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December 16, 1997

PRIVILEGED ATTORNEY
CLIENT COMMUNICATION

R. Davis Maxey, Esq.
Enron Corporation
1400 Smith Street, EB-1445
Houston, Texas 77002-7361

Dear Dave:

You have requested our opinion as to whether the accuracy-related penalty under section 6662 of the Internal Revenue Code of 1986, as amended (the "Code"),[1] would be imposed in the event that the Internal Revenue Service (the "Service") disallowed tax deductions for the net losses generated from the REMIC residual interests contributed by Bankers Trust (Delaware) ("BTDel") and Bankers Trust Company ("BTCo") to ECT Investing Partners, L.P. ("ECT") in the transaction (the "Transaction") that is the subject of our separate opinion dated the same date herewith (the "REMIC Opinion"). In addition, you have requested our opinion as to whether the tax shelter registration requirements of section 6111 will apply to the Transaction.

I. FACTS AND REPRESENTATIONS

The facts and representations set forth in the REMIC Opinion are incorporated herein by reference, as is the description, in the second paragraph on page one of the REMIC Opinion, of the scope of our review and of the matters upon which we have relied in preparing our opinion.

Except as explicitly set forth herein and in the REMIC Opinion, we express no opinion as to the tax consequences, whether federal, state, local, or foreign, of the Transaction to any party.

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[1] All section references herein are to the Code or the Treasury regulations promulgated thereunder.

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II. OPINION

Based upon the facts and representations incorporated herein and the existing law:

(1) We believe that the accuracy-related penalty under section 6662 should not apply in the event that the net losses otherwise generated from the REMIC residual interests contributed by BTDel and BTCo to ECT are disallowed.

(2) We believe that no person principally responsible for, or participating in, the organization and management of ECT should be required to register ECT as a tax-shelter under section 6111.

Our opinion is based on the Code in effect on the date hereof, and applicable Treasury regulations, case law, administrative rulings and pronouncements, and other authoritative sources. In the event of any change in the body of law upon which our opinion is based, our opinion on the matters expressed herein may change. We disclaim any undertaking to advise you of any subsequent changes in applicable law.

Our opinion represents our best legal judgment as to the ultimate outcome if the issues addressed herein were presented to a court of law. Our opinion is not binding on the Service or the courts, however, and there can be no assurance that the Service or the courts would agree with our opinions on the issues discussed herein if those issues were presented to them.

III. ANALYSIS

A. *The Accuracy-Related Penalty*

Under section 6662, if any portion of an underpayment of tax is attributable to, *inter alia*, "negligence or disregard of rules or regulations" (the "negligence component") or a "substantial understatement of income tax" (the "substantial understatement component"), then, subject to certain exceptions discussed below, an accuracy-related penalty equal to 20 percent of such portion of the underpayment is imposed. Section 6662(a) and (b)(1), (2).[2]

1. *The Negligence Component*

With regard to the negligence component of the accuracy-related penalty, the regulations provide that "[a] position with respect to an item is attributable to negligence if it

[2] The accuracy-related penalty also applies to underpayments attributable to substantial valuation misstatements, substantial overstatements of pension liabilities, and substantial estate or gift tax valuation understatements, but none of those are relevant under the instant facts.

lacks a reasonable basis." Reg. § 1.6662-3(b). The "reasonable basis" standard is "significantly higher than the not frivolous standard," Reg. § 1.6662-3(b)(3)(ii),[3] but less stringent than the "substantial authority" standard (discussed *infra*). *See* Reg. § 1.6664-4(d)(2); Prop. Reg. § 1.6662-3(b)(3). The regulations further provide that "'disregard' includes any careless, reckless or intentional disregard of rules or regulations." Reg. § 1.6662-3(b)(2).

2. *The Substantial Understatement Component*

a. *Overview*

With regard to the substantial understatement component of the accuracy-related penalty, an "understatement" is defined as the excess of (i) the amount of tax required to be shown on the taxpayer's return for the taxable year, *over* (ii) the amount of tax actually shown on that return (reduced by certain credits, refunds, or other payments). Section 6662(d)(2); Reg. § 1.6662-4(b)(2). An understatement is "substantial" if it exceeds the greater of 10 percent of the tax required to be shown on the taxpayer's return for the taxable year or $10,000. Section 6662(d)(1); Reg. § 1.6662-4(b)(1).[4] The accuracy-related penalty for a substantial understatement does not apply to any portion of the understatement that is attributable to a tax position for which the taxpayer has "substantial authority," *except that* any portion of the understatement that represents a "tax shelter" item is subject to the penalty. Section 6662(d)(2)(B)(i) & (C)(ii).[5]

b. *Substantial Authority Defined*

Under the regulations, the "substantial authority" standard is less stringent than the "more likely than not" standard (*i.e.*, a greater than 50 percent likelihood of success if litigated) but, as noted *supra*, more stringent than the "reasonable basis" standard. Reg. § 1.6662-4(d). A taxpayer's tax treatment of an item is supported by substantial authority if the weight of authorities supporting such tax treatment "is substantial in relation to the weight of

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[3] Reg. § 1.6694-2(c)(2) provides that a frivolous position "is one that is patently improper."

[4] Only the statutory provisions applicable to C corporations (other than personal holding companies) are reviewed herein.

[5] Additionally, the understatement may be reduced by the portion thereof that is attributable to any item (other than a tax shelter item) if the facts relevant to the tax treatment of that item are adequately disclosed on the taxpayer's return (or on an attached statement) *and* there was a "reasonable basis" for the tax treatment of the item. Section 6662(d)(2)(B)(ii); Reg. § 1.6662-4(a), -4(e), -4(f). Pursuant to a 1997 Act amendment to section 6662, a corporation does not have a "reasonable basis" for the tax treatment of an item attributable to a "multi-party financing transaction" if the treatment does not clearly reflect the income of the corporation. Section 6662(d)(2)(B)(ii).

authorities supporting contrary tax treatment." Reg. § 1.6662-4(d)(3)(i). The weight of an authority depends on its relevance, persuasiveness, and source. Reg. § 1.6662-4(d)(3)(ii). Substantial authority may exist for more than one position on an item. In addition, substantial authority may exist despite the absence of certain types of authority. Accordingly, a taxpayer may have substantial authority for a position that is "supported only by a well-reasoned construction of the applicable statutory provision." *Id.*

The substantial authority exception applies if substantial authority exists either at the time the taxpayer's return is filed or on the last day of the taxpayer's taxable year. Reg. § 1.6662-4(d)(3)(iv)(C).

c. *Tax Shelter Items*

Prior to the enactment of the Taxpayer Relief Act of 1997 (the "1997 Act"), a "tax shelter" was defined as any entity, plan or arrangement "*the principal* purpose" of which was to avoid or evade federal income tax. Section 6662(d)(2)(C)(iii) (prior to amendment).[6] As part of the 1997 Act, and effective for items with respect to transactions entered into after August 5, 1997, Congress amended the definition of a "tax shelter" for purposes of the accuracy-related penalty. A tax shelter is now defined as any entity, plan or arrangement that has "a significant purpose" (rather than *the principal* purpose) of tax avoidance or evasion.

Regulations interpreting the pre-1997 Act definition of a "tax shelter" state that a purpose to obtain a tax benefit "in a manner consistent with the statute and Congressional purpose" is not a tainted tax avoidance or evasion purpose. Reg. § 1.6662-4(g)(2)(ii). Nothing in the recent legislation indicates that this provision was intended to be overridden.

d. *Summary*

To summarize, an underpayment attributable to an item for which the taxpayer has substantial authority is not subject to the substantial understatement component of the accuracy-related penalty unless that item is a tax shelter item. Such an item also would not be subject to the negligence component of the accuracy-related penalty, since a position for which the taxpayer has substantial authority necessarily is a position that satisfies the "reasonable basis" standard.[7]

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[6] The regulations promulgated under that provision provide that a purpose is the principal purpose if it "exceeds any other purpose." Reg. § 1.6662-4(g)(2)(i). In addition, those regulations provide that an item is a "tax shelter item" if it "is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade Federal income tax." Reg. § 1.6662-4(g)(3).

[7] Under a literal reading of the regulations, the "disregard of rules or regulations" prong of the negligence component could be satisfied if the taxpayer knowingly disregarded, and took a position contrary to, a regulation, even if that contrary position was supported by substantial authority. (A regulatory exception for a contrary position

3. *The Reasonable Cause and Good Faith Exception*

a. *General Rules*

An underpayment that satisfies all the requirements for the imposition of the accuracy-related penalty under section 6662 nonetheless will not be subject to that penalty to the extent that the taxpayer had reasonable cause for the position taken and acted in good faith (the "reasonable cause and good faith exception"). Section 6664(c)(1); Reg. § 1.6664-4(a). Set forth below is a review of the general rules for the operation of this exception. Special rules applicable to tax shelter items are discussed separately thereafter.

The reasonable cause and good faith exception is applied on a case-by-case basis and requires a review of "all pertinent facts and circumstances." Reg. § 1.6664-4(b). The regulations specify that the most important consideration in determining whether the exception applies "is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." Reg. § 1.6664-4(b)(1). In addition, the regulations provide the following guidance:

> Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional (such as an appraiser, attorney or accountant) does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

Reg. § 1.6664-4(b).

Accordingly, the regulations governing the reasonable cause and good faith exception expressly state that reliance on professional advice "constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." *Id.* This rule is illustrated in the regulations by the following example:

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that "has a realistic possibility of being sustained on its merits" literally applies only to revenue rulings or notices. Reg. § 1.6662-3(b)(2).) However, the overriding "reasonable cause and good faith" exception, described below, should apply in such circumstances.

> *Example 1.* A, an individual calendar year taxpayer, engages B, a tax professional, to give him advice concerning the deductibility of certain state and local taxes. A provides B with the full details concerning the taxes at issue. B advises A that the taxes are fully deductible. A, in preparing his own tax return, claims a deduction for the taxes. Under these facts, A is considered to have demonstrated good faith by seeking the advice of a tax professional, and to have shown reasonable cause for any underpayment attributable to the deduction claimed for the taxes. However, if A had sought advice from someone that he knew, or should have known, lacked knowledge in federal income taxation, A would not be considered to have shown reasonable cause or to have acted in good faith.

Reg. § 1.6664-4(b)(2) *Ex.* 1.

The scope of the reasonable cause and good faith exception, however, is limited by Reg. § 1.6664-4(c), which provides as follows:

> (c) *Reliance on opinion or advice*—(1) *Facts and circumstances; minimum requirements.* All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. However, in no event will a taxpayer be considered to have reasonably relied in good faith on advice unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.
>
> (i) *All facts and circumstances considered.* The advice must be based upon all the pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the

requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item.

(ii) *No unreasonable assumptions*. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.[8]

b. *Tax Shelter Items*

A corporation generally is considered to have acted with reasonable cause and in good faith with respect to a tax shelter item (as defined *supra*) *if* (i) there is substantial authority for the tax treatment of the item (the "authority requirement") *and* (ii) "the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more

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[8] In addition to the foregoing regulatory provisions regarding reliance on a tax professional, the courts have long recognized that a taxpayer's bona fide reliance on the advice of a tax professional constitutes "reasonable cause" sufficient to preclude the imposition of tax penalties. The Supreme Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985), although involving the penalty for failure to file a return rather than the substantial understatement penalty, frequently is cited in this regard:

> Courts have frequently held that "reasonable cause" is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney that it was unnecessary to file a return, even when such advice turned out to have been mistaken . . . .
>
> *When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether liability exists, it is reasonable for the taxpayer to rely on that advice.* Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. *To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. . . . "Ordinary business care and prudence" do not demand such actions.*

469 U.S. at 251 (emphasis added). In *Boyle*, the Court concluded that the taxpayer there at issue could not avoid the failure to file penalty by blaming his attorney, since "one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due." *Id.*

likely than not the proper tax treatment" (the "belief requirement"). Reg. § 1.6664-4(e)(2)(A) & (B). Further:

> [A] corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or than an issue will be settled)--
>
> *(1)* The corporation analyzes the pertinent facts and authorities . . . and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or
>
> *(2)* The corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service. . . .

Reg. § 1.6664-4(e)(2)(B). The regulations describe the foregoing rules for tax shelter items as "minimum requirements," and reserve to the Service broad discretion to disallow the reasonable cause and good faith exception in cases of perceived abuse:

> For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter
>
> that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.

Reg. § 1.6664-4(e)(3).

4. *Application of the Accuracy-Related Penalty to Losses Attributable to the Transaction*

Focusing first on the rules applicable to items other than tax shelter items, the accuracy-related penalty should not apply to any underpayment attributable to a disallowance of losses on the REMIC residual interests held by ECT as a result of the Transaction if and to the extent that such disallowance is based on a position contrary to one of the opinions set forth in the REMIC Opinion. This follows because each of those opinions is expressed in terms of the tax result that "should" or that "more likely than not" would obtain. Each of those standards is more stringent than the "substantial authority" standard applicable to the substantial understatement component of the accuracy-related penalty. As seen, moreover, the substantial authority standard is itself more stringent than the "reasonable basis" standard applicable to the negligence component of the penalty. With regard to the "disregard" prong of the negligence component, none of the opinions set forth in the REMIC opinion is premised on the disregard of any rule or regulation.

Even if "substantial authority" were deemed *not* to exist for the positions taken in the REMIC Opinion, the reasonable cause and good faith exception properly should apply by reason of the taxpayers' reliance on an opinion of counsel (the REMIC Opinion) that takes into account all of the relevant facts and that is not premised upon any unreasonable factual or legal assumptions or representations.

Even if the Transaction were characterized as a tax shelter, moreover, the reasonable cause and good faith exception should apply if the losses were disallowed on the basis of a position contrary to one of the express opinions set forth in the REMIC Opinion. This follows because (i) substantial authority exists for each of the opinions set forth in the REMIC Opinion, (ii) the taxpayer-recipients of the REMIC Opinion properly should be considered to have reasonably relied in good faith on the REMIC Opinion, and (iii) the REMIC Opinion unambiguously concludes that the likelihood that the opinions expressed therein will be upheld is greater than 50 percent.

B. *Tax Shelter Registration*

Section 6111(a)(1) of the Code requires a "tax shelter organizer" to register a "tax shelter" with the Service no later than the day on which the first interest in the tax shelter is offered for sale.

For this purpose, a "tax shelter" is defined to include any investment with respect to which an investor could reasonably infer from representations made, or to be made, in connection with the offering for sale of interests in the investment, that the "tax shelter ratio" is greater than 2 to 1 for any investor as of the close of any of the first 5 years ending after the date on which such investment is offered for sale. Section 6111(c)(1)(A). Additionally, the

investment must (i) be required to be registered under a federal or state securities law, (ii) be sold pursuant to a registration exemption that requires the filing of a notice with the appropriate federal or state securities regulators, or (iii) involve a substantial investment (*i.e.*, the aggregate amount offered for sale exceeds $250,000 and 5 or more investors are expected). Section 6111(c)(1)(B); Section 6111(c)(4).

The "tax shelter ratio" for any year is the ratio that (i) the aggregate amount of deductions and 350 percent of the credits which are represented as potentially allowable to any investor for all periods through the close of such year, bears to (ii) the "investment base" for such year. Section 6111(c)(2). The "investment base," in turn, for any year generally is the amount of money and the basis of any property (less any liabilities to which such property is subject) contributed by the investor as of the close of such year. Section 6111(c)(3).

In addition to the foregoing, the Taxpayer Relief Act of 1997 recently expanded the definition of a "tax shelter" to include certain confidential arrangements. Under new section 6111(d) of the Code, a "tax shelter" also includes any entity, plan, arrangement or transaction (i) a significant purpose of which is the avoidance or evasion of federal income tax by a direct or indirect corporate participant, (ii) that is offered to any potential participant under conditions of confidentiality, and (iii) for which the tax shelter promoters may receive aggregate fees in excess of $100,000. Section 6111(d)(1).

In this regard, a transaction is considered to be offered under conditions of confidentiality if a potential participant (or person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to limit disclosure of the transaction or any of its significant tax features. Section 6111(d)(2)(A). In addition, a transaction is considered to be offered under conditions of confidentiality if any promoter "(i) claims, knows or has reason to know, (ii) knows or has reason to know that any other person (other than the potential participant) claims, or (iii) causes another person to claim, that the tax shelter (or any aspect thereof) is proprietary to the promoter or any person other than the potential participant or is otherwise protected from disclosure to or use by others. Section 6111(d)(2)(B).

The Transaction might be analyzed in one of two ways as a "tax shelter" under section 6111. The first, and the better, reading of section 6111 is that the Residual Interests are themselves the object of a tax shelter investment by ECT. In that event, while the 2 to 1 tax shelter ratio test for registration is likely met, the tax shelter does not appear to meet the remaining part of the conjunctive test for registration. Specifically, (i) no securities registration is required for such investment, (ii) no exemption requiring the filing of a notice with securities regulators was employed, and (iii) no "substantial investment" is present because ECT is the sole investor (and five investors are required for a substantial investment).[9] Thus, where the Residual

[9] Reg. § 301.6111-1T Q&A 22 provides that similar investments involving fewer than 5 investors will be "aggregated solely for the purpose of determining whether investments involving fewer than 5 investors...are

Interests are themselves treated as the object of the tax shelter, registration should not be required.

The second mode of analysis that might be applied is that the investments in ECT are themselves the investment in the tax shelter. This mode does not appear appropriate because since ECT is not a flow through entity, the investors in fact receive no deductions from the Residual Interests. Those deductions are all realized by ECT.[10] However, Bankers Trust has prepared a calculation of the tax shelter ratio that includes the very conservative assumption that the deductions of ECT should be compared to the outside investment base of the Enron-affiliate investors in ECT. The computation of the tax shelter ratio is also conservative in that it uses a series of assumptions as to the rate at which deductions would be generated by the Residual Interests that is far in excess of the projected rate of deductions and that was presented to Enron as a sensitivity analysis rather than as a projection. Even at this unanticipated rate of deductions from the Residual Interests, a tax shelter ratio of less than 2 to 1 was determined.[11] The rules in calculating the tax shelter ratio, especially the investment base, are not elaborately established. However, the calculation of the investment base utilized, which included the contribution to ECT of the preferred stock of Enron Liquids Holding Corp. as the only contribution increasing the investment base, is a conservative calculation under the rules. Thus, although we do not believe that this second mode of analysis is the appropriate analysis under section 6111, we believe that the tax shelter ratio calculation under such scenario should sustain a determination that no registration was required.

In addition, the newly added provisions relating to corporate tax shelters should not be applicable. We understand and assume that Enron and its affiliates have not entered into any agreement with nor have any understanding with any person that directly or indirectly restricts Enron's disclosure of the Transaction. Further, we understand and assume that Enron does not believe that the Transaction is proprietary to any person.

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substantial investments." In Section 3.3(c) of the Contribution Agreement between BTDel, BTCo and ECT, BTDel and BTCo have represented that each of them and their affiliates will not be involved in more than 3 additional similar investments. Thus, even with aggregation of future similar transactions, the Transaction should not be a substantial investment if it is analyzed as though the Residual Interests were the tax shelter.

[10] Even if the Service were to take the position that ECT is a flow through entity by virtue of the consolidated return rules, the deductions from the Residual Interest are subject to the SRLY rules.

[11] The greatest amount of potential deductions under the Residual Interests was used inasmuch as the regulations refer to deductions represented as "potentially allowable." *See* Reg. § 301.6111-1T Q&A 6.

The foregoing opinions of the Firm represent our best legal judgment on the issues discussed and are subject to the limitations discussed herein, including changes in law or the inaccuracy of any factual matter relied on herein.

Very truly yours,

Akin, Gump, Strauss, Hauer & Feld, LLP

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