officers of the tax administration.

According to the Ruling, Sec. 8b para. 7 is to be applied not only for corporate income tax purposes but also for trade tax purposes if a dividend is exempt based on a tax treaty. In all circumstances, 5 %, and only 5 %, of the exempt dividends received in any year is to be added back to the tax base as non-deductible expense after the gross amount of the dividends has been deducted from the net income shown in the financial statements. This means that, on the one hand, 5 % is added back even if the total amount of all expenses is less than this amount and, on the other hand, that any expenses exceeding the amount of 5 % of the dividends are deductible even if directly connected to the exempt dividends. For corporate income tax purposes, this has the effect that for a German corporation which has no other income than exempt dividends, there is no taxable income nor loss if the actual expenses are exactly 5 % of the amount of dividends received in any given year. If the expenses are lower, then the German tax administration will assess taxable income in the amount of the difference. If the expenses are higher, there will be a loss which can be carried back to a limited degree or forward indefinitely.

As the interest expenses Rheingold will incur match 5 % of the dividend income it is expected to have each year, there should be a small amount of tax loss each year based on any other expenses that Rheingold will incur, such as rent, management fees etc.

With regard to the exact effects of Sec. 8b para. 7 on the trade tax assessment at the present time, there is no clear guidance from the German tax administration or the tax courts. According to the trade tax regulations mentioned above, the 5 % deemed non-deductible expense should decrease the amount deductible as exempt dividend and, to the extent that the non-deductible expense is interest, the 50 % add-back should not apply. However, the

trade tax regulations are older than Sec. 8b para. 7 and, therefore, do not necessarily reflect the view of the tax administration on the new deemed non-deductible expense. Systematically there should be no add-back of any interest for which the taxpayer has not received an effective deduction. Therefore, it is reasonable to take the position on Rheingold's tax return that there is no income (other than Investment Income) for Trade Tax purposes. However, it cannot be entirely excluded that the tax administration may consider the deemed non-deductible expense as a separate item totally unrelated to actual expenses. Only in that case, it could be argued that the interest expense is deductible and, therefore, 50 % of the interest must be added back to the tax base. For Rheingold this would result in additional taxable income for trade tax purposes in the amount of 50 % of the interest paid on the Note.

3. Foreign exchange gains or losses

3.1 Euro depreciated against USD between Closing and Unwind

If the Euro depreciates against the USD, the price received for the Preferred Shares when the Rheingold Put Option is exercised as well as the principal to be paid back upon redemption of the Note will still be the same USD amounts as paid initially, but those will each represent a higher amount in Euro. Rheingold must use Euro for its financial statements and for the calculation of its income tax base. Therefore, it will show a profit in the amount of the difference in the original Euro price paid for the Preferred Shares and the Euro price received upon putting the Preferred Shares to Valkyrie, and a loss in the amount of the difference between the original Euro amount received for the Note and the Euro amount paid upon its redemption. However, since this profit will be considered as capital gain realized upon the sale of shares which qualifies for the participation exemption under the Treaty, the resulting income is exempt from corporate income tax as well as from trade tax.

When the Participation Rights are put to Valhalla by Deutsche Bank, Valhalla pays the initial USD price and, therefore, in Euro more than the amount of equity initially contributed to Rheingold. In the merger between Rheingold and Valhalla, Valhalla will incur a corresponding merger loss which will set-off most of the profit in Rheingold in the financial statements. For tax purposes, however, the tax exempt income of Rheingold is carried over to Valhalla and the merger loss is deducted from any capital reserve (paid in capital in

addition to the registered share capital, so-called "EK 04"). If there is no or not a sufficient capital reserve, a negative capital reserve is created.

When the excess cash is distributed to Enron, there is no corporate income tax but a 5 % withholding tax will be applied since all distributions are deemed to be made out of distributable income first before any (even a negative) capital reserve is considered, unless the distribution is made in liquidation. Upon liquidation, the registered share capital can be paid out first and will, therefore, be protected.

3.2 Euro appreciated against USD between Closing and Unwind

If the Euro appreciates against the USD between the Closing and the Unwind, the amounts paid for the Preferred Shares and the redemption of the Note will be the USD amounts representing the original Euro prices. As Rheingold must account for its income or loss in Euro, no income or loss will be incurred.

When the put is exercised, Valhalla will acquire the Participation Rights for an amount which in Euro is lower than the equity originally contributed for the Participation Rights. In the merger between Rheingold and Valhalla, Valhalla will, therefore, show a merger gain which is shown in the financial statements as profit, but which for tax purposes will be added to the capital reserve.

When the excess cash is distributed to Enron, any amount paid out of the capital reserve will be considered repayment of paid-in equity and will, therefore, not trigger any withholding tax.

4. <u>German tax residence</u>

In principle, in order to remain a German tax resident, it is sufficient for Rheingold to maintain its seat <u>or</u> principal place of management in Germany.

For German tax purposes, the seat of a GmbH is in principle the place specified as seat in the corporate documents (*Gesellschaftsvertrag*). However, if this specification is only fictitious, i.e. if the relevant GmbH does not plan to have an active office in the specified location, then the choice of the seat is disregarded as a sham and the principal place of management is then considered to be the actual seat of the company instead. Furthermore, under German conflict-of-law rules, the principal place of management is considered to be determinative

for the law applicable to the relevant entity. Therefore, if a GmbH formed and registered in Germany has its principal place of management outside of Germany, it may lose its qualification as a legal entity and, therefore, as a corporation. The details of this theory and its consequences are largely disputed and, therefore, unclear. As the participation exemption under the Treaty applies only to corporations, Rheingold should not rely on the specification of its seat in its corporate documents, but should maintain its principal place of management in Germany in order to ensure that the participation exemption is applied. Furthermore, to minimize the trade tax risk (discussed above at 2.), Rheingold's business activities generally must be carried out in the office in Eschborn.

The principal place of management is in the location where the majority of the decisions are made that are important for the management of the company. This is in principle the place where the management is physically present when it receives relevant information and prepares and carries out any response. The kind of activities this includes in detail depends on the business of each individual company. In the case of Rheingold and Valhalla, all correspondence should be sent to the Eschborn office. The managing director should be present in the Eschborn office on a regular basis, i.e. at least once or better several times each year to take care of the day-to-day business, i.e. mostly controlling functions such as monitoring the cash-flows, supervising the accountants' work, reviewing of financial statements and bank statements. All activities should be documented, i.e. by itemized telephone bills, travel expenses, minutes of meetings with accountants, Deutsche Bank representatives, etc. The managing director must also be prepared to come to the Eschborn office whenever there is a problem or crisis, or at least to send a representative. Generally, it is not necessary (or sufficient) to hold shareholder meetings in the relevant location. However, in the case of Valhalla the shareholder meetings for Rheingold should be held in Eschborn, as this will be the principal business activity of Valhalla until the Unwind.

5. Preferred Shares

Under German tax law, preferred shares are treated as equity if the profit distributions on such shares qualify for dividend treatment pursuant to Sec. 20 para.1 no.1 of the German Income Tax Act (*Einkommensteuergesetz* – "**EStG**"). Pursuant to the definition in Sec. 20 para.1 no.1 EStG, this is the case for dividends and other income from shares or profit participation rights which carry the right to the profits and liquidation proceeds of a corporation.

There is no clear guidance on the interpretation of what exactly constitutes a participation in the liquidation proceeds. The Federal Tax Court has held that an actual participation in the liquidation proceeds is necessary. However, the German tax administration does not apply this case law other than to the individual cases actually decided by the tax courts and considers it sufficient that the shares or profit participation rights are not redeemable before the liquidation of the corporation. Therefore, the tax administration may in some cases treat participation rights as equity for tax purposes, which would be classified as debt by the tax courts. However, the Preferred Shares include the right to participate to a limited extent in the liquidation proceeds of RMT.

Furthermore, there is no published case law or other guidance as to any required minimum participation either in amount or as a percentage of the funds invested. Although this means in principle that even the smallest participation should be sufficient, the tax administration could still disregard the participation as economically insubstantial under general anti-abuse rules. However, this would only be likely in extreme cases. We consider the participation in the liquidation proceeds under the Preferred Shares as too substantial to constitute such an extreme case and, therefore, the preferred shares should be treated as equity for German tax purposes.

6. Further qualifications

- This opinion is based on the facts existing on the date hereof of which we are aware and the opinions set forth herein shall not be deemed to relate to facts and conditions prevailing, or laws and regulations in effect, at any time after the date hereof.

- We do not purport to be experts on any laws other than the laws (not including unpublished case law) of the Federal Republic of Germany as in effect, enforced and interpreted on the date hereof.

- This opinion is limited by the effect of any applicable bankruptcy, reorganization, insolvency, moratorium and other similar laws including, without limitation, court decisions of general application, statutory or other laws regarding fraudulent or preferential transfers, relating to, limiting or affecting the enforcement of creditors' rights generally, save as expressly set out otherwise herein.

- We express no opinion on the commercial value of the Transaction including without limitation whether any alternative structure or investment to those referenced herein may provide for a higher value or more beneficial tax treatment to any party in any jurisdiction.

- This opinion does not include any statement on the validity or enforceability of any agreement or legal relationship with regard to the Transaction.

Reliance

This opinion is addressed only to the addressee set out above in connection with the Transaction, and may not be communicated or delivered to any other person other than the addressee (and its U.S. legal advisers) or used for any other purpose without our prior written consent.

This letter and the opinions expressed herein are issued under and shall be interpreted and applied solely in accordance with the laws of the Federal Republic of Germany. The courts in Frankfurt am Main, Federal Republic of Germany, shall have exclusive jurisdiction regarding any disputes arising under or in accordance with this letter or the opinions expressed herein.

Very truly yours,

(Jutta Schneider)
Clifford Chance Pünder

CLIFFORD
CHANCE
PÖNDER

Opinion Project Valhalla
ANNEX

Transaction Documents

1. **Series 1 Non-voting Preferred Stock Certificate of Designations, Preferences and Rights of Risk Management & Trading Corp.** dated May 2, 2000 issued by RMT. *Delaware Law*.

2. **Series 2 Voting Preferred Stock Certificate of Designations, Preferences and Rights of Risk Management & Trading Corp.** dated May 2, 2000 issued by RMT. *Delaware Law*.

3. **Agreement on Participation Rights** (*Genussrechtsvertrag*) dated as of May 2, 2000 between Rheingold as issuer, Valhalla GmbH ("**Valhalla**") as holding and DBOFD as investor. *German Law*.

4. **Subscription and Procurement Agreement** dated as of May 2, 2000 between Valhalla as holding and Rheingold is issuer. *German Law*.

5. **Call Option Agreement** dated as of May 2, 2000 between Enron Valkyrie, LLC ("**Valkyrie**") and Deutsche Bank as Investor. *German Law*.

6. **Put Option Agreement** dated as of May 2, 2000 between Deutsche Bank as Investor and Valhalla. *German Law*.

7. **Promissory Note** dated May 2, 2000 issued by Deutsche Bank as maker to Enron as payee and accepted by Valkyrie, Valhalla and Rheingold. *New York Law*.

8. **Enron Guarantee** dated as of May 2, 2000 between Enron as guarantor, Deutsche Bank as counterparty, Valkyrie, Valhalla and Rheingold. *New York Law*.

9. **Note** dated May 2, 2000 issued by Rheingold to Enron. *New York Law*.

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September 12, 2000

Enron Corp.
1400 Smith Street
Houston, Texas 77002

Attorney-Client Privileged Communication

Re: Project Valhalla Financing Transaction

Ladies and Gentlemen:

You have requested our opinion concerning certain United States federal income tax consequences of a financing transaction involving the creation of U.S. and German limited liability companies, the purchase and sale of preferred shares, the issuance of participating debt and various other related transactions.

Our opinion is based upon: (i) the Subscription and Procurement Agreement between Valhalla GmbH ("Valhalla") and Rheingold GmbH ("Rheingold"), each a German limited liability company; (ii) the Participation Agreement among Rheingold, Valhalla and Deutsche Bank AG, Frankfurt, a German corporation ("Deutsche Bank"); (iii) the Put Option Agreement between Deutsche Bank and Valhalla; (iv) the Call Option Agreement between Deutsche Bank and Enron Valkryie, LLC, a Delaware limited liability company ("Enron Valkyrie"); (v) the Amended and Restated Articles of Association of each of Valhalla and Rheingold; (vi) the Certificates of Designations, Preferences and Rights for Series 1 Non-Voting Preferred Stock and Series 2 Voting Preferred Stock of Risk Management & Trading Corp., a Delaware corporation ("RMT"); (vii) the Securities Purchase Agreement between RMT and Rheingold; (viii) the Company Agreement of Enron Valkyrie, LLC (the "Valkyrie LLC Agreement"); (ix) the Enron Guaranty by Enron Corp. ("Enron") in favor of Deutsche Bank; (x) a letter agreement regarding the U.S. tax characterization of the transactions executed by Enron and Deutsche Bank AG, New York Branch ("DBNY"); (xi) the Promissory Note issued by DBNY to Enron (all such agreements are referred to collectively as the "Agreements"); and (xii) our assumptions as to the existence of certain material facts. Capitalized terms not defined herein have the meanings set forth in the Participation Agreement or in the referenced agreement.

Based on the initial and continuing accuracy of all of such facts, documents and assumptions, and as more fully described herein, it is our opinion that for U.S. federal income tax purposes (i)

Valhalla and Rheingold should be treated as entities disregarded as separate from their owners (ii) the transactions contemplated by the Agreements should be treated as a loan from Deutsche Bank to Enron Valkyrie with respect to which deductible interest payments are made, and (iii) and RMT should continue to be includible in the Enron Group (as defined below).

FACTS

A. Parties to the Transaction

1. Enron Valkyrie

Enron Valkyrie is a newly-formed Delaware limited liability company, the members of which are Enron and Enron Diversified Investments Corp., a Delaware corporation ("EDIC"). EDIC is a member of the affiliated group of corporations filing a consolidated federal income tax return of which Enron is the common parent (the "Enron Group"). Enron contributed $67.5355 million in exchange for a ninety-five percent member interest and EDIC contributed $3.5545 million in exchange for a five percent member interest in Enron Valkyrie. Enron Valkyrie is classified as a partnership for U.S. federal income tax purposes. Under the Enron Valkyrie LLC Company Agreement, all items of income, gain, loss, deduction and credit are allocated in accordance with the members' respective interests in Enron Valkyrie.

2. Risk Management & Trading Corp.

RMT is a Delaware corporation, all of the outstanding stock of which ("RMT Common Stock") is indirectly owned by Enron. RMT is a member of the Enron Group and is engaged in the business of hedging and trading financial instruments and commodities in the United States.

3. Valhalla and Rheingold

Valhalla and Rheingold are newly-formed German limited liability companies that are wholly-owned by Enron Valkyrie. Enron Valkyrie contributed $71.09 million to Valhalla in exchange for all of the common shares of Valhalla. Valhalla, in turn, contributed $71.09 million to Rheingold in exchange for all of the common shares of Rheingold. Rheingold obtained additional capital through a loan from Enron of $106.63 million and issued a note to Enron evidencing such indebtedness with interest payable at 7.7 percent annually (the "Rheingold Note"). In order to address certain German tax and accounting issues, the note provides for repayment of the greater of (i) the EURO equivalent of $106.63 million at the exchange rate on the date of issuance, or (ii) the EURO equivalent of $106.63 on the day the note is repaid. Rheingold has the right under the Rheingold Note to prepay all or any portion of the principal amount of the loan. Each of Valhalla

and Rheingold has filed an election to be treated as an entity disregarded from its owner for United States federal income tax purposes.

4. *Deutsche Bank*

Deutsche Bank is a German corporation that is engaged in the banking and financial services business. Deutsche Bank is a resident of Germany for German tax purposes and is eligible for the benefits of the Income Tax Treaty Between the United States and Germany (the "Treaty").

B. The Financing Transaction

Following the formation of Enron Valkyrie, Valhalla and Rheingold, as described above, the parties undertook a series of transactions on or about the same date in order to facilitate a borrowing by the Enron Group from Deutsche Bank and an offsetting loan to DBNY (the transactions are referred to together as the "Financing Transaction").

1. The Subscription and Procurement Agreement

Valhalla and Rheingold entered into a Subscription and Procurement Agreement (the "Subscription Agreement") pursuant to which Valhalla agreed to procure a subscriber for, or to subscribe for, certain participating debt rights in Rheingold, referred to as *Genussrechte* (the "Participation Rights"). The subscription price for the Participation Rights was $2 billion.

2. The Participation Agreement (Genussrechtsvertrag)

Rheingold, Valhalla and Deutsche Bank entered into an Agreement on Participation Rights (*Genussrechtsvertrag*) (the "Participation Agreement") pursuant to which Rheingold issued to Deutsche Bank, and Valhalla waived its rights to subscribe for, the Participation Rights. Under German law, the holder of such Participation Rights has no voting rights and generally has the rights of a creditor. However, the Participation Rights have the following terms: (i) they participate with the common stock in distributions made by Rheingold to the extent of their ratable share of Rheingold's capital; (ii) for the first five years, the Participation Rights are entitled to a minimum distribution, payable each December, at the rate of 7.7 percent (the "Minimum Distribution"), contingent on Rheingold's having sufficient distributable profits; (iii) they participate in liquidation proceeds to the extent of their ratable share of Rheingold's capital; and (iv) they have a fixed maturity of 35 years. Because the amount paid by Deutsche Bank for the Participation Rights represents approximately 98 percent of the capital in Rheingold, the interest in the Participation Rights entitles the holder to 98 percent of any distributions on common shares and a 98 percent interest in the proceeds of a liquidation of Rheingold. There is no requirement under German law that distributions be made with respect to the common shares and it is assumed that no such

distributions will be made. In addition, after the expiration of the initial five-year period, no Minimum Distribution is required to be paid with respect to the Participation Rights.

The Participation Agreement requires Deutsche Bank to provide to Rheingold or its agent at closing and from time to time thereafter upon request, any forms, certificates or documents that may be required or reasonably requested by Rheingold to allow it to make payments under the Participation Agreement free of withholding except for certain specified German withholding taxes. At the closing, Deutsche Bank delivered to Rheingold a properly completed Form W-8 BEN executed by an authorized person for Deutsche Bank.

3. *The Put Option Agreement*

Deutsche Bank and Valhalla entered into a Put Option Agreement (the "Put Agreement") pursuant to which Valhalla granted Deutsche Bank the right to sell its Participation Rights to Valhalla upon the occurrence of a "Put Circumstance." The Put Agreement provides that a Put Circumstance occurs: (i) when any Interim Distribution provided for in the Participation Agreement or any payment under the Enron Guaranty is not paid within five business days of the date when due; (ii) if there is an amendment to, or change (including any proposed change) in, the law or regulations of Germany or the United States or any political subdivision or taxing authority thereof or therein, or any official administrative pronouncement or judicial decision interpreting or applying such laws or regulations, or any other activities of the taxing authorities of Germany or the United States which amendment or change is effective or which pronouncement, decision or action is announced on or after the "Effective Date" (as defined in the Participation Agreement), that in the opinion of a nationally recognized tax counsel, would result in Deutsche Bank or any of its Affiliated Companies suffering a loss greater than $250,000 per annum with respect to the Participation Rights or related agreements; (iii) there is a material breach of a representation or warranty, or a failure to comply with any undertaking or provision, of the Agreements by Valhalla, Rheingold or Enron that is not remedied within five business days; (iv) Valhalla, Rheingold or Enron shall generally not pay its debts as they become due, or otherwise shall become bankrupt or insolvent; (v) at any time it becomes or will become unlawful for, or a breach of the Articles of Association (or similar constitutional documents) of, or otherwise in excess of the powers of, Deutsche Bank to perform or comply with any of its obligations under the Put Agreement or the Participation Agreement; (vi) the senior, unsecured and otherwise unsupported long-term obligations of Enron or Deutsche Bank are downgraded by Standard & Poor's corporation ("S&P"); (vii) on December 15 of 2000 through 2004 and on the fifth anniversary of the Effective Date; or (viii) an amendment to, or change in, regulatory or accounting rules under United States or German generally accepted accounting principles that would cause Deutsche Bank to suffer any loss in excess of $250,000 or force Deutsche Bank to significantly change the presentation of this transaction on its consolidated financial statements.

The Put Agreement provides that the "Put Right" shall arise on the date on which a Put Circumstance occurs and shall last for the following 90 days. The exercise of the Put Right must

be made by written notice (the "Put Notice") specifying a business day on which the exercise of the Put Right shall become effective. The date so specified shall be within the period commencing on the fifth business day following Valhalla's and Guarantor's receipt of the Put Notice and ending on the 60th day after receipt of the Put Notice. The Put Price will be equal to (i) $2 billion plus (ii) the difference between the Minimum Distribution that would be payable (without regard to "Distributable Profits" as defined in the Participation Agreement) for the period from the Effective Date through the last day of the fiscal year immediately preceding the year in which the Put Right is exercised and the amount actually paid by Rheingold, plus (iii) the difference between the Minimum Distribution that would be payable (without regard to "Distributable Profits" as defined in the Participation Agreement) for the current fiscal year up to the date the Put Price becomes due and the amount actually paid by Rheingold, less (iii) any distribution on the Participation Rights in excess of the Minimum Distribution. Any portion of the Minimum Distribution paid by Valhalla (rather than Rheingold) as part of the Put Price may result in a taxable gain to Deutsche Bank, which in turn will require Valhalla to pay an additional amount to compensate Deutsche Bank for German taxes imposed. For this reason, it is understood that the entire amount of the Minimum Distribution will be paid by Rheingold prior to the date the Put Price becomes due.

4. The Call Option Agreement

Enron Valkyrie and Deutsche Bank entered into a Call Option Agreement (the "Call Agreement") pursuant to which Deutsche Bank granted Enron Valkyrie the right to acquire the Participation Rights subject to the conditions precedent that (i) one or more of the "Call Circumstances" has occurred, (ii) Enron Valkyrie exercises the Call Right by written notice in accordance with the Call Agreement, (iii) the Participation Rights have not been sold and assigned to Valhalla, and (iv) the Call Price has been paid in full. In the Call Agreement, Deutsche Bank represents that other than with Affiliated Companies (direct and indirect 10 percent shareholders of Valhalla and companies in which Valhalla or such shareholders have an interest of at least 10 percent of the votes or capital) of Enron Valkyrie, it has not and will not enter into any contractual arrangement with respect to the sale, assignment, pledge or other transfer of the Participation Rights. In addition, Deutsche Bank further agrees in the Call Agreement that it will not transfer the Participation Rights or any interest therein other than to Valhalla, to Enron Valkyrie, or to an affiliate of Deutsche Bank upon the prior written consent of Enron Valkyrie and Enron.

The Call Agreement provides that a Call Circumstance occurs: (i) if there is an amendment to, or change (including any proposed change) in, the law or regulations of Germany or the United States or any political subdivision or taxing authority thereof or therein, or any official administrative pronouncement or judicial decision interpreting or applying such laws or regulations, or any other activities of the taxing authorities of Germany or the United States which amendment or change is effective or which pronouncement, decision or action is announced on or after the Effective Date, that in the opinion of a nationally recognized tax counsel, would result in, or would increase the risk or likelihood of Valhalla, Enron or any of their Affiliated Companies suffering a

loss greater than $250,000 per annum with respect to the Call Agreement, the Participation Agreement or related agreements; (ii) there is a material breach of representation or warranty, or a failure to comply with any undertaking or provision of, the Agreements, by Deutsche Bank that has not been remedied; (iii) it becomes unlawful or otherwise in excess of the powers of Rheingold or any Affiliated Company to issue the Participation Rights, to perform or comply with any obligations under any documents issued in connection with the transactions, issuing the Participation Rights or performing its obligations would require Rheingold or any Affiliated Company to fail to comply with a direction or instruction from a regulatory body, or there is a change in circumstances that is reasonably expected to result in RMT not having sufficient earnings and profits to pay a dividend to Rheingold, as a result of which Rheingold would not have sufficient Available Distributable Profits to pay the Minimum Distribution; or (vi) there is a significant and material adverse change in the prevailing economic climate ("Material Change"). A Material Change is defined to include, but not be limited to, the following circumstances, which may have occurred prior to the Exercise Date or which occur on or after the Exercise Date: (x) the 3 Month US$-LIBOR has decreased by more than 150 basis points during any 180 day period since the 4th anniversary of the Effective Date; (y) the 3 Month EURIBOR has decreased by more than 125 basis points during any 180 day period since the 4th anniversary of the Effective Date; or (z) the countervalue of EURO/US-$ has changed by more than EURO 0.06 during any 180 day period since the 4th anniversary of the Effective Date. Enron has determined that one of the foregoing Material Changes is virtually certain to occur.

The Call Agreement provides that the Call Right arises on the day a Call Circumstance occurs and continues for as long as the Call Circumstance exists. The exercise of the Call Right must be made by written notice (the "Call Notice") and must specify a business day on which the exercise of the Call Right will become effective. The date so specified must be within the period commencing on the fifth business day following Deutsche Bank's receipt of the Call Notice and ending on the 60th day after receipt of the Call Notice. The Call Price will be equal to (i) $2 billion, plus (ii) the difference between the Minimum Distribution that would be payable (without regard to "Distributable Profits" as defined in the Participation Agreement) for the period from the Effective Date through the last day of the fiscal year immediately preceding the year in which the Call Right is exercised and the amount actually paid by Rheingold, plus (iii) the difference between the Minimum Distribution that would be payable (without regard to "Distributable Profits" as defined in the Participation Agreement) for the current fiscal year up to the date the Call Price becomes due and the amount actually paid by Rheingold, less (iv) any distribution on the Participation Rights in excess of the Minimum Distribution. Any portion of the Minimum Distribution paid by Enron Valkyrie (rather than Rheingold) may result in a taxable gain to Deutsche Bank, which in turn will require Enron Valkyrie to pay an additional amount to compensate Deutsche Bank for German taxes imposed. For this reason, it is understood that the entire amount of the Minimum Distribution will be paid by Rheingold prior to the date the Call Price becomes due.

5. *Investment in RMT Preferred Shares*

Rheingold used the funds from (i) the capital contribution by Valhalla of $71.09 million, (ii) the loan from Enron in the amount of $106.63 million, and (iii) the purchase of the Participation Rights by Deutsche Bank for $2 billion to purchase two classes of preferred stock of RMT. Pursuant to a Securities Purchase Agreement with RMT, Rheingold purchased 1,979,740 shares of Series 1 Non-Voting Preferred Stock in the amount of $1,979.74 million (the "Series 1 Preferred Stock") and 197,980 shares of Series 2 Voting Preferred Shares in the amount of $197.98 million (the "Series 2 Preferred Stock"). The Series 1 Preferred Stock and the Series 2 Preferred Stock are referred to collectively herein as the "RMT Preferred Stock." It is assumed that (i) the value of the Series 1 Preferred Stock will not at any time represent more than 75 percent of the total value of the outstanding stock of RMT; (ii) the aggregate value of the RMT Common Stock and the Series 2 Preferred Stock will not at any time represent less than 25 percent of the total value of the outstanding stock of RMT; (iii) the value of the Series 2 Preferred Stock will not at any time represent less than 5 percent or more than 20 percent of the value of the voting shares of RMT including the RMT Common Stock and the Series 2 Preferred Stock; and (iv) the dividend rate on the Series 1 Preferred Stock represents a market rate for such dividend.

The Series 1 Preferred Stock is non-voting, non-participating (except to the extent of its fixed 7.54048 percent dividend), and is not convertible into any other class of RMT stock. The Series 2 Preferred Stock has voting rights representing 10 percent of the total voting power of RMT and is non-participating (except to the extent of its fixed 7.54048 percent dividend). Upon liquidation, the holders of the Series 1 Preferred Stock and Series 2 Preferred Stock are entitled to receive the price paid for each share ($1000), plus any accrued but unpaid dividends, plus a liquidation premium that accrues at the rate of .2 percent per year not to exceed $25 per share. Neither the Series 1 Preferred Stock nor the Series 2 Preferred Stock is subject to mandatory redemption rights nor do they provide for a redemption premium. RMT has loaned all or a portion of the proceeds from the sale of the RMT Preferred Stock to Enron and will use the remainder of the proceeds (if any) in its trading operations.

On the Effective Date, Enron Valkyrie granted to Rheingold the right to put the RMT Preferred Stock to Enron Valkyrie at a price that is the greater of (i) the original issue price of the RMT Preferred Stock, or (ii) the U.S. dollar equivalent of the original Deutschmark price on the date the put is exercised (the "Internal Put"). The Internal Put to Enron Valkyrie by Rheingold has been executed solely to avoid a mismatch of foreign exchange gains and losses for German tax and accounting purposes.

6. *Enron Guaranty*

Pursuant to the Enron Guaranty, Enron has provided to Deutsche Bank a guaranty of the performance of certain obligations of its affiliates in connection with the Financing Transaction.

Specifically, Enron has guaranteed (i) Valhalla's obligation to pay the Put Price pursuant to the Put Agreement, and (ii) Enron Valkyrie's obligation to pay the Call Price pursuant to the Call Agreement.

7. *Promissory Note From Deutsche Bank AG, New York Branch*

In connection with the transactions described above, Enron loaned to DBNY $1.950 billion pursuant to the terms of a Promissory Note (the "Promissory Note"). The Promissory Note requires DBNY to make annual Coupon Payments that consist of a fixed interest rate component and a variable component equal to the value on the coupon payment date of certain options designated by Enron at the beginning of the relevant coupon period. The Promissory Note is due and payable on May 2, 2005 or on the occurrence of any Required Payment Event under the Promissory Note. Required Payment Events under the Promissory Note include, among other events, the exercise of the Put Right pursuant to the Put Agreement, exercise of the Call Right pursuant to the Call Agreement, a downgrade of either Enron's or Deutsche Bank's credit rating below certain prescribed levels and a failure of Enron and DBNY to agree annually on the designation of options related to the variable component of the Coupon Payment. The Promissory Note further contains a contractual agreement between Enron and DBNY to set off their respective obligations under the Enron Guaranty and the Promissory Note.

8. *Tax Characterization Letter Agreement*

At the closing of the Financing Transaction, Enron and DBNY executed a letter agreement acknowledging that solely for United States federal income tax purposes, the transactions would be treated as an extension of credit by Deutsche Bank to Enron Valkyrie and that payments of the Minimum Distribution would be treated as payments of interest by Enron Valkyrie on the indebtedness. The parties further agreed not to take, or allow their affiliates to take, any position for United States federal income tax purposes that is inconsistent with the foregoing characterization.

9 *Unwind of Financing Transaction*

The parties intend that the Financing Transaction will remain outstanding for a period of up to five years after the Effective Date. At the present time, the parties contemplate that the Financing Transaction will be terminated through a series of steps designed to minimize or eliminate various U.S. and German tax consequences including foreign currency gains and losses. Such steps and the associated tax and legal consequences will, however, be reevaluated at the time the transaction is terminated. The series of steps described below assumes that (i) either the Put Right or Call Right has been exercised, and (ii) the Promissory Note has been repaid by Deutsche Bank.

First, Rheingold will pay all Minimum Distributions payable for the period up to the date of payment of the Put Price or Call Price. Enron will contribute to Enron Valkyrie the funds necessary

to repay the principal amount of the Participation Rights plus any additional amounts necessary to satisfy the terms of the Internal Put. For purposes of German tax law, the funds will be transferred to Rheingold, and thereafter, the RMT Preferred Stock will be treated as owned by Enron Valkyrie. The Put Price or the Call Price will be paid to Deutsche Bank by the appropriate party.

At some point following the repayment of the Participation Rights, Enron will purchase EDIC's interest in Enron Valkyrie. Although the Rheingold Note will merge out of existence for U.S. tax purposes, for German tax purposes, Rheingold will be required to make a payment to Enron in satisfaction of the Rheingold Note. This may require Enron to make a "contribution" to its division, Rheingold, of the funds necessary for repayment of such note. Depending on the state of the U.S. tax law at that time, prior to the purchase of EDIC's interest and the deemed dissolution, it may be necessary or advisable to cause RMT to redeem the RMT Preferred Stock with a note payable to Enron Valkyrie in the face amount of the RMT Preferred Stock.

Rheingold and Valhalla will be liquidated under German law pursuant to mergers that should be treated as tax-free for German tax purposes. Amounts, if any, remaining to be distributed to Enron upon the mergers may be subject to a German withholding tax. Enron Valkyrie may either be dissolved in accordance with Delaware law or remain as a division of Enron.

AUTHORITIES AND ANALYSIS

A. Ownership of the Participation Rights

The issue of whether a putative purchaser of property is considered the owner of such property for tax purposes has been addressed in case authorities and in published rulings of the Internal Revenue Service. In the proposed transaction, Deutsche Bank purports to purchase a right to participate in the profits of Rheingold similar to the rights of an equity owner. However, whether Deutsche Bank actually owns such an interest for tax purposes or has merely made a loan to Rheingold significantly affects the tax consequences of the Financing Transaction, including the entity classification of Rheingold and the taxes imposed on payments made to the various parties in the transaction.

1. Entity Classification

The classification of an entity as an association taxable as a corporation, a partnership or an entity disregarded from its owner is determined under rules set forth in Treasury Regulation § 301.7701. Treasury Regulation § 301.7701-2(b) describes the types of domestic business entities that are classified as corporations and sets forth a list of specific foreign business entities that must be classified as corporations. An entity not classified as a corporation under the provisions of Treasury Regulation §301.7701-1(b) (an "eligible entity") can elect its classification for federal tax purposes pursuant to Treasury Regulation §301.7701-3. A domestic eligible entity that does not file

an election will be (i) a partnership if it has two or more members, or (ii) disregarded as an entity separate from its owner if it has a single owner.

A foreign eligible entity that does not elect otherwise will be (i) a partnership if it has two or more members and at least one member does not have limited liability; (ii) an association if all members have limited liability; and (iii) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability. Treasury Regulation §301.7701-3(b)(2). A foreign eligible entity may elect to be classified other than as provided above by filing the appropriate form. Treasury Regulation §301.7701-3(c)(1).

Under the foregoing regulations, Enron Valkyrie, as a domestic eligible entity with two members, will be classified as a partnership for federal income tax purposes. A German GmbH is not an entity classified as a corporation under §301.7701-2(b) and therefore, each of Valhalla and Rheingold is eligible to elect to be classified as an entity disregarded from its owner. As a result of these elections, for U.S. federal income tax purposes, Valhalla and Rheingold would be considered German branches of Enron Valkyrie notwithstanding that Enron Valkyrie, Valhalla and Rheingold will be treated as separate entities under German law. However, disregarded entity status will be available to Rheingold only if it is treated as having one owner for tax purposes. As described below, the Participation Rights should not be viewed as granting Deutsche Bank an equity interest in Rheingold and therefore Rheingold's status as a disregarded entity should not be affected by reason of Deutsche Bank holding such rights.

2. *Sale and Repurchase Authorities*

The Participation Rights are considered equity under German tax law and indebtedness under German corporate law and the holder thereof generally has the rights of a creditor. Because the capital of Rheingold attributable to the Participation Rights represents approximately 98 percent of Rheingold's total capital, such an interest could, under a debt-equity analysis, also be recharacterized for U.S. tax purposes as an equity interest in Rheingold. Assuming such a characterization applied, Rheingold could maintain its status as a disregarded entity only if the equity interest were treated as beneficially owned by Valhalla and thus by Enron Valkyrie rather than by Deutsche Bank. In the proposed transaction, Valhalla agreed to subscribe for the Participation Rights or to procure a subscriber for those rights. Contemporaneously with Deutsche Bank's subscription for such rights, Deutsche Bank entered into both a Put Agreement with Valhalla and a Call Agreement with Enron Valkyrie. The intent of these agreements is to ensure that the Participation Rights will be repurchased by Valhalla or Enron Valkyrie not later than five years after the original issuance of such rights.

The question of whether a purported sale and repurchase of property effects a transfer of beneficial ownership to the purchaser or is merely a collateralized loan has been addressed in a number of published rulings of the Internal Revenue Service and in case authorities. The principal

published ruling addressing this issue is Rev. Rul. 74-27, 1974-1 C.B. 25, which involved the purchase by a bank of tax-exempt securities from its customers under "purchase and resale" agreements. In the ruling, the bank agreed to purchase the securities and the customer agreed to repurchase such securities on or before a certain date. If the customer failed to accept delivery and make payment for the securities, the bank was entitled to sell the securities and apply the proceeds to the contract price. If the proceeds were insufficient to satisfy the contract price, the customer remained liable for the difference. If the bank failed to deliver the securities and accept payment therefor, the customer had the right to "buy in" the bank's interest without further notice to the bank. The ruling holds that the bank did not purchase the securities and thus was not entitled to treat income from the transactions as tax-exempt interest excludable from income. Rather, the "purchase and resale" agreements merely effected loans of money by the bank upon collateral security and amounts charged with respect to such loans represented taxable interest.

In analyzing the treatment of the transactions in Rev. Rul. 74-27, the Internal Revenue Service articulated the following five-part test for determining whether a purchase and resale agreement is treated as a loan: (1) that the identical securities that are sold are required to be held for repurchase by the purported seller; (2) that if the seller refuses to repurchase the securities, the purported purchaser may sell the securities and apply the proceeds to the purchase price, and either credit the seller for the excess or hold the seller liable for the deficiency; (3) that the seller is legally bound both to repurchase the securities and pay any deficiency remaining unpaid after the application of the proceeds of sale (the seller not having a mere option to repurchase); (4) that the seller agrees to pay interest at a stipulated rate upon the amount advanced by the purchaser; and (5) that the value of the securities may or may not equal the amount advanced by the purchaser.

The Internal Revenue Service addressed a similar situation in Rev. Rul. 79-108, 1979-1 C.B. 75, which involved a "reverse repurchase" agreement. In the ruling, a city transferred U.S. Treasury Notes for 300x cash to a securities dealer who retransferred the notes to the city at the end of a specified period for the same amount of cash and retained the interest that accrued on the notes during the period. The ruling holds that the transaction was a loan and the dealer never owned the Treasury Notes; therefore the interest was earned by the city and not by the dealer. The ruling states that the essence of the transaction is that the interest income on the Treasury Notes was earned by the city and assigned to the dealer in consideration for the dealer's loan to the city of 300x. In other words, the interest income earned by the dealer was derived from its loan to the city and not from the U.S. Treasury Notes.[1]

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[1] To the same effect is Rev. Rul. 77-59, 1977-1 C.B. 196, in which the Internal Revenue Service held that a real estate investment trust (REIT) that purported to purchase U.S. Treasury obligations from a bank under an agreement to resell the obligations to the bank on a fixed date at the purchase price plus the current rate of interest for such obligations, did not own the U.S. Treasury obligations. Rather the assets of the REIT were the bank's obligations to repay the funds to the REIT.

The courts have similarly analyzed the issue of beneficial ownership in transactions involving purported purchases and resales. In *American National Bank of Austin v. United States*, the Fifth Circuit held that a bank holding municipal bonds for various dealers did not demonstrate ownership of the bonds, and thus, the bank was required to report the interest payments received under the bonds as part of the bank's taxable income.[2] In the case, the bank used its own funds to purchase municipal bonds from the issuing authority for the successful bidder. The bank held the bonds until the bidder-dealer sold the bonds to its customers, usually resulting in the bank's holding the bonds for no longer than thirty days. The bank never refused to transfer the bonds to the bidder-dealer once the dealer had paid the book value of the bonds plus the bank's costs. During the period that the bank held the bonds, interest accrued and was paid to the bank. The bank took the position that it was the owner of the bonds for U.S. federal income tax purposes and therefore was entitled to exclude the interest from tax under section 103(a)(1) of the Code.[3] The court concluded that the bank could not be the actual owner of the bonds because (i) the bank did not control the disposition of the bonds even when in its possession, (ii) the bank received a fixed percent of interest for its services and did not share in the profits generated by the sale to customers, and (iii) the bank incurred no risk other than the risk that the dealer would not be able to dispose of the bonds or take possession of the bonds from the bank.[4]

In contrast, in *Citizens National Bank of Waco v. United States*, the Claims Court found that an actual sale of municipal bonds had occurred.[5] As in the financing cases, the bank had the right to demand that the customer reacquire the bonds for an amount equal to the bonds' par value plus the accrued interest. However, the parties agreed that the bank was not required to resell the bonds and in fact had the right to sell the bonds while they were in the bank's possession. In addition, the bank had the right to retain any profits made on such sales to third parties. The bank collected the interest paid on the bonds during the period in question and did not report such interest as part of its gross income under section 103(a)(1) of the Code. The court held that the transaction was a sale with economic substance and not a loan.

In situations in which the property subject to a sale and repurchase arrangement is an equity interest, the courts nonetheless have applied a similar analysis. In *Comtel Corp. v. Commissioner*, the Second Circuit found that a purported purchaser of stock, a new corporation (Comtel Corp.) created by a hotel corporation (Zeckendorf) and other "Investors", did not actually own the stock but

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[2] 421 F.2d 442 (5th Cir. 1970).

[3] References to "section" or to the "Code" are to the Internal Revenue Code of 1986, as amended (or to an earlier version of such statute) unless otherwise noted.

[4] *Id.*

[5] 213 Ct. Cl. 236 (1977).

rather was merely providing short-term financing for Zeckendorf.[6] Under an agreement, Zeckendorf bought the shares of a public company and immediately sold them to Comtel for the same purchase price, retaining an exclusive option to repurchase the stock for the same price plus interest costs, expenses, and an additional lump sum payment of $600,000. Zeckendorf's shares of Comtel were subordinated to the payment rights of the other Investors with respect to their Comtel stock and Zeckendorf guaranteed the Investors the return of their investment plus interest and expenses.

The Court found that the transaction was a financing rather than a sale because (i) Zeckendorf at all times sought to acquire the stock and never surrendered ownership of its shares to Comtel; (ii) the objective of the Investors in Comtel was to make a high yield, risk-free investment, not purchase a hotel corporation; (iii) Comtel could not sell, dispose of or pledge the stock while Zeckendorf's option was outstanding; (iv) the profits generated by the transaction were not due to the appreciation in the value of the Comtel stock but were due to the fixed option price set by the parties; (v) Zeckendorf could exercise the option by paying a sum which appeared to the court to represent the equivalent of interest and compensation for financing services on a purchase-money mortgage[7]; and (vi) Zeckendorf was, for all practical purposes, compelled to exercise its repurchase option or risk losing its capital investment in Comtel due to the terms of the subordination agreement.[8]

3. *Applicability of Section 1058 to Sale-Repurchase Transactions*

Section 1058(a), dealing with securities lending transactions, provides that in the case of a taxpayer who transfers securities (as defined in section 1236(c)) pursuant to an agreement which meets the requirements of section 1058(b), no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer. Section 1236(c) defines a security as any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

An agreement meets the requirements of section 1058(b) if it (i) provides for the return to the transferor of securities identical to the securities transferred; (ii) requires that payments be made to the transferor of amounts equivalent to all interest, dividends and other distributions which the

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[6] 376 F.2d 791, 792 (2d Cir. 1967).

[7] *See also Commercial Capital Corp. v. Comm'r*, 27 T.C.M. 897, [43] (U.S.T.C. 1968) (stating that the situation where stock transferred to a corporation would be returned to the transferring party subject to a put is more like a secured loan arrangement where "a deed, absolute on its face, is coupled with an agreement to reconvey upon payment of a stipulated sum, [resulting in a] transaction [that] is nothing more than a mortgage.")

[8] *Id.* at 794-5.

owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor; (iii) does not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and (iv) meets other requirements prescribed in regulations. Proposed Treasury Regulation § 1.1058-1(b)(3) provides that in order to meet the requirement that risk of loss or opportunity for gain not be reduced, the agreement must provide that the lender may terminate the loan upon notice of not more than five business days.

The Senate Committee Report underlying section 1058 states that the provision is intended to clarify existing law by providing that no gain or loss is recognized by the owner of securities when the owner transfers securities for the contractual obligation of the borrower to return identical securities.[9] The Report additionally states that "the committee does not intend to change the tax treatment of 'repurchase agreements' in which loans of money collateralized by securities are structured as sales and repurchases of securities. See, for example, Rev. Rul. 77-59, 1977-1 C.B. 196."

4. Application of Authorities to Financing Transaction

In the Financing Transaction, Deutsche Bank purchased an interest that purports to entitle it to participate in the profits of Rheingold. However, for the reasons described below, the substance of the arrangement should be a five-year loan bearing a fixed rate of interest with repayment of the principal guaranteed by Enron.

The Participation Rights have a term of thirty-five years and entitle the holder to participate in distributions including preferred "Minimum Distributions" at the rate of 7.7% and distributions on common shares. However, Minimum Distributions are payable for only five years, and during that time and thereafter, no additional dividends are required to be paid on the common shares of Rheingold. There is no intention on the part of Enron to cause Rheingold to distribute dividends on its common shares. Moreover, in the event that any such distributions were made, there would be a corresponding reduction in the Put Price and the Call Price. Thus, at the end of five years, Deutsche Bank will no longer be assured of any return on its $2 billion investment. As a result of these provisions, Deutsche Bank's profit participation is effectively limited to the yearly Minimum Distribution for five years.

At the time Deutsche Bank subscribed for the Participation Rights, it obtained the right under the Put Agreement to require the purchase of the Participation Rights by Valhalla for an amount equal to the purchase price of the rights plus the amount of any unpaid Minimum Distributions. Should any distributions actually be made with respect to the common shares of Rheingold, such

[9] S. Rep. No. 762, 95th Cong. 2d Sess. 5-9.

amounts (in excess of the Minimum Distribution) as are received by Deutsche Bank will reduce the Put Price and thus will be treated as a repayment of principal (*i.e.*, the purchase price). The payment of the Put Price was guaranteed by Enron and therefore repayment is assured even if Rheingold has no funds. The Put Right can be exercised based on a number of circumstances as well as on December 15 of each year for the first five years. Although Deutsche Bank is not required to exercise the Put Right, there are certain factors that will compel exercise of the put by the end of the fifth year including (i) the Minimum Distribution will no longer be payable after five years, and (ii) the offsetting financing arrangement between Deutsche Bank and Enron (*i.e.*, the Promissory Note) will be terminated. It is understood that, absent exercise of the Put Right, the termination of the offsetting loan will result in adverse credit and regulatory consequences to Deutsche Bank. Thus, the Put Right is virtually certain to be exercised. Moreover, under the terms of the Put Agreement, Deutsche Bank does not have the potential for loss of its investment as would an equity investor and its only risk of recovering its investment plus a fixed return is Enron's creditworthiness.

As the holder of the Participation Rights, Deutsche Bank also is entitled to share in the liquidation proceeds of Rheingold pro rata based on its proportionate share of the capital of the company. Thus, the Participation Rights would appear to grant Deutsche Bank the potential to share in an increase in value of the company. However, at the time the Participation Rights were acquired, Deutsche Bank also granted a call option to Enron Valkyrie pursuant to which Enron Valkyrie can "purchase" the Participation Rights for an amount equal to the price paid by Deutsche Bank plus the amount of any unpaid Minimum Distributions (less any distributions in excess of the Minimum Distributions). The Call Right can be exercised on the occurrence of a number of Call Events, one of which is virtually certain to occur. Thus, if the value of Rheingold increases such that upon a liquidation Deutsche Bank would be entitled to amounts in excess of it purchase price for the Participation Rights plus the Minimum Distributions (and the Put Right is not exercised), Enron can ensure that a liquidation does not occur while the Participation Rights are held by Deutsche Bank by having Enron Valkyrie exercise its Call Right. The Call Agreement also provides that Deutsche Bank cannot transfer the Participation Rights other than to Valhalla, Enron Valkyrie, or to an affiliate of Deutsche Bank provided it has obtained the prior written consent of Enron and Enron Valkyrie. Thus, Deutsche Bank does not have the right of an owner to alienate property and as a result, has no possibility of realizing a profit through a sale to a third party.

The agreements described above indicate that (i) Deutsche Bank has no right to a return on its investment except for a fixed minimum return payable only for the first five years; (ii) Deutsche Bank is assured of not suffering a loss on the Participation Rights as Valhalla is required to purchase the Participation Rights and the Put Price is guaranteed by Enron; (iii) Deutsche Bank cannot share in any increase in value in Rheingold as Enron Valkyrie's Call Right effectively precludes Deutsche Bank's ability to realize on such an increase; and (iv) Deutsche Bank cannot sell the Participation Rights except pursuant to the Put Right or Call Right and thus cannot realize a profit on its investment through a sale to a third party. Accordingly, Deutsche Bank's ownership of the Participation Rights should not be treated as an equity interest in Rheingold. Rather, the transaction

should be treated as a financing requiring the payment of interest at the rate of 7.7 percent and repayment of principal at the end of five years unless demand for repayment or the right to repay is exercised at an earlier time. Such a characterization is consistent with the letter agreement executed by Enron and Deutsche Bank describing such characterization and the delivery by Deutsche Bank of the Form W-8 BEN indicating an exemption from U.S. withholding tax on interest payments.

It is possible that the transfer of the Participation Rights to Deutsche Bank could be viewed as a loan of the Participation Rights (*i.e.*, a security) subject to section 1058. In such case, the agreements would meet some but not all requirements of section 1058 and the proposed regulations inasmuch as the agreements do not specifically require Deutsche Bank to pay over the equivalent of dividends earned with respect to the underlying securities (presumably earnings attributable to the RMT Preferred Stock). However, even if the transaction does not technically meet the requirements of section 1058, as indicated in the Senate Report, it should nonetheless be treated as a financing and not as a sale if it meets the relevant tests under the sale and repurchase authorities.

The transaction taken in its entirety alternatively could be viewed as merely producing a fee earned by Enron equal to the difference between the amount of interest paid with respect to the Participation Rights and the amount of interest received on the Promissory Note. Regardless of the characterization, the spread between the interest paid and received will be included in income in the Enron Group's consolidated federal income tax return.

B. Inclusion of RMT in the Enron Group

A corporation will be included in an affiliated group, as defined in section 1504(a) of the Code, only if stock in such corporation meeting the requirements of section 1504(b) is owned directly by one or more other members of the group. The ownership of stock meets the requirements of section 1504(b) if it possesses at least 80 percent of the total voting power of the stock of such corporation and has a value equal to at least 80 percent of the total value of the stock of such corporation. Section 1504(a)(4) provides that for purposes of this test, the term "stock" does not include any stock which (i) is not entitled to vote,[10] (ii) is limited and preferred as to dividends[11] and does not participate in corporate growth to any significant extent,[12] (iii) has redemption and

[10] The IRS ruled in Rev. Rul. 69-126, 1969-1 C.B. 218, that preferred stock that has the right to vote in the election of directors constitutes voting stock. *Cf.* Rev. Rul. 71-83, 1971-1 C.B. 268 (which held that preferred stock that had no voting rights except with respect to certain changes in the articles of incorporation or the corporation's rights to create additional stock that was senior to or on parity with the preferred stock was not voting stock for purposes of section 1504, as it existed prior to amendment in 1984).

[11] *See* Rev. Rul. 79-21, 1979-1 C.B. 290. The ruling held that participating preferred stock, which was entitled to receive not only a preferred dividend priority over common stock but was also entitled to participate with common stock in further distributions, was not limited and preferred as to dividends for purposes of section 1504.

[12] *Cf.* Treasury Regulation § 1.305-5(a), which contains similar language. The regulation provides that for

liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption premium), and (iv) is not convertible into another class of stock. In describing these requirements, the legislative history underlying section 1504(a)(4) states as an example that preferred stock carrying a dividend rate materially in excess of a market rate when issued would not be ignored for consolidation purposes.[13]

Except for the RMT Preferred Stock owned by Rheingold (and thus by Enron Valkyrie), all of the stock of RMT is owned by members of the Enron Group. The Series 1 Preferred Stock (i) has no voting rights (except as required under Delaware corporate law which does not include the right to vote for the election of directors), (ii) is entitled to preferred dividends limited to a rate of 7.7 percent, (iii) has redemption and liquidation rights equal to the issue price of the stock plus any accrued but unpaid dividends and a liquidation premium accruing at the rate of .2 percent per year, and (iv) is not convertible into another class of stock of RMT. The Series 1 Preferred also bears a dividend rate that represents a market rate. Because of these features, the Series 1 Preferred Stock should not be taken into account in determining whether the stock ownership requirements of section 1504(a) are met. Although the Series 1 Preferred Stock will represent a substantial portion of the total equity in the company, the RMT Common Stock and the Series 2 Preferred Stock will represent not less than 25 percent of the overall value of the company and, thus, will have a significant interest in the underlying profits and assets of RMT. Moreover, there is no indication in the statute or legislative history that Congress intended to impose limitations on the amount of preferred stock that could be excluded under section 1504(a)(4).

Section 1504(a) does not specify what constitutes a reasonable redemption or liquidation premium. However, the Internal Revenue Service indicated in a private ruling that the rules of section 305 with respect to redemption premiums may be analogous.[14] Since the issuance of that ruling, the regulations under section 305 have been revised and there currently are no additional authorities interpreting the meaning of reasonable for purposes of section 1504(a)(4). However, Treasury Regulation § 1.305-5(b)(1), as amended, provides that constructive distribution treatment will not result if a redemption premium does not exceed a *de minimis* amount, as determined under the principles of section 1273(a)(3). Section 1273(a)(3) provides that if the amount of original issue discount with respect to a debt instrument is less than 1/4 of 1 percent of the stated redemption price at maturity multiplied by the number of years to maturity, the original issue discount will be treated

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purposes of section 305(b)(4), the term "preferred stock" generally refers to stock which, in relation to other classes of stock outstanding enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent.

[13] H. Conf. Rep. No. 861, 98th Cong. 2d Sess. 833 (1984).

[14] In a 1987 ruling, the IRS applied the safe harbor provisions of former Treas. Reg. §1.305-5(b). PLR 8753005 (Sept. 30, 1987). Pursuant to section 6110(k)(3), a private letter ruling may not be used or cited as precedent except by the taxpayer to which it was issued.

as zero. By analogy, the Series 1 Preferred Stock provides for a liquidation premium of .2 percent per year not to exceed $25 per share. Thus, such premium is less than the amount generally regarded as *de minimis* and, therefore, should be treated as reasonable.

The Series 2 Preferred Stock has voting rights and thus will be taken into account in determining whether RMT is a member of the Enron Group. However, the voting rights of the Series 2 Preferred Stock represent only 10 percent of the total voting power of all of the stock of RMT. In addition, the Series 2 Preferred Stock has and will have a value not less than 5 percent nor more than 20 percent of the total value of the voting shares of RMT. Accordingly, following the issuance of the RMT Preferred Stock, RMT should continue to be includible in the Enron Group.

C. Taxability of Dividends on the RMT Preferred Stock

Section 243 provides that a corporation, in computing its taxable income, may deduct a certain percentage of amounts it receives as dividends from a domestic corporation subject to United States federal income taxation. One hundred percent of dividends received by a corporation may be deducted where the dividends constitute "qualifying dividends" under section 243(b). Section 243(b)(1) provides that a dividend is a qualifying dividend if it is (i) received by a corporation from another corporation that is, at the close of the day on which such dividend is received, a member of the same affiliated group and (ii) paid out of the earnings and profits from taxable years of the distributing corporation on each day of which the distributing corporation and the corporation receiving the dividend were members of the same affiliated group within the meaning of section 1504(a).

Among other exceptions and limitations, section 246(c)(1)(A) disallows the deduction provided in section 243 with respect to any dividend paid on a share of stock that is held by the recipient of the dividend for 45 days or less during the 90-day period beginning 45 days prior to the dividend payment date. In the case of certain preference dividends, section 246(c)(2) provides that the deduction is disallowed where the stock is held by the recipient for 90 days or less during the 180-day period beginning 90 days prior to the dividend payment date.

Section 246A(a) provides that in the case of any dividend on debt-financed portfolio stock, the percentage of dividends eligible for the dividends received deduction under section 243 shall be reduced. Section 246A(b) provides, however, that subsection (a) shall not apply to qualifying dividends, as defined in section 243(b).

Distributions are eligible for the dividends received deduction under section 243 only if they are distributions out of earnings and profits.[15] Treasury Regulation § 1.312-6(b) provides that among

[15] Sections 316 and 312 of the Code.

the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable under the Constitution, as well as all items includible in gross income under section 61.

Section 312 and the regulations thereunder contain no specific rules related to income attributable to payments made by one member of a consolidated group to another member of that group. Treasury Regulation § 1.1502-33(c)(2) provides that intercompany items and corresponding items are not reflected in earnings and profits before they are taken into account under Treasury Regulation § 1.1502-13. Example 1 of Treasury Regulation § 1.1502-13(g)(5) illustrates the timing and recognition of income on intercompany indebtedness:

> (a) Facts. On January of Year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year and repayment of $100 a the end of Year 5. B fully performs its obligations. Under their separate entity methods of accounting, B accrues a $10 interest deduction annually under section 163, and S accrues $10 of interest income annually under section 61(a)(4).
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> (b) Matching rule. Under paragraph (b)(1) of this section, the accrual of interest on B's note is an intercompany transaction. Under the matching rule, S takes its $10 of income into account in each of Years 1 through 5 to reflect the $10 difference between B's $10 of interest expense taken into account and the $0 recomputed expense. S's income and B's deduction are ordinary items.

Based on the foregoing provisions of section 312 and the applicable regulations under sections 312 and 1502, interest on intercompany indebtedness should be included in income of the recipient for purposes of earnings and profits calculations consistent with the accrual of the deduction of the payor.

Section 702(a) provides that in determining his income tax, each partner shall take into account separately his distributive share of certain of the partnership's items including dividends with respect to which there is a deduction under part VIII of subchapter B (sections 241-249 of the Code). Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (a)(1) through (7) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Section 1059(a) requires a corporation that receives an extraordinary dividend with respect to a share of stock that the corporation has not held for more than two years before the dividend announcement date to reduce its basis in the stock by the amount of the nontaxed portion of the dividend. Section 1059(e)(2) provides that except as provided in regulations, the term extraordinary dividend does not include any qualifying dividend within the meaning of section 243. Treasury

Regulation § 1.1059(e)-1(a) provides that the exception for qualifying dividends does not apply to any distribution treated as an extraordinary dividend under section 1059(e)(1) (dealing with partial liquidations and non pro rata redemptions).

Section 1059(e)(3) provides that section 1059 does not apply to certain qualified preferred dividends if the taxpayer holds the stock for more than five years; if the stock is held for five years or less, the aggregate reduction will not exceed the excess, if any, of the qualified preferred dividends actually paid during the period the taxpayer holds the stock over the qualified preferred dividends that would have been paid for such period on the basis of the stated rate of return. Section 1059(e)(3)(C) defines a qualified preferred dividend as any fixed dividend payable with respect to a share of stock which provides for fixed preferred dividends payable not less frequently than annually, and is not in arrears as to dividends at the time the taxpayer acquires the stock. The term does not apply to any dividend if the rate of return of such stock exceeds 15 percent.

Enron Valkyrie will receive dividends on the RMT Preferred Stock through its German branch, Rheingold, and will allocate those dividends to Enron and EDIC under the Enron Valkyrie Agreement. Under the foregoing authorities, Enron and EDIC should be treated as if such dividends had been received directly from RMT. Therefore, assuming distributions from RMT are paid out of earnings and profits, such amounts should constitute qualifying dividends and Enron and EDIC should be entitled to exclude 100 percent of those dividends from income pursuant to section 243(b) of the Code.

Distributions from RMT will be eligible for the dividends received deduction only if they are paid out of earnings and profits. It is expected that RMT will have sufficient earnings and profits from its trading operations to support the dividends on the RMT Preferred Stock. However, even if such earnings are insufficient, interest income accrued by RMT on the intercompany loan to Enron of the proceeds from the sale of the RMT Preferred Stock will be taken into account each year and thus should increase RMT's earnings and profits available for distribution.

Enron Valkyrie should not be required to reduce its basis in the RMT Preferred Stock under section 1059 as dividends paid on such stock should constitute qualifying dividends within the meaning of section 243 (and also should constitute qualifying preferred dividends within the meaning of section 1059(e)(3)). The RMT dividends will, however, reduce the earnings and profits of RMT that will tier up to Enron under Treasury Regulation § 1.1502-33 and thus will have the effect of a downward basis adjustment (or a lesser increase in basis) in the common shares of RMT held by members of the Enron Group.

D. Deductibility of Interest Expense

Section 163 provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. Section 702(a)(8) provides that a partner shall take into

account his distributive share of taxable income or loss, exclusive of items requiring separate computation. Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction or credit shall, except as otherwise provided under the relevant Code provisions, be determined by the partnership agreement. Under the Enron Valkyrie Agreement, Enron and EDIC will be allocated their respective distributive shares of interest expense paid by Enron Valkyrie. Such interest expense should be deductible by such members of Enron Valkyrie unless precluded or recharacterized by other authority.

In Notice 94-48, 1994-1 C.B. 357, the Internal Revenue Service indicated that it would scrutinize transactions designed to produce interest deductions with respect to a related issuance of stock. The notice states that although the details of the transactions may vary, they are designed to give the issuing corporation the tax benefits of issuing debt even though the corporation actually issues stock. The transaction described in the notice involves a corporation (X) which created PRS, a partnership, to allow X to achieve its financing objectives. X contributed $20x to PRS in return for a limited partnership interest and GP contributed $5x to PRS. PRS then issued debt instruments (notes) to third-party investors for $80x. Of the $105x in capital raised by PRS, $100x was used to purchase newly issued preferred stock of X. The notice states that X intends to take the position that (a) the dividends it pays to PRS are not income to the extent that they are allocable to X because X, in effect, is paying a dividend to itself, and (b) it is entitled to deduct its distributive share of interest deductions for payments on the notes. The Internal Revenue Service indicates that it believes that the overall substance of the arrangement as to X is simply the issuance of preferred stock and thus, the deduction of interest on the notes is inappropriate. The Internal Revenue Service also notes that even if X were treated as having issued its share of the notes, the notes would be nonrecourse as to X and secured solely by the X preferred stock. Depending on all of the facts and circumstances, the notes would be economically equivalent to debt instruments that are convertible into X preferred stock at the option of X and thus would be treated as equity for federal income tax purposes.[16]

Although Notice 94-48 is broadly drafted and purports to apply to other arrangements, interest paid under the proposed transaction should not be subject to disallowance under the Notice. In contrast to the Notice, the indebtedness issued by Enron Valkyrie is not nonrecourse indebtedness secured only by the stock of RMT. Rather, should Rheingold, Valhalla or Enron Valkyrie fail to pay Minimum Distributions, the Put Price or the Call Price, respectively, Deutsche Bank has full recourse under the Enron Guaranty and offset rights under the Promissory Note. Moreover, the indebtedness arising under the Participation Rights cannot be considered payable in RMT stock or convertible into RMT stock as Deutsche Bank has no right (or obligation) to foreclose on the property held by Rheingold in satisfaction of the indebtedness.

[16] The notice cites Notice 94-47, 1994-1 C.B. 357.

Enron has agreed to guarantee the payment of the Put Price and the Call Price, which includes the payment of any unpaid Minimum Distributions. Certain authorities dealing with corporate debt indicate that where a corporation is thinly capitalized and a loan might not be made but for the guarantee of the shareholder, the loan may be considered indebtedness of the shareholder rather than the corporation. In *Plantation Patterns v. Commissioner*, the court held that purported debt of a corporation should be treated as debt of its shareholder who had guaranteed the loan.[17] The court treated payments of principal and interest by the corporation as constructive distributions to the shareholder and interest as correspondingly deductible by the shareholder.

The thin capitalization analysis as applied to a partnership generally involves the distinction between capital contributions and loans made by a partner rather than an analysis of which party is the primary obligor on indebtedness.[18] However, even if the rationale of the *Plantation Patterns* case could be applied in the partnership context to treat Enron as the primary obligor on the indebtedness, such application should have no adverse effect as all income and deductions, including interest deductions, of Enron Valkyrie will be allocated to its members under the partnership tax rules.

E. Withholding of US Tax

1. General Rules

Sections 881 and 882 of the Code impose tax at the rate of 30 percent on certain types of income including interest and dividends, which is collected through withholding at source pursuant to sections 1441 and 1442 of the Code. Under regulations currently in effect and under regulations that will become effective on January 1, 2001, no withholding is required on payments of such income to a domestic partnership provided the appropriate documentation is obtained by the payor.[19]

The 30-percent tax imposed on interest and dividends under sections 881 and 882 of the Code may be reduced or eliminated under an applicable tax treaty. Under Article 10 of the Treaty, interest derived by a resident of Germany may be taxed only in Germany. Thus, no withholding is required on payments of interest from a U.S. resident to a resident of Germany.

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[17] 462 F. 2d 712(1972).

[18] *See, e.g., Hambuechen v. Commissioner*, 43 T.C. 90 (1964).

[19] *See* Treasury Regulation § 1.1441-5(b) (effective before January 1, 2001); Treasury Regulation § 1.1441-5(b)(1) (effective on January 1, 2001).

2. *Conduit Regulations*

In certain cases, the "conduit" regulations issued under section 881 may recharacterize payments or impose additional taxes on conduit financing arrangements.[20] Treasury Regulation § 1.881-3(a)(2)(i) defines a financing arrangement as a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and the advance and receipt are effected through one or more other persons (intermediate entities), and there are financing transactions linking the financing entity, each of the intermediate entities and the financed entity. Stock in a corporation can constitute a financing transaction if the holder has the right to require the issuer to redeem the stock, or the issuer has the right to redeem the stock and based on the facts and circumstances as of the issue date redemption is more likely than not to occur.[21]

Treasury Regulation § 1.881-3(a)(2)(iii) defines a conduit entity as an intermediate entity whose participation in the financing arrangement may be disregarded in whole or in part. A conduit financing arrangement is defined as a financing arrangement effected through one or more conduit entities.[22] Treasury Regulation § 1.881-3(a)(4) states that an intermediate entity is a conduit entity with respect to a financing transaction if (i) the participation of the intermediate entity 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 arrangement with the tax that would have been imposed as determined under the regulation); (ii) the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and either (A) the intermediate entity is related to the financing entity or the financed entity, or (B) the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.

Treasury Regulation §1.881-3(e), example 9, illustrates the analysis of whether tax has been reduced under section 881 or 882:

> Example 9. Reduction of Tax. (i) On February 1, 1995, FP issues debt to the public that would satisfy the requirements of section 871(h)(2)(A) (relating to obligations

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[20] *See generally* Treasury Regulation § 1.881-3. These regulations were issued under authority granted to the Secretary under section 7701(l) of the Code.

[21] Treasury Regulation § 1.881-3(a)(2)(ii).

[22] Treasury Regulation § 1.881-3(a)(2)(iv).

that are not in registered form) if issued by a U.S. person. FP lends the proceeds of the debt offering to DS in exchange for a note.

(ii) The debt issued by FP and the DS note are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(1) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The holders of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Because interest payments on the debt issued by FP would not have been subject to withholding tax if the debt had been issued by DS, there is no reduction in tax under paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

3. Application of the Withholding Rules to Dividends and Interest

RMT will pay dividends on the RMT Preferred Stock to Rheingold which, under the analysis described above, should be treated as a German branch of Enron Valkyrie. Enron Valkyrie is a domestic partnership and, accordingly, no withholding should be required on such dividends.

The Minimum Distributions paid by Rheingold to Deutsche Bank with respect to the Participation Rights should be treated as interest paid by a U.S. partnership to a resident of Germany. Deutsche Bank provided a Form W-8 BEN to Enron at the closing of the transactions. Thus, provided Deutsche Bank continues to provide appropriate certification when necessary, no withholding of U.S. tax will be required on such interest payments.

The conduit regulations issued under section 881 should have no applicability to the Financing Transaction. The various transactions may constitute a financing transaction even though the instrument issued by RMT to Rheingold is preferred stock. However, even if the transactions were treated as subject to the rules of Treasury Regulation § 1.881-3, Rheingold (Enron Valkyrie) should not be disregarded as a conduit entity. Interest paid by Enron Valkyrie to Deutsche Bank is not subject to withholding under the Treaty. However, the same result would obtain if the interest were paid by RMT (or treated as paid by Enron under a thin capitalization analysis, as described in D, above) as each of Enron Valkyrie, RMT and Enron is a U.S. resident for purposes of payments of interest to a German resident under the Treaty. Accordingly, there has been no reduction in the tax imposed by sections 881 or 882.

F. Certain Partnership Issues

1. Adjustments to Partnership Basis

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, shall be the amount of such money and the adjusted basis

of such property to the contributing partner at the time of the contribution, increased by the amount of gain recognized under section 721(b) to the contributing partner at such time. Under section 705, a partner's adjusted basis is increased by his distributive share of taxable income of the partnership and income exempt from tax, and is decreased by losses of the partnership and expenditures of the partnership not deductible in computing taxable income and not properly chargeable to capital account.

Under section 752, an increase in a partner's share of partnership liabilities is treated as a contribution of money to the partnership, and a decrease in a partner's share of such liabilities is treated as a distribution of money. Treasury Regulation § 1.752-2(a) provides that a partner's share of a recourse partnership liability equals the portion of such liability, if any, for which the partner or a related person bears the economic risk of loss. Under Treasury Regulation § 1.752-2(b), a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership assets became worthless and the partnership liquidated, the partner or a related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner (or related person as to that partner).

Enron and EDIC should have an initial basis in their respective interests in Enron Valkyrie equal to the amount of money contributed to Enron Valkyrie and their allocable share of partnership indebtedness under the Rheingold Note. Enron's basis also should include the amount of the obligation to repay the principal amount of the Participation Rights ($2 billion), which it has guaranteed. Dividends received on the RMT Preferred Stock will result in an increase in each partner's basis in its partnership interest, and corresponding interest deductions for the Minimum Distributions and interest on the Rheingold Note will decrease basis.

2. *Unwind and Distribution of Assets*

Section 731(a) provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. Section 737(c)(1) provides that for purposes of subsection (a), the term money includes marketable securities.

Section 731(c)(2)(B) defines marketable securities to include financial instruments that are readily convertible into or exchangeable for, money or marketable securities. A financial instrument is further defined under section 731(c)(2)(C) to include stocks and other equity interests and evidences of indebtedness. Under Section 731(c)(3), however, the foregoing rules do not apply to "eligible partners" of "investment partnerships." An investment partnership is defined in section 731(c)(3)(C)(i) as any partnership provided it has never been engaged in a trade or business and substantially all of its assets have always consisted of certain items including money, stock in a

corporation, and notes and other evidences of indebtedness. An eligible partner is defined in section 731(c)(3)(C)(iii) as any partner who, before the date of the distribution, did not contribute to the partnership any property other than assets described in subparagraph (C)(i).

In certain circumstances, the nonrecognition rule of section 731(a) may not apply to the distribution of property by a partnership. In Notice 89-37, 1989-1 C.B. 679, the Internal Revenue Service indicated that regulations would be issued that would provide that a partnership distribution to a corporate partner of stock in such corporate partner (or a member of the affiliated group of which such partner is a member) will be treated as a redemption by the corporate partner of such stock with property consisting of such partner's partnership interest. Therefore, the regulations would provide that section 311(b) rather than section 731(a) will apply and gain (but not loss) will be recognized.

Treasury Regulation § 1.337-3(d), which would apply to distributions that occur after March 9, 1989, was proposed in 1992. The regulation provides that a distribution to a corporate partner of stock in that partner or an affiliate is treated as a redemption or exchange by the corporate partner of its stock for a portion of the corporate partner's partnership interest equal to the value of the stock distributed. Thus, if the partnership interest has appreciated, gain (but not loss) would be recognized by the corporate partner under section 311(b). The proposed regulation has never been finalized and there is no indication when, if ever, the regulation will be finalized.

Section 732(b) provides that the basis of property distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the transaction. Section 732 and the regulations thereunder provide rules for the allocation of basis among different types of assets.

In connection with the termination of the Financing Transaction, it is anticipated that Enron will purchase the interest held by EDIC and thus, Enron Valkyrie will be treated as liquidating and distributing its assets and liabilities to Enron. Under section 731(c), neither the RMT Preferred Stock nor a note issued in redemption of such stock should be considered readily marketable or convertible or exchangeable into money or marketable securities However, even if the RMT Preferred Stock or note could be viewed as readily exchangeable for money, such a distribution should not be subject to the provisions of section 731(c). Under the rules described above, Enron Valkyrie should qualify as an investment partnership as it will not be engaged in a trade or business and will hold only cash, the RMT Preferred Stock, and possibly a note issued by RMT in redemption of such stock. Further, Enron, as a contributor of only money, should be considered an eligible partner.

Following Enron's contribution of funds to Enron Valkyrie, the repayment of the Participation Rights, and the purchase of EDIC's interest, Enron generally should have a basis in its partnership interest in Enron Valkyrie equal to the sum of (i) its initial cash investment, (ii) the cash

contributed to repay the Participation Rights (an amount not less than the face amount of the RMT Preferred Stock), (iii) the principal amount of the Rheingold Note, and (iv) the amount paid for EDIC's interest in Enron Valkyrie. Thus, the value and basis of Enron's partnership interest should be approximately equal. However, because the RMT Preferred Stock has a liquidation premium that accrues each year, the RMT Preferred Stock (and thus Enron's partnership interest) could be viewed as having appreciated in value notwithstanding that the parties intend to cause the stock to be redeemed at the end of the five-year period rather than in connection with a liquidation of RMT. Therefore, if Notice 89-37 and the proposed regulations remain outstanding (or have been finalized to require gain recognition for such future appreciation), Enron should cause RMT to redeem the RMT Preferred Stock from Enron Valkyrie prior to the purchase of EDIC's interest so that the assets distributed would include a note payable from RMT rather than the RMT Preferred Stock.

As a result of the deemed liquidation, Enron's basis in its partnership interest in Enron Valkyrie would be reduced by the amount of cash distributed and the remainder of such basis would be allocated to the other assets (the note payable from RMT and the Rheingold Note). Following the liquidation, Enron would be able to offset the note payable from RMT against any outstanding intercompany indebtedness to RMT resulting from the original loan of the proceeds from the sale of the RMT Preferred Stock. Moreover, although the Rheingold Note should be treated as merging out of existence (as Rheingold would now be a division of Enron), it is assumed that for German tax and legal reasons, Rheingold will nonetheless make a payment to Enron in satisfaction of the indebtedness.

OPINION

Based on the facts, law, and analysis set forth above, it is our opinion that for U.S. federal income tax purposes:

(i) each of Valhalla and Rheingold should be treated as an entity disregarded as separate from its owner, Enron Valkyrie;

(ii) the transactions comprising the Financing Transaction, including the purchase of the Participation Rights, the Put and Call arrangements and the purchase of the RMT Preferred Stock, and the Enron Guaranty should be treated as a loan from Deutsche Bank to Enron Valkyrie;

(iii) notwithstanding the issuance of the Series 1 Preferred Stock and the Series 2 Preferred Stock, RMT should continue to be a member of the Enron Group;

(iv) the members of Enron Valkyrie should be eligible for the 100-percent dividends received deduction under section 243 of the Code with respect to dividends from RMT allocated to such members under the Enron Valkyrie Agreement;

(v) the Minimum Distributions paid with respect to the Participation Rights should be treated as interest deductible by the members of Enron Valkyrie;

(vi) dividends paid by RMT to Rheingold should not be subject to U.S. withholding tax; and

(vii) provided Enron Valkyrie continues to receive the appropriate certifications from Deutsche Bank, no withholding of U.S. federal income tax should be required on interest payments made to Deutsche Bank as Minimum Distributions.

We express no opinion as to the tax treatment of any transaction not specifically addressed in the foregoing opinion. Our opinion is based upon the existing provisions of the Internal Revenue Code of 1986, as amended, regulations (and administrative pronouncements) promulgated or proposed thereunder, and interpretations thereof by the Internal Revenue Service and the courts, all as of the date hereof, all of which are subject to change with prospective or retroactive effect, and our opinion could be adversely affected or rendered obsolete by such change.

This opinion is given to you by us solely for your use and is not to be quoted or otherwise referred to or furnished to any governmental agency (other than the Internal Revenue Service in connection with an examination of the transactions contemplated herein) or to other persons without our prior written consent.

Very truly yours,

VINSON & ELKINS L.L.P.

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