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December 21, 1995

Mr. Robert J. Hermann
Vice President Tax
Enron Corp.
1400 Smith Street, P.O. Box 1188
Houston Texas 77251-1188

Dear Bob:

You have requested that we provide our opinion regarding the federal income tax treatment to Enron Corp. ("Enron") and its Subsidiaries of a proposed transaction involving Enron Management, Inc. ("EMI"). EMI is a subsidiary that oversees the deferred compensation and postretirement benefit management functions of Enron Corp. and its affiliated group and administer all other Enron Corp. sponsored benefit and compensation plans, and certain related transactions. For a further description of the factual circumstances of these transactions see Appendix A, Facts and Assumptions As Provided By Management. Our opinions are limited to the following tax issues.

1. Enron's transfer of notes receivable to EMI, subject to the contractual assumption of Enron's deferred compensation and postretirement benefit obligations in exchange for all of the voting participating preferred stock of EMI should, more likely than not, qualify for nonrecognition of gain or loss under IRC Section 351(a).

2. Enron's tax basis in the voting participating preferred stock of EMI should, more likely than not, equal the tax basis in the notes receivable contributed to EMI, and should not be reduced by the amount of the deferred compensation and postretirement benefit obligations assumed by EMI.

3. Losses on the sale of the voting participating preferred stock of EMI should, more likely than not, not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1).

4. Enron's contribution of the notes receivable to EMI in exchange for its voting participating preferred stock should, more likely than not, not constitute an acquisition made to evade or avoid income tax within the meaning of Internal Revenue Code Section 269.

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Furthermore, based on our analysis, we have concluded that the overall tax result of the transaction should, more likely than not, be the recognition of a capital loss by Enron on the sale of the voting participating preferred stock of EMI.

In analyzing the authorities relevant to the potential tax issues outlined in opinions one through four, above, and the overall tax result, we have applied the standards of "substantial authority" and "more likely than not proper," as used in IRC Section 6662 under current law. Based upon our analysis, we have concluded that there is substantial authority for the indicated tax treatment of these issues and result, and we also believe the indicated tax treatment of such issues and result is more likely than not proper.

The opinions expressed herein are based on the facts and assumptions you have provided to us as summarized in Appendix A and you have represented to us that we have been provided all the facts and assumptions necessary for us to form our opinion. Any misstatement of a fact or omission of any fact or any amendment or change in any of the facts referred to may require a modification of all or a part of these opinions. We have no responsibility to update these opinions for events, transactions or circumstances occurring after the date of issuance of these opinions.

The opinions expressed herein are based upon our interpretation of the Internal Revenue Code and income tax regulations as interpreted by court decisions, and rulings and procedures issued by the IRS as of the date of this letter. The opinions expressed herein are not binding on the IRS, and there can be no assurance that the IRS will not take a position contrary to the opinions expressed herein.

We have not considered any nonincome tax, state or local income tax consequences and, therefore, do not express any opinion regarding the treatment that would be given the transactions of Enron and its Subsidiaries by the applicable authorities on any nonincome tax or any state or local tax issues. We also express no opinion on nonfederal income tax issues, such as personal property transactions or securities law matters.

If there is any change in the Internal Revenue Code, the regulations and published rulings issued thereunder, the current administrative rulings, the previous judicial interpretations, or in the current understanding and interpretation of accounting practices, the opinions expressed herein would necessarily have to be reevaluated in light of any such changes.

The opinions expressed herein reflect our assessment on the merits of the probable outcome of litigation and other adversarial proceedings based solely on an analysis of the existing tax authority relating to the issues. It is important, however, to note that litigation and other adversarial proceedings are frequently decided on the basis of such matters as negotiation and pragmatism. Furthermore, in recent years, courts of law have exhibited a willingness to interpret prior authorities, as well as to develop new theories, which will maximize tax revenues. We have not considered the effect of such negotiation, pragmatism and judicial willingness upon the outcome of such potential litigation or other adversarial proceedings.

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These opinions are solely for your benefit and are not intended to be relied upon by anyone other than you. We assume no responsibility for tax consequences to other parties. Instead, each of the other parties must consult and rely upon the advice of his/her/its own counsel, accountant or other adviser. Without the prior written consent of this firm, this letter may not be quoted in whole or in part or otherwise referred to in any documents or delivered to any other person or entity.

The opinions expressed herein reflect what we regard to be the material federal income tax effects to Enron and its Subsidiaries of the transactions as described herein; nevertheless, they are opinions only and should not be taken as an assurance of the ultimate tax treatment.

Very truly yours,

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FACTS AND ASSUMPTIONS AS PROVIDED BY MANAGEMENT

DESCRIPTION OF TRANSACTION

You have represented that Enron has potential deferred compensation obligations of approximately $67.7 million and potential postretirement medical, life insurance and executive death benefit (collectively "postretirement benefit") obligations of approximately $120.8 million as of December 1, 1995. These obligations arose over time as employees performed services for Enron and its various subsidiaries and deferred portions of their salaries and/or earned additional benefits under Enron's postretirement benefit plans.

Enron is the parent of a consolidated group of corporations which includes EGP Fuels Company, Enron Capital & Trade Resources Corp. and Enron Property & Services Corp. In addition, Enron owns an active subsidiary, Enron Service Corp. ("ESC"). ESC was formed in December 1992 to provide real estate, facility management and other administrative services to Enron Corp., and third parties. These functions have recently been transferred to Enron Property & Services Corp. (EPSC), a newly created subsidiary of Enron. As part of this transfer of functions, all of ESC's contracts and equipment leases have been transferred to EPSC. However, ESC will remain liable for the contracts because the transfer was in the form of an assignment rather than a novation. ESC retained all existing assets and liabilities other than liabilities arising under the contracts and leases described above. As of December 1, 1995, ESC had assets consisting of intercompany accounts receivable and Officer/Employee accounts receivable with a current book value of approximately $1.9 million and liabilities for taxes payable of approximately $20,000. ESC does not have a net operating loss carryover, built-in deduction or any other favorable tax attribute. ESC was previously incorporated and capitalized for the purposes described above and not for the purpose of managing deferred compensation and postretirement benefit obligations and administering other compensation and benefit plans.

Enron continually strives to control all costs, including the costs associated with administering and funding its obligations under various compensation and benefit plans. This is particularly true for its obligations under its deferred compensation plans and postretirement benefit plans. These cost containment efforts are consistent with other cost control efforts being implemented in all phases of Enron's business. For example, Enron has recently outsourced its internal audit function and its information system functions. As a variation on this strategy, Enron is considering offering management and employees who oversee the compensation and benefit functions of Enron an incentive to control these costs and to share in the cost savings. Enron hopes to utilize the skills and experience of these employees to review Enron's strategic

direction and develop creative and innovative solutions to control costs. Such an arrangement is consistent with new methods of approaching employee compensation which is tied to performance in areas where the employees have direct control, and which is not at the mercy of the overall performance of the company.

To achieve this objective, Enron will use ESC to oversee the deferred compensation and postretirement benefit management function and to administer Enron's other compensation and benefit plans. It is envisioned that this subsidiary will employ current Enron employees in the compensation and benefits group, as well as engage outside advisers. The purpose of using the special purpose subsidiary was to segregate the compensation and benefits function to allow management to better control the costs associated with this function.

Enron enlarged ESC to manage its deferred compensation and postretirement benefit liabilities, administer Enron's other compensation and benefit plans, and better control the costs associated with these obligations. This subsidiary will employ current employees of Enron's compensation and benefits departments. Consistent with Enron's policy, these employees will transfer from Enron effective January 1, 1996. In addition it is contemplated that additional employees may be hired in the future. The subsidiary may institute its own incentive compensation plans.

The expansion of ESC to include the deferred compensation and postretirement benefit management function and administration of Enron's other compensation and benefit plans took the following form. Enron changed the name of ESC to Enron Management, Inc. ("EMI"). Next, Enron transferred a 20 year note receivable from EGP Fuels Company with a tax basis of $120.84 million and a 10 year note receivable from Enron Capital & Trade Resources Corp. with a tax basis of $67.7 million, subject to a contractual assumption of Enron's deferred compensation and postretirement benefit obligations. In addition, EMI has assumed responsibility for administering Enron's other compensation and benefit plans. EMI will charge an administrative fee to Enron for managing these plans. The contribution of these notes coupled with the assumption of the deferred compensation and postretirement benefit liabilities results in EMI having a net worth of approximately $1.94 million. (See Exhibit A, EMI Balance Sheet, attached.)

The note receivable from EGP Fuels Company was formalized from an existing intercompany account receivable. The note has a term of 20 years and accrues interest at a fixed rate of 7.77%. Interest accrues and is payable quarterly and the principal will be due on maturity of the note.

The note receivable from Enron Capital & Trade Resources Corp. was formalized from an existing intercompany account receivable. The note has a term of 10 years and accrues interest at a floating rate of interest (currently 13.35%). Interest of $1.5 million is payable quarterly. The excess accrued interest is added to principal. The note principal (plus unpaid accrued interest) is due at maturity. The floating rate of interest and the payment terms of this note were designed to approximate the expected interest accruals and payments under the deferred compensation plan obligations.

In exchange for the transfer, Enron received all of a newly created class of voting participating preferred stock in EMI which pays an annual 9 percent dividend and represents, in the aggregate, $40,000 of EMI's existing Net Equity of $1.94 million and 3 percent of any increase in EMI's Net Equity up to a maximum redemption value of $340,000. The holders of the voting participating preferred stock have the right to elect one of the six directors of EMI. The voting

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participating preferred shareholders have no other voting rights. Enron has represented that it did not receive any other property in the transaction. In addition the amended Certificate of Incorporation grants the holders of these shares the right to require EMI to redeem (i.e., "put") its shares anytime after five years from the date of initial issuance based on the formula described above calculated using a Redemption Value balance sheet. The Redemption Value balance sheet follows generally accepted accounting principles except that the liability for postretirement benefits under FAS 106 will be calculated using a discount rate of 7.5% instead of the rate which would normally be required under FAS 106. This modification to the GAAP basis financial statements is designed to remove the interest rate risk from EMI's economics and isolate the elements of the FAS 106 liability which management has the ability to control (i.e. the actual costs of benefits, etc.). The adjustment to the GAAP balance sheet will closely approximate the fair market value of EMI's Net Equity because a change in interest rates will affect the value of both the FAS 106 liability and the $120.8 million note receivable in a similar manner.

Similarly, EMI may call the voting participating preferred shares after six years from the date of initial issuance based on the same formula. However, the redemption value is capped at $340,000 so that the holders of these shares will not realize an "unbargained for" windfall in the value of its shares due to, amongst other things, an unexpected favorable change in healthcare legislation or significant technological breakthroughs.

The $340,000 redemption cap was determined by setting up various cash flow models based on potential favorable and unfavorable resolutions of the deferred compensation and postretirement benefit liabilities. For instance, under the scenario in which all deferred compensation and postretirement benefit obligations experience no significant change from the amounts currently projected based on information currently available the potential fair market value and Redemption Value of EMI remains unchanged. Thus, the holder of these shares would be able to recover their initial investment. In the scenario where actual costs exceed anticipated costs, the voting participating preferred shareholders would lose their initial investment. Under the most favorable foreseeable conditions (i.e. where actual future deferred compensation and postretirement liabilities are less than the amounts projected) the Redemption Value of EMI was computed to be approximately $11.94 million. Since the voting participating preferred shares represent $40,000 of the first $1.94 million of Redemption Value and 3 percent of the excess the voting participating preferred shareholders would be entitled to a $340,000 redemption price under the most favorable scenario.

The value of the notes is $40,000 greater than the current estimated value of the deferred compensation and postretirement benefit obligations contractually assumed by EMI. As a result, the value of the voting participating preferred is $40,000 at the time of the exchange. As stated above, the future redemption value of this stock is contingent on the success of the cost containment efforts in that the voting participating preferred stock will be entitled to 3 percent of the total cost savings generated by EMI as measured principally by the value of the notes receivable, less the liability under the revolving credit facility and the reserves for deferred compensation and postretirement benefits.

The management of EMI can reduce the postretirement benefit reserve by implementing plans which reduce the expected future costs of medical benefits and life insurance for retirees. One of the most significant factors used to determine these expected future costs is Enron's current experiences in paying medical costs for its current employees and retirees. If the current payment experience can be improved through implementing cost effective plans, the

postretirement benefit obligation decreases. Additionally, the management of EMI can reduce the postretirement benefit obligation by improving the rate of return on assets held by the VEBA trust. The obligation for deferred compensation can be controlled and reduced to the extent the management of EMI can effectively influence negotiations with retiring employees for a voluntary termination designation in situations where it is appropriate.

Since the postretirement benefit obligation is so greatly affected by the payment experience under Enron's medical plan for current active employees, it is logical for EMI to have responsibility for administering and managing the active medical benefit plan as well as the postretirement benefit plan. Furthermore, the EMI employees who manage Enron's medical benefit plans also manage and administer other compensation and benefit plans. Therefore, in order to minimize administrative costs and avoid duplication of efforts, it is necessary for EMI to assume responsibility for managing all other compensation and benefit plans, including the assumption of Enron's obligations for deferred compensation. Additionally, managing all of these plans are a tremendous burden which Enron wants to shift to the management of EMI.

Enron plans to sell the voting participating preferred stock in EMI to management and certain employees in the compensation and benefits group to provide them with an incentive to control costs and share in the rewards of these cost containment efforts. At the time of Enron's receipt of the voting participating preferred stock in EMI, Enron had not identified these persons and had no firm commitment from any party to participate in this venture. In addition, they were not contractually bound to sell this stock. Furthermore, following the sale of the voting participating preferred stock, EMI will continue to be a part of Enron's affiliated group under the provisions of Section 1504 (All citations to Section or Treasury Regulation Section are in reference to the Internal Revenue Code (IRC) of 1986, as amended (Code), and the regulations thereunder).

Furthermore, by offering management and certain employees stock in a special purpose subsidiary, Enron would effectively increase the after-tax cash compensation payable without increasing its cash cost. Any cost savings achieved by EMI should increase the fair market value of its stock. A sale of this appreciated stock should enable these individuals to obtain capital gains treatment.

It is anticipated that the interest income on the notes receivable, along with an administrative charge to Enron, will provide the funds necessary to cover day-to-day payroll and operating expenses of EMI. Additionally, Enron has agreed to lend EMI up to $75 million through 2015 on a revolving basis at a rate equal to LIBOR. Furthermore, EMI has entered into several intercompany service agreements with Enron to provide and receive various services established at customary intercompany rates. For example, EMI has agreed to provide administrative services to Enron for managing Enron's obligations under certain compensation and benefit plans which have not been expressly assumed by EMI.

ENRON MANAGEMENT INC.
PROFORMA INITIAL BALANCE SHEET
as of December 1, 1995

Exhibit A

Assets		
	Accounts Receivable	1,886,379
	Notes Receivable	188,555,109
	Total Assets	190,441,488
Liabilities		
	Income Taxes Payable	21,738
	Accrued Taxes Payable	815
	Enron Corp. 1988 Deferral Plan	61,206,796
	HNG Deferral Income Program	6,508,313
	Other Post Retirement Employee Benefits	120,800,000
Total Liabilities		188,537,662
Equity		
	Common Stock	1,000
	Preferred Stock	40,000
	Retained Earnings	1,862,826
Total Equity		1,903,826
		190,441,488

Note: This balance sheet is based on prior EMI activity as of October 31, 1995. This balance sheet will be updated for November 30, 1995 amounts when they are available.

TRANSFERS TO CONTROLLED CORPORATIONS—GENERAL RULES

Enron changed ESC into a special purpose subsidiary to oversee its deferred compensation and postretirement benefit management function by changing the name of ESC which is currently 100 percent owned by Enron, to EMI. Enron transferred to EMI a $120.84 million 20-year intercompany note receivable and a $67.7 million 10 year intercompany note receivable, subject to a contractual assumption of $188.5 million of Enron's deferred compensation and postretirement benefit obligations. In exchange, Enron received 100 percent of a second class of voting participating preferred stock in EMI. Based on the discussion below, this exchange should, more likely than not, qualify for nonrecognition of gain or loss under IRC Section 351.

IRC Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for its stock and if the transferor (or transferors) control the corporation immediately after the exchange. If the transferor receives money or other property in addition to stock, the transferor will recognize gain, limited to the amount of money received plus the fair market value of other property received. IRC Section 351(a). No loss may be recognized. IRC Section 351(b).

Although IRC Section 351 itself does not define the term "property," the term has been broadly defined to include almost any asset a taxpayer may own. Revenue Ruling 69-357, 1969-1 C.B. 101, indicates that the term "property" as used in IRC Section 351 includes money. A transferor's own stock also constitutes property for purposes of IRC Section 351. Rev. Rul. 74-503, 1974-2 C.B. 117 (corporation's transfer of treasury stock to its controlled subsidiary was held a tax-free transfer of property under Section 351). The term "property" also includes installment obligations. See Rev. Rul. 73-423, 1973-2 C.B. 161, Jack Ammann Photogrammetric Engineers Corporation v. Commissioner, 39 TC 500 (1965).

The transferor will receive tax-free treatment only if the transfer of property occurs "solely for stock." The concept of "stock" has been generally understood to refer to instruments that provide the holder with an equity interest in the issuing corporation. Treasury Regulation Section 1.351-1(a)(1) indicates that "stock" does not include stock rights and stock warrants.

If money or other property is received by the transferor in addition to stock, the transferor must recognize gain, not in excess of the amount of money or the fair market value of such other property received, but it may not recognize loss. IRC Section 351(b). The assumption of liabilities is treated not as boot under IRC Section 351(b), but under the assumption of liability rules of IRC Section 357. These rules are discussed in Appendix C.

The requirement that the transferor must be in control immediately after the exchange employs the IRC Section 368(c) definition of control. To have "control" the transferor must have:

1. 80 percent of the total combined voting power of all classes of stock entitled to vote, and

2. 80 percent of the total number of shares of all classes of nonvoting stock.

Rev. Rul. 59-259, 1952-2 C.B. 115, clarifies the second prong of the test to mean that 80 percent ownership of total shares in the aggregate does not suffice; to satisfy the "control" requirement 80 percent of each class must be held.

The "control" requirement is measured immediately after the exchange. Control need not be acquired in the exchange itself; the transferor may already have control entering into the exchange. See, e.g., Rev. Rul. 73-473, 1973-2 C.B. 115. The IRS and courts have found in some circumstances that mere physical ownership immediately after the transfer may not satisfy the control requirement. These authorities typically find that a binding commitment to sell the stock at the time of the transaction will defeat the control immediately after requirement.

It is important to note that in this transaction, Enron acquired voting participating preferred stock of EMI entitled to elect one of the six directors of EMI. Based on the rationale in Rev. Rul 69-126, 1969-1 C.B. 218 this class of stock possesses approximately 17% of the voting power of the corporation. More importantly, besides the existing common and new voting participating preferred stock classes, there are no other classes of stock in the corporation. Consequently, throughout the transactions contemplated Enron will possess a range of 83 to 100% of the total combined voting power of all classes of stock entitled to vote. Thus, Enron has continued to meet the control requirement of IRC Section 368(c) throughout the transaction. In the unlikely event the Service attempts to argue that the voting participating preferred stock possesses more than 20% of the combined voting power of all classes of stock of EMI, Enron should nonetheless meet the control requirement since it had not entered into any contracts or other legal commitments to sell or otherwise relinquish its legal ownership in the stock.

In Rev. Rul. 79-70, 1979-1 C.B. 144, Corporation X transferred property to a newly organized corporation, Newco, in exchange for Newco's stock. Pursuant to a prearranged binding agreement between X and Corporation Y, X sold 40 percent of Newco's stock to Y, and Y purchased securities for cash from Newco. The agreement was an integral part of the incorporation; Newco would not have been formed if Y had not agreed to purchase securities for cash from Newco and a portion of the Newco stock from X.

The ruling held that the control requirements of IRC Section 351(a) were not satisfied under these facts. Y's ownership of Newco stock purchased from X cannot be countered in determining whether the control requirement is met. For purposes of IRC Section 351(a), X only owned 60 percent of Newco stock immediately after the exchange.

The Tax Court in Intermountain Lumber Company v. Commissioner, 65 TC 1025 (1976), reached the conclusion that the control requirement was not met in light of the existence of a preexisting binding contract to sell a portion of the stock. In that case, the transferor irrevocably contracted as part of the incorporation transaction to sell 50 percent of the stock received in the transfer to a third party. The court found that the transfer did not satisfy the "control" requirement due to the presence of the contract and, therefore, did not qualify for nonrecognition treatment under IRC Section 351(a). However, this court stated that a mere plan to dispose of stock would not violate the control immediately after requirement of IRC Section 351:

> A determination of "ownership," as that term is used in Section 368(c) and or purposes of control under Section 351, depends upon the obligations and freedom of action of the transferee with respect to the stock when he acquired

> it from the corporation. Such traditional ownership attributes as legal title, voting rights, and possession of stock certificates are not conclusive. If the transferee, as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of Section 351. By contrast, if there are no restrictions upon freedom of action at the time he acquired the shares, it is immaterial how soon thereafter the transferee elects to dispose of his stock or whether such disposition is in accord with a preconceived plan not amounting to a binding obligation. Id. at 1031-1032 (emphasis added).

As the Intermountain Lumber decision suggests, cases and rulings involving a binding commitment to sell stock are distinguishable from cases where no binding commitment existed and stock is sold soon after the IRC Section 351 transaction.

In American Bantam Car Co. v. Commissioner, 11 TC 397 (1948), *aff'd per curiam*, 177 F2d 513 (3d Cir. 1949), the owners of a manufacturing company transferred its assets to a new corporation ("Newco") in exchange for all its common stock. The shareholders had a general plan to issue Newco preferred stock to the public soon after the transfer of assets to Newco. Under the plan, the underwriters of the preferred stock were to receive common stock from the shareholders if a target amount of preferred stock was sold to the public. Five days after the contribution of assets to Newco, and receipt of 100 percent of Newco's stock by the shareholders, Newco, the shareholders and the underwriter entered into a binding agreement to sell the preferred stock. The agreement provided that the underwriter would be entitled to a maximum of 33 percent of the Newco common stock if its sales efforts were successful. This contract could be canceled by Newco. Eventually, 29 percent of Newco's common stock was transferred to the underwriter 16 months after the IRC Section 351 transaction. The Tax Court held that the requisite control existed immediately after the exchange, and that the loss of control that occurred 16 months later was not an integral part of the transaction. The language used by the court indicates that the mere existence of a plan to dispose of control is irrelevant. As the court stated:

> The understanding with the underwriters for disposing of the preferred stock, however, important, was not a sine quo non in the general plan, without which no other step would have been taken. While the incorporation and exchange of assets would have been purposeless one without the other, yet both would have been carried out even though the contemplated method of marketing the preferred stock might fail. The very fact that in the contracts of June 8, 1936, the associates retained the right to cancel the marketing order and, consequently, the underwriters' means to own common stock issued to the associates, refutes the proposition that the legal relations resulting from the steps of organizing the corporation and transferring assets to it would have been fruitless without the sale of the preferred stock in the manner contemplated. Id. at 406-407.

In a later case, the Tax Court confirmed that a mere plan to transfer control after an IRC Section 351 transaction will not destroy the tax-free nature of the transaction. In Wilgard Realty Company, Corporation v. Commissioner, 127 F2d 514 (2nd Cir. 1942), an individual transferred real estate and cash to a newly formed corporation in exchange for 197 shares of the company's stock. The company transferred three additional shares of stock to the individual's

children for no consideration. On the same day, the individual made a gift of 156 shares to his children. The court found that the requisite control was met immediately after the exchange. As stated by the court:

> In the absence of any restriction upon (the transferor's) freedom of action after he acquired the stock, he had "immediately after the exchange" as much control of the (corporation) as if he had not before made up his mind to give away most of his stock and with it consequently his control. And that is equally true whether the transaction is viewed as a whole or as a series of separate steps where the recipient of the stock on the exchange has not only the legal title to it "immediately after the exchange" but also the legal right then to determine whether or not to keep it with the control that flows from such ownership, the requirements of the statute are fully satisfied. (Emphasis added.)

Thus, under the Wilgard and American Bantam decisions, a disposition of stock soon after an IRC Section 351 transfer will not taint the transaction, unless the transferor had relinquished his legal rights to the stock received from the corporation prior to the exchange.

On December 7, 1995 the Clinton Administration announced its Seven-Year Balance Budget Proposal which included a provision which would treat certain preferred stock as "boot" in reorganization transactions under Section 368 or Section 351 transactions. Effective for transactions on or after December 7, 1995, the proposal would treat certain preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, including through a conversion privilege) as "boot" in such cases and tax its receipt currently. This new proposal, if enacted, should not apply to Enron's transaction since the EMI voting participating preferred stock was issued on December 1, 1995 prior to the proposed effective date of this provision, December 7, 1995. Additionally, even if this proposal were effective, EMI's voting participating preferred stock should not meet the definition of "preferred stock" in the proposal because its redemption feature provides for significant participation in corporate growth.

Application of IRC Section 351 to the Proposed Transaction

Enron transferred to EMI a $120.84 million 20-year note receivable and a $67.7 million 10 year note receivable subject to EMI's contractual assumption of $188.5 million of deferred compensation and postretirement benefit obligations. In exchange, Enron received 100 percent of the voting participating preferred shares of EMI. Additionally, Enron previously owned and continues to own 100 percent of the common stock of EMI. Thus, Enron controlled 100 percent of EMI immediately before and after the transfer. Furthermore, Enron has exchanged property (the notes receivable) solely for stock of EMI. Therefore, the contribution to EMI should qualify as an IRC Section 351 transaction, if the "control immediately afterward" requirement is met.

Enron has represented that at the time of the transaction, it had not entered into any contracts or other binding agreements to sell the voting participating preferred stock or in any other way relinquish its legal ownership in the stock. Therefore, Enron should be treated as being in control of EMI immediately after the contribution of property regardless of any subsequent sale of the voting participating preferred stock.

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Based on the discussion above, Enron's contribution to EMI of the intercompany note, subject to the contractual assumption of the deferred compensation and postretirement benefit obligations in exchange for all of the voting participating preferred stock of EMI should, more likely than not, qualify for nonrecognition of gain or loss under IRC Section 351(a).

ENRON'S BASIS IN THE PREFERRED STOCK OF EMI

IRC Section 358 sets forth the rules for determining the basis of stock received by a transferor in an IRC Section 351 exchange. This section generally provides that the basis of stock received by a transferor is equal to the basis of the property transferred to the controlled corporation, decreased by the money and fair market value of any property received by the transferor and increased by the amount of gain recognized by the transferor. IRC Section 358(a).

Enron has represented that its basis in the intercompany notes receivable transferred to EMI is $188.54 million. Enron has also represented that it did not receive any other property in the transaction. Thus, under the general rules, Enron's basis in the EMI voting participating preferred stock should be equal to its basis in the intercompany notes receivable of $188.5 million.

IRC Section 358(d) treats a controlled corporation's assumption of certain types of liabilities in a Section 351 transaction as a receipt of money by the transferor. This causes a basis reduction under the general rules discussed above.

However, not all liabilities fall under this rule. IRC Section 358(d) states:

> (1) In general—Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.
>
> (2) Exception—Paragraph (1) shall not apply to the amount of any liability excluded under Section 357(c)(3).

Thus, in certain situations, the assumption of a liability by the company issuing stock in a transaction in which IRC Section 351 applies may result in a decrease in the tax basis of the stock received in the transaction. This provision should, more likely than not, not apply to the transaction consummated by Enron because the deferred compensation and postretirement benefit obligations do not yet rise to the level to liabilities within the meaning of the Internal Revenue Code. Since the deferred compensation and postretirement benefit obligations are not liabilities under the Internal Revenue Code, they should not result in a basis adjustment in the EMI voting participating preferred stock received in the transaction. Even if, theoretically, the IRS were to assert on audit that the deferred compensation and postretirement benefit obligations rose to the level of liabilities, they should not result in a basis adjustment in the voting participating preferred stock. As described more fully below, the expenditures related to these deferred compensation and postretirement benefit obligations would have been deductible if paid by Enron or when paid by EMI. Consequently, these obligations are excludable for purposes of this basis adjustment rule. Although we are not rendering an opinion on the deductibility of these costs when paid by EMI, a discussion of the relevant law is included in support of this alternative position.

Enron and its subsidiaries have generated an obligation to pay deferred compensation and postretirement benefits in the course of their normal business operations. Although Enron can estimate the potential costs of these obligations, actual future outlays will depend on many factors including future interest rates and future health care costs. EMI has contractually assumed Enron's obligations for deferred compensation and postretirement benefits.

The obligations contractually assumed by EMI do not yet rise to the level of liabilities as defined under the Internal Revenue Code. Under IRC Sections 461 and 461(h), a liability of an accrual basis taxpayer is incurred, and generally taken into account for federal income tax purposes in the taxable year in which: (i) "All events" have occurred that establish the fact of the liability, (ii) the amount of the liability can be determined with reasonable accuracy and (iii) economic performance has occurred. Treasury Regulation Section 1.461-1(a)(2). If any one of these requirements is not met, a liability cannot be taken into account for federal income tax purposes.

IRC Section 461(h) provides that the "all events" test of IRC Section 461 will not be satisfied any earlier than when economic performance occurs with respect to the liability in question. IRC Section 461(h) applies to capital expenditures under IRC Section 263, as well as to current deductions under IRC Section 162.

For plans deferring the receipt of compensation (deferred compensation plans) or welfare benefit funds, the economic performance requirement of Section 461(h) is satisfied to the extent that any amount is otherwise deductible under Section 404 or 419. Treasury Regulation Section 1.461-1(a)(2)(D).

With respect to Enron's deferred compensation plans, Sections 404(a) and (a)(5) provide that amounts paid under a deferred compensation plan shall be deductible under Section 404 in the taxable year in which an amount attributable to the contribution under the deferred compensation plan is includible in the gross income of employees participating in the plan. With respect to unfunded pension plans such as Enron's deferred compensation plans, where payments are made directly to former employees, such payments are includible in their gross income when paid, and accordingly, such amounts are deductible under Section 404(a)(5) when paid. Treasury Regulation Section 1.404(a)-12(b)(2).

With respect to Enron's unfunded postretirement benefit plans, Section 404(b)(2) provides that any plan providing for deferred benefits (other than compensation) for employees, their spouses or their dependents shall be treated as a deferred compensation plan. However, since many deferred benefits are not taxable, for this purpose Section 404(a)(5) is applied by ignoring the otherwise applicable exclusions from income. Treasury Regulation Section 1.404(b)-1T(A-1). Accordingly, amounts payable under this plan are deductible when paid in a manner similar to that described above for deferred compensation plans.

With respect to Enron's postretirement benefit plans funded through a VEBA pursuant to Section 501(c)(9), Section 419 governs the timing of the deduction. Section 419(a)(2) provides that contributions paid or accrued by an employer to a welfare benefit fund shall (subject to certain limitations) be deductible for the taxable year in which paid.

Enron has not made payments related to any of the obligations assumed by EMI. Therefore, "economic performance" should not have occurred with respect to these obligations at the time they were contractually assumed by EMI.

Since the contingent obligations should fail the "all events" and "economic performance" tests of IRC Section 461, these obligations should not be taken into account under IRC Section 358(d) because they have not yet risen to the level of "liabilities" for purposes of the Internal Revenue Code. Thus, the assumption of the deferred compensation and postretirement benefit obligations will not be treated as money received on the exchange and will not reduce Enron's basis in the EMI voting participating preferred stock.

The IRS has seemingly adopted this same reasoning in PLR 9343011 (July 16, 1993). In this ruling, the IRS has held (Holding number 11) that unspecified liabilities (the "Q" and "R" liabilities) assumed by the transferee corporation pursuant to a Section 351 incorporation "will be excluded in determining the amount of liabilities assumed or to which the property transferred is subject for purposes of Sections 357(c) and 358(d) of the Code (Sections 357(c)(3) and 358(d)(2))". Under the facts of PLR 9343011, an accrual basis member in a consolidated group of corporations transferred the assets of a division and stock in other members to a newly incorporated subsidiary in exchange for stock. As part of this transfer the subsidiary assumed the Q and R liabilities. None of the Q and R liabilities assumed by the transferee subsidiary had been previously taken into account for tax purposes by the transferor corporation. Furthermore, since Holding number 12 provides that the Q and R liabilities will be deductible by the transferee under Sections 162, 404(a)(5), 404(b) and 461(h), these liabilities presumably included deferred compensation obligations and deferred benefit obligations.

The Service has since formalized its position on this issue in Rev. Rul. 95-74, 1995-46 I.R.B.1 (October 27, 1995). In this ruling, the Service held that contingent environmental liabilities that have not been deducted or capitalized by the transferor and are assumed by the transferee corporation in a Section 351 incorporation are not liabilities for purposes of Sections 357(c) and 358(d). The Service also ruled that the liabilities assumed by the new subsidiary in the Section 351 exchange are deductible by it as business expenses under Section 162 or are capital expenditures under Section 263, as appropriate, under its method of accounting. Under the facts of the ruling, P, an accrual basis corporation, transferred the assets of a division to a newly incorporated subsidiary, S, in exchange for all of the stock of S and for S's assumption of the liabilities associated with the division, including environmental liabilities. P did not undertake any environmental remediation efforts before the transfer and did not deduct or capitalize any amount with respect to the contingent environmental liabilities. P had no plan or intention to dispose of (or have S issue) any S stock at the time of the transfer. In later years S undertook remediation efforts relating to property transferred in the Section 351 exchange.

These transactions were intended and were held to qualify as a tax-free transfers under Section 351. As stated above, the IRS held that such previously not deducted liabilities would not reduce the basis of the stock received by the transferor corporation as provided in Section 358(d). Thus, in applying the holdings in PLR 9343011 and Rev. Rul. 95-74 to the instant case, the assumption of the previously not deducted deferred compensation and postretirement benefit obligations should not reduce Enron's basis in the EMI voting participating preferred stock.

The holdings of Rev. Rul 95-74 are subject Section 482 and other applicable sections of the Code and principles of law, including the limitations discussed in Rev. Rul 80-198, 1980-2 C.B. 113 (limiting the scope of the revenue ruling to transactions that do not have a tax avoidance purpose) and limitations on "stripping transactions" described in Notice 95-53, 1995-44 I.R.B. 1. These limitations on the applicability of Rev. Rul 95-74 should not apply to Enron for the

following reasons: Enron entered into these transactions for valid business reasons and not for tax avoidance purposes and all transactions occurred at an arm's length fair market value.

Recently, the Service issued a Revenue Ruling in which it held that a short sale obligation transferred in a Section 351 transaction does give rise to a basis reduction in the underlying shares. In Revenue Ruling 95-45, I.R.B. 1995-26, (June 6, 1995) Corporation P entered into a short sale of XYZ securities. P's broker took XYZ securities on hand and sold them on P's behalf for $1000x. P left the cash proceeds with the broker and was thereafter obligated to deliver identical XYZ securities in the future to close out the short sale. Prior to the delivery of these securities P contributed its interest in the cash proceeds from the short sale to the capital of S corporation in a valid Section 351 transaction. S assumed the obligation of P to deliver the XYZ securities.

The Service held that since the proceeds of the short sale were not taxed to the short seller but nonetheless created an asset with tax basis, the concurrent obligation of the short seller to return the borrowed securities was a liability for purposes of determining basis reduction under Sec. 358. Thus, the basis that P had in the additional S stock of $1000x was similarly reduced by $1000x, the amount of the liability assumed by S to deliver the XYZ securities.

This ruling is distinguishable from the transaction at hand and should, more likely than not, not effect the basis that Enron had in the EMI voting participating preferred stock. First, the basis of the short sale asset was completely dependent on the short sale obligation. The tax basis created in the short sale asset was entirely a function of the creation of the concurrent liability to deliver the underlying securities. Here, the deferred compensation and postretirement benefit obligations do not give rise to any basis and are completely unrelated to the note receivable contributed to EMI. Enron has tax basis in the note receivable regardless of the existence of any deferred compensation and postretirement benefit liability.

Furthermore, unlike a short sale liability, the deferred compensation and postretirement benefit liabilities assumed by EMI are entirely contingent in nature. The amount and certainty of the deferred compensation and postretirement benefit liabilities are uncertain and indeterminate. Short sale liabilities, on the other hand, are fixed and quantifiable in that the short seller is obligated to return a fixed amount of securities at a future time. The value of the obligation may fluctuate with market conditions, but the obligation remains fixed and determinable at any point in time. Thus, because the nature of the short sale obligations is so different from the deferred compensation and postretirement benefit obligations Rev. Rul. 95-45 should be inapplicable to the present transaction.

As discussed above, since the contingent obligations should fail the "all events" and "economic performance" tests, these obligations should not reduce Enron's basis in the EMI voting participating preferred stock. However, even if in the unlikely event the IRS were to successfully assert on audit that the deferred compensation and postretirement benefit obligations rose to the level of "liabilities" under IRC Section 461, the obligations are the type specifically excluded from IRC Section 358(d). Thus, even if these obligations theoretically rose to the level of "liabilities," they should not result in a basis reduction in the voting participating preferred stock received in the exchange.

As discussed above, IRC Section 358(d) treats the controlled corporation's assumption of certain types of liabilities as the receipt of money by the transferor in a IRC Section 351 transaction. This treatment results in a decreased basis in the controlled company's stock

received in the transaction. IRC Section 358(a). However, not all liabilities fall under this rule. IRC Section 358(d)(2) excludes the liabilities listed under IRC Section 357(c)(3) from this treatment. IRC Section 357(c)(3) provides:

> (3) Certain Liabilities Excluded –
>
> (A) In General–If a taxpayer transfers, in an exchange to which Section 351 applies, a liability the payment of which either–
>
> (i) would give rise to a deduction, or
>
> (ii) would be described in Section 736(a),
>
> then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject
>
> (B) Exception–Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

Thus, even if Enron's deferred compensation and postretirement benefit obligations theoretically rise to the level of "liabilities" under IRC Section 461 for all tax purposes, these obligations should not cause a basis adjustment in the voting participating preferred stock if they would have been deductible when paid by Enron or will be deductible when paid by EMI. Additionally, Rev. Rul. 95-74 has expanded the Section 357(c)(3) exception to include not only liabilities that give rise to deductible items, but also to liabilities that give rise to capital expenditures as well.

Therefore, even if the IRS were to successfully assert that certain payments under Enron's deferred compensation plans or postretirement plans gave rise to a capital expenditure under Section 263 through an application of INDOPCO Corporation v. Comm., 112 S. Ct. 1039 (1992), the exception under Section 357(c)(3) remains applicable.

To summarize, these deferred compensation and postretirement benefit obligations fail the "all events" and "economic performance" tests of IRC Section 461. Therefore, they should not constitute "liabilities" and should not decrease Enron's basis in the voting participating preferred stock received in the transaction. Alternatively, in the unlikely event the deferred compensation and postretirement benefit obligations assumed by Subsidiary constituted "liabilities," they should not be liabilities that decrease Enron's basis in its EMI voting participating preferred stock since these obligations should be deductible (or capitalizable) when paid and, thus, are specifically excluded under IRC Section 358(d)(2) and IRC Section 357(c)(3)(A)(i) as interpreted by Rev. Rul. 95-74.

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Based on the arguments discussed above, Enron's tax basis in the voting participating preferred stock of stock of EMI should, more likely than not, equal Enron's basis in the intercompany notes contributed to EMI not reduced by the amount of deferred compensation and postretirement benefit obligations assumed by EMI.

DUPLICATED LOSS

Enron transferred the intercompany notes subject to EMI's contractual assumption of Enron's deferred compensation and postretirement benefit obligations in exchange for EMI voting participating preferred stock. The value of the intercompany notes is approximately $188.54 million and the amount of Enron's deferred compensation and postretirement benefit obligations is $188.5 million. Therefore, Enron's participating preferred stock should have nominal fair market value of $40,000. Enron may later sell the voting participating preferred stock to management and certain employees associated with the benefits function to provide them with an incentive to control costs and to allow them to share in the rewards of these cost containment efforts. Since the fair market value of Enron's voting participating preferred stock is only $40,000 while Enron's basis in the voting participating preferred stock should be equal to its basis in the intercompany note of $188.54 million (see Appendix C for a detailed discussion), Enron should recognize a loss on the sale of the voting participating preferred stock. A loss on the sale of the voting participating preferred stock of EMI should, more likely than not, not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1)(iii).

The consolidated tax return regulations (specifically Treasury Regulation Section 1.1502-20) generally limit the recognition of loss on the sale or other disposition of stock of a consolidated group member where a "duplicated loss" exists in that member.

Treasury Regulation Section 1.1502-20(c)(2)(vi) provides the definition of a duplicated loss. It states:

> (vi) Duplicated loss. "Duplicated loss" is determined immediately after a disposition or deconsolidation, and equals the excess (if any) of
>
> (A) The sum of–
>
> (1) The aggregate adjusted basis of the assets of the subsidiary other than any stock and securities that the subsidiary owns in another subsidiary, and
>
> (2) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and
>
> (3) Any deferred deductions (such as deductions deferred under Section 469) of the subsidiary, over
>
> (B) The sum of–
>
> (1) The value of the subsidiary's stock, and
>
> (2) Any liabilities of the subsidiary, and

(3) Any other relevant items.

At the time of the disposition of the voting participating preferred stock, the only assets that EMI has are the intercompany account receivable and the Employee/Officer accounts receivable and the intercompany notes. The intercompany notes should be excluded from this computation since, by its terms, they should qualify as securities in another subsidiary.

The term "security" is not defined anywhere in the Treasury Regulation Section 1.1502-20 regulations and, in fact, is not defined anywhere else in the Internal Revenue Code or regulations. Rather, the definition of security has been developed by judicial decisions. The leading case on whether a debt obligation constitutes a security is Camp Wolters Enterprises Corporation v. Commissioner, 22 TC 737 (1954), *aff'd* 230 F2d 555 (5th Cir.), *cert. denied* 352 U.S. 826 (1956). In Camp Wolters, the court stated:

> The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to cash payment, the purpose of the advances, etc.

Even though the controlling consideration of whether a note is a security is the "overall evaluation of the nature of the debt," the length of time to maturity is usually the most important factor. "Notes with a five-year term or less rarely seem able to qualify as securities, while a term of 10 years or more ordinarily is sufficient to bring them within the statute." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, [paragraph 3.04(6th ed. 1994).]

The intercompany notes should be securities because they give the holder of the note a significant degree of participation and continuing interest in the business as required by Camp Wolters. The notes have 10 year and 20 year terms with none of the principal payable until maturity. Clearly, the holder of the notes has a significant continuing interest in the issuers such that the notes should qualify as securities.

As discussed above, the intercompany notes should qualify as securities. Based on the facts and assumptions the only other assets held by EMI with any adjusted tax bases should be the intercompany accounts receivable and Officer/Employee accounts receivable possessing a tax basis of approximately $1.9 million. Thus, since both the issuers and EMI are subsidiaries of Enron and members of Enron's consolidated group, under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(1), the aggregate adjusted basis of the assets of EMI, other than the stock and securities that EMI owns in other subsidiaries (i.e., the intercompany notes), should be approximately $1.9 million.

Immediately after the disposition of the voting participating preferred stock of EMI by Enron, EMI should have no losses attributable to it that will be carried over to its next taxable year under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(2). Although EMI had been a going concern for many years it did not have any losses attributable to it that can be carried over to its next taxable year after the disposition of the voting participating preferred stock. However, if significant deferred compensation and postretirement benefit payment activities occur before

the sale of any of the voting participating preferred stock, EMI must be reevaluated to determine if there is any loss to be carried over to its next taxable year. Currently, since EMI has interest income from the intercompany notes and, since it is anticipated that substantial deferred compensation and postretirement benefit costs will not be incurred for some time, EMI has no losses attributable to it that will be carried over to its taxable year under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(2).

Immediately after the disposition of the voting participating preferred stock of EMI by Enron, EMI should not have any deferred deductions under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(3). The term "deferred deduction" is not defined anywhere in the regulations and the only example given is a deduction deferred under IRC Section 469. IRC Section 469 limits the amount of passive losses that can be deducted in any one year. Any passive loss realized in a tax year, but disallowed due to the passive loss limitation of IRC Section 469, is allowed to be carried over to the next taxable year. Presumably, a deferred deduction is a deduction or loss that is realized in a taxable year and would generally be recognized for tax purposes but for some other limitation in the Internal Revenue Code.

> Lerner, Antes, Rosen and Finkelstein, Federal Income Taxation of Corporation Filing Consolidated Returns, Section 21.02[4] n. 80.2 (1993) states with regard to deferred deductions:
>
> No other example of "deferred deductions" is provided in the regulations. Presumably, other comparable items, such as losses deferred under IRC Section 267(f), at risk losses subject to Section 465, and excess interest carryovers under Section 163(j), would also be taken into account under this provision.

Each of these types of "deferred deductions" are deductions that are realized, but whose recognition for tax purposes is deferred. EMI did not and does not have any of these kinds of deferred deductions. Clearly, the deferred compensation and postretirement benefit obligations assumed by EMI should not rise to the level of realized deductions, as EMI should not be entitled to a deduction until payments are made. See Appendix C for a more detailed discussion. Thus, EMI should have no deferred deductions under Treasury Regulation Section 1.1502- 20(c)(2)(vi)(A)(3).

Thus, the sum of the amounts under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A)(1), (2) and (3) should be $1.9 million.

Immediately after the disposition of the voting participating preferred stock of EMI by Enron, the value of that stock under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(1) should be approximately $40,000, the value of the intercompany notes contributed to EMI in exchange for the voting participating preferred stock of $188.54 million reduced by the amount of Enron's deferred compensation and postretirement benefit obligations assumed by EMI of $188.5 million. The value of the common stock retained by Enron should be $1.9 million, the net equity of EMI reduced by the amount of net equity attributable to the voting participating preferred stock.

Immediately after the disposition of the voting participating preferred stock of EMI by Enron, EMI has a liability for taxes payable of approximately $20,000. under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(2). Enron's deferred compensation and postretirement benefit

obligations should not rise to the level of liabilities for federal income tax purposes. See Appendix C for a more detailed discussion of this issue.

Immediately after the disposition of the voting participating preferred stock of EMI by Enron, EMI should not have "any other relevant items" under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(3). No indication is given as to the meaning of the term "other relevant items." The preamble to the regulations states that guidance will be issued in connection with IRC Section 338 and IRC Section 382(h) which use similar terminology. To date however, no such guidance has been published. It is unlikely however, that EMI has any relevant items that would impact a duplicated loss. When final guidance is issued, this issue may need to be reexamined.

Thus the sum of the amounts under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B)(1), (2) and (3) should be $1.94 million.

Since the amount of a duplicated loss is the excess (if any) of the sum of the items under Treasury Regulation Section 1.1502-20(c)(2)(vi)(A) over the sum of the items listed under Treasury Regulation Section 1.1502-20(c)(2)(vi)(B), the amount of duplicated loss on the disposition of the voting participating preferred stock of EMI should be zero ($1.9 million is less than $1.94 million).

Treasury Regulation Section 1.1502-20(e) provides that the loss disallowance rules must be applied in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of these rules, adjustments must be made as necessary to carry out their purposes. Similarly, the new deferred intercompany transaction rules (whose application to this transaction are unclear) are generally effective for Enron's taxable year beginning January 1, 1996, and thus inapplicable to these transactions occuring during 1995. Treasury Regulation Section 1.1502-13(l)(1). However, Treasury Regulation Section 1.1502-13(l)(2) provides an accelerated effective date for avoidance transactions engaged in after April 8, 1994 with a principal purpose to avoid the general effective date of the new deferred intercompany transaction rules. Since Enron has an overriding business purpose for entering into these transactions, these anti-avoidance rules should not apply.

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Based on the arguments discussed above, a loss on the sale of the voting participating preferred stock of EMI by Enron should, more likely than not, not be a duplicated loss within the meaning of Treasury Regulation Section 1.1502-20(c)(1)(iii).

ACQUISITION MADE TO EVADE OR AVOID INCOME TAX

Enron's contribution of the intercompany note to EMI in exchange for all of the voting participating preferred stock of EMI should, more likely than not, not constitute an acquisition made to evade or avoid income tax within the meaning of IRC Section 269.

Enron will transfer a $120.84 million, 20-year intercompany note receivable and a $67.7 million, 10-year note receivable, subject to a contractual assumption of $188.5 million of Enron's deferred compensation and postretirement benefit obligations. In exchange, Enron will receive 100 percent of the voting participating preferred stock in EMI.

This transaction raises the issue whether Enron's contribution of the intercompany notes to EMI in exchange for all of the voting participating preferred stock of EMI is an acquisition made to evade or avoid income tax within the meaning of IRC Section 269.

IRC Section 269(a) states:

> (a) In general–If–
>
> (1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or
>
> (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transfer corporation,
>
> and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all class of stock of the corporation.

EMI was "acquired" as that term is used in IRC Section 269(a)(1) when Enron subscribed to all of the common stock of its predecessor, Enron Services Corp. The principal purpose of acquiring Enron Services Corp./EMI at that time was not tax avoidance. For IRC Section 269(a)(1) to apply, the principal purpose of the acquisition must be the evasion or avoidance of federal income tax by securing the benefit of a deduction, credit or allowance which the acquiring corporation would not otherwise enjoy.

Enron's principal purpose in acquiring EMI is determined at the time EMI was formed and Enron received all of its common stock, not when Enron received the voting participating preferred stock. The voting participating preferred stock will represent less than 20 percent of the vote and value of EMI. Therefore, Enron will not acquire control of EMI within the meaning of IRC Section 269(a)(1) when it obtains the voting participating preferred stock, since Enron controlled EMI from its inception and continued to control EMI at all times thereafter.

In The Challenger Corporation v. Commissioner, 23 TCM 2096 (1964), the taxpayer transferred property to two dormant corporations that it controlled. The Commissioner argued that the revival of dormant corporations was the equivalent of the "acquisition" of the corporation under IRC Section 269(a)(1) and that the taxpayer should not be entitled to multiple surtax exemptions. The court disagreed with the Commissioner and stated:

> Section 269(a)(1) requires acquisition of "control," not acquisition of the corporation. Congress undertook to define "control" for these purposes in terms of stock ownership. [citation omitted]. The revival of a dormant corporation does not constitute the acquisition of ownership of stock.

Section 269 is essentially a reenactment of Section 129 of the Internal Revenue Code of 1939, added by Section 128 of the Revenue Act of 1943. The Senate Finance Committee Report stated (S. Rep. No. 627, 78th Cong., 1st Sess., 1943, p. 60):

> Control once acquired could not be again acquired, unless the group was in some way broken. A mere shift in the form of control—from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect—cannot, therefore, amount to acquisition of control within the meaning of (Section 269).

Enron acquired control of EMI when it subscribed to all of the common stock of its predecessor, Enron Services Corp. It acquired Enron Services Corp./EMI for nontax purposes. Enron controlled Enron Services Corp./EMI at its formation and that control has continued unbroken at all times since. Most importantly, Enron Services Corp./EMI has continued to be an ongoing operating business since its inception in 1992. Therefore, it is clear that, under the rationale of The Challenger Corporation case that when Enron exchanged the intercompany notes, subject to the deferred compensation and postretirement benefit obligations, for all the voting participating preferred stock of EMI, it was not acquiring control of EMI under IRC Section 269(a)(1).

Even if Enron acquired control of EMI under IRC Section 269(a)(1) at the time it acquired all the voting participating preferred stock of EMI, the principal purpose of the acquisition was not the evasion or avoidance of federal income tax.

IRC Section 269 provides for the disallowance of deductions and other tax benefits when tax avoidance is the principal purpose for acquisition of control of a corporation or for certain transfers from one corporation to another. A corporation's principal purpose in acquiring another corporation's stock or assets is tax avoidance if it "exceeds the importance of any other purpose." Treasury Regulation Section 1.269-3(a).

As stated above, Enron has represented that the principal purpose of EMI was not the evasion or avoidance of income tax. The business purposes for which EMI was formed include, but are not limited to:

- to consolidate all of Enron's compensation and benefit management activities in one subsidiary,

- to better control the administrative costs and actual healthcare and insurance costs associated with the deferred compensation and postretirement benefit obligations, and

- to offer management and certain employees associated with the deferred compensation and postretirement benefit management function an incentive to control these costs and to share in the cost savings.

IRC Section 269(a)(2) is not applicable to this transaction. IRC Section 269(a)(2) only applies to the acquisition of property by the transferee corporation (i.e., EMI) where the principal purpose is to secure a deduction, etc., by the transferee corporation which it would not otherwise enjoy. Here, the loss at issue is a loss by the transferor (Enron) and not the transferee (EMI).

Treasury Regulation Section 1.269-3(c) clarifies that IRC Section 269(a)(2) only applies to the transferee corporation. IRC Section 269(a)(2) applies in transactions where there is a transfer of built-in loss property for the purpose of recognizing the loss at the transferee corporation, and transactions where there is a transfer of built-in gain property to a transferee with losses otherwise unavailable to the transferor so that the transferee may recognize the gain and utilize its losses. Enron's contribution of the intercompany notes is not similar to either of these transactions, and IRC Section 269(a)(2) does not apply.

* * * * * * * * * *

Based on the arguments discussed above, Enron's contribution of the intercompany notes to EMI in exchange for all of the voting participating preferred stock of EMI should, more likely than not, not be an acquisition made to evade or avoid income tax within the meaning of IRC Section 269.