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July 29, 1997

R. Davis Maxey, Esquire
Senior Director, Tax Research
Corporate Tax
Enron Corp.
1400 Smith Street
Houston, TX 77002-7361

Re: Stock Purchase

Dear Dave:

You have requested our opinion with respect to certain federal income tax consequences of the purchase by Enron Pipeline Company ("Enron Pipeline") of preferred stock of Enron Liquids Holding Corp. ("Liquids") from Enron Leasing Partners, L.P. ("Partnership").

This document is subject to the attorney-client privilege and the work-product doctrine. It contains the legal opinions, thoughts, impressions and conclusions of King & Spalding with respect to certain federal income tax matters. King & Spalding, as special tax counsel for Enron Corp. ("Enron"), has prepared this document at the request of Enron for its sole use. It has been prepared to aid Enron, among other things, in anticipation of possible future litigation regarding the federal income tax matters referenced above and covered herein. In that regard, this document has been prepared to help define, and as part of, the litigation strategy of Enron in the event of any challenge to the federal income tax treatment claimed with respect to the transactions that it addresses.

I. STATEMENT OF FACTS

Enron directly owns all of the common stock, which is all of the outstanding stock, of each of Enron Pipeline, Enron Capital & Trade Resources Corp. ("ECTR"), Enron Power Corp., and Enron Cayman Leasing, Ltd. ("Enron Cayman"). Enron Power Corp. owns all of the common stock, which is all of the outstanding stock, of Enron Development Corp. ("EDC"). Enron owns all of the

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outstanding common stock of Organizational Partner, Inc. ("OPI"). All of the outstanding shares of Series A preferred stock of OPI are owned by Potomac Capital Investment Corporation ("PCI") and all of the outstanding shares of Series B preferred stock of OPI are owned by EN-BT Delaware, Inc. ("EN-BT"). The common stock of Liquids is owned 80 percent by Enron and 20 percent by OPI. The preferred stock of Liquids is owned by Partnership. OPI is a limited partner in Partnership with a 98 percent interest in capital and profits. EN-BT is a limited partner in Partnership with a one percent interest in capital and profits. Enron Property Management Corp. ("Enron GP"), a wholly-owned subsidiary of Enron Cayman, is the general partner of Partnership with a one percent interest in capital and profits.

As of April 28, 1997 there was outstanding an intercompany indebtedness from ECTR to Enron in an amount in excess of $600 million. This indebtedness was incurred for working capital advances made by Enron to ECTR prior to April 28, 1997 and for obligations of ECTR to third parties that were satisfied on behalf of ECTR by Enron prior to April 28, 1997. As of April 28, 1997, there was outstanding an intercompany indebtedness from EDC to Enron in an amount in excess of $400 million. This indebtedness was incurred for working capital advances made by Enron to EDC prior to April 28, 1997 and for obligations of EDC to third parties that were satisfied on behalf of EDC by Enron prior to April 28, 1997.

On April 29, 1997, ECTR issued to Enron a $600 million note (the "$600 Million ECTR Note") and EDC issued to Enron a $400 million note (the "EDC Note"), in each case reflecting a portion of the existing intercompany debt between the issuer and Enron. At the time of the issuance of the $600 Million ECTR Note, ECTR's assets, liabilities, and anticipated cash flows were such that it would have been commercially reasonable for an unrelated person to lend ECTR $600 million on terms substantially the same as those of the $600 Million ECTR Note At the time of the issuance of the EDC Note, EDC's assets, liabilities, and anticipated cash flows were such that it would have been commercially reasonable for an unrelated person to lend EDC $400 million on terms substantially the same as those of the EDC Note. On April 29, 1997, Enron contributed the $600 Million ECTR Note and the EDC Note to Enron Pipeline. On May 14, 1997, ECTR issued two notes, one in the principal amount of $198 million (the "$198 Million ECTR Note") and one in the principal amount of $402 million (the "$402 Million ECTR Note"), in amendment and restatement of the $600 Million ECTR Note. Payment by ECTR to Enron Pipeline of interest on the $600 Million ECTR Note for the period from April 29, 1997 to May 14, 1997 was reflected in intercompany accounts in accordance with the usual and customary procedures followed by Enron and its wholly-owned subsidiaries with respect to intercompany debts.

On May 14, 1997, Enron Pipeline purchased 1,980 shares of Liquids preferred stock from Partnership (the "Purchase") in exchange for $198 million (the "Purchase Price") in the form of the $198 Million ECTR Note. At that time, Enron guaranteed the $198 Million ECTR Note.

II. DOCUMENTS EXAMINED

In rendering this opinion, we have examined and relied upon the following documents:

Certificate of Amendment of Certificate of Incorporation of Organizational Partner, Inc., filed March 21, 1997.

Certificate of Amendment of Certificate of Incorporation of Enron Liquids Holding Corp., filed March 21, 1997.

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between PCI and OPI ("PCI Subscription Agreement").

Subscription and Contribution Agreement, dated as of March 27, 1997, by and between EN-BT and OPI ("EN-BT Subscription Agreement").

Letter, dated March 27, 1997, from PCI to Enron, relating to representations by PCI and liquidity of OPI.

Letter, dated March 27, 1997, from EN-BT to Enron, relating to representations by EN-BT and liquidity of OPI.

Letter, dated March 27, 1997, from Enron to EN-BT, relating to representations by Enron.

Limited Partnership Agreement of Enron Leasing Partners, L.P., effective as of March 27, 1997, by and among Enron GP, OPI, and EN-BT ("Partnership Agreement").

Promissory Note of ECTR, dated April 29, 1997, in the amount of $600 million.

Promissory Note of ECTR, dated May 14, 1997, in the amount of $198 million.

Promissory Note of ECTR, dated May 14, 1997, in the amount of $402 million.

Promissory Note of EDC, dated April 29, 1997, in the amount of $400 million.

Contribution Agreement, dated as of April 29, 1997, by and between Enron and Enron Pipeline ("Enron/Enron Pipeline Contribution Agreement").

Stock Purchase Agreement, dated as of May 14, 1997, between Partnership and Enron Pipeline ("Purchase Agreement").

Guaranty of Obligations, dated as of May 14, 1997, by Enron in favor of Partnership, relating to the $198 Million ECTR Note.

In our examination of documents and in our reliance upon them in issuing this opinion, we have assumed, with your consent, that all documents submitted to us as photocopies faithfully reproduce the originals, that the originals are authentic, that all documents submitted to us have been duly executed and validly signed to the extent required in substantially the same form as they have been provided to us, that each executed document constitutes the legal, valid, binding and enforceable agreement of the signatory parties, that all representations and statements set forth in the documents are true and correct, and that all obligations, covenants, conditions or terms imposed on the parties by any of the documents have been or will be performed or satisfied in accordance with their terms. We have further assumed that, for our examination in connection with this opinion, you have disclosed to us all of the documents that are relevant to the transactions that are the subject of this opinion and that there are no undocumented agreements related to these transactions that modify or alter the effect of any documents listed above or that create any additional obligations or rights among the parties to those documents. We are not aware of any documents related to these transactions that would alter our opinion as set forth below.

Any capitalized terms not defined herein have the same meaning as in the appropriate documents from the list above.

III. ASSUMPTIONS

In rendering this opinion, we have relied upon the facts as set forth in the Statement of Facts in Section I above, which you have represented to us are true to the best of your knowledge and belief. In addition, you have consented to our reliance, in rendering this opinion, on the following assumptions:

1. Enron and its Affiliates[1] will at all times act in accordance with the form of the transactions as reflected in the documents listed above.

2. The predominant purpose of Enron and its Affiliates for participating in the Purchase was to generate income for financial accounting purposes. The accounting treatment of the Purchase

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[1] For purposes of this letter, the "Affiliates" of a person are those persons directly or indirectly controlling, controlled by, or under common control with such person.

provides Enron and its Affiliates with significant and material benefits. Partnership and the Purchase were structured to achieve this purpose without increasing or decreasing, on a present value basis (determined using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period), the aggregate federal income tax liability of the Enron consolidated group or those Affiliates of Enron that are included on Enron's consolidated financial statements.

3. Neither OPI's nor Partnership's holding period with respect to the stock of Liquids has at any time been subject to reduction under section 246(c)(4).[2] Enron's holding period with respect to the stock of Enron Pipeline has not at any time been subject to reduction under section 246(c)(4).

4. On the date of the Purchase, the terms of the Partnership Agreement were commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree. The Purchase Price was a value to which adverse parties dealing at arm's length could reasonably agree as being the value of the purchased shares of Liquids preferred stock on the date of the Purchase.

5. The terms of any transactions, including any loan, lease, license, or fee for services, between any of OPI, Enron GP, Partnership and members of the Enron consolidated group[3] are commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree.

6. Each of Enron, Enron Pipeline, ECTR, EDC, Liquids, OPI, and Enron GP will at all times represent itself to third parties as a separate entity in all transactions, observe all corporate and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Partnership will at all times represent itself to third parties as a separate entity in all transactions, observe all partnership and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees

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[2] All references to sections are to the Internal Revenue Code of 1986 (the "Code"), as amended and in effect as of the date of this letter, unless otherwise noted. All references to regulations are to U.S. Treasury Department regulations, as most recently adopted, amended, or proposed, as the case may be, as of the date of this letter, unless otherwise noted.

[3] As used in this letter, the term "consolidated group" has the same meaning as in the consolidated return regulations. Treas. Reg. § 1.1502-1(h) (a consolidated group is an affiliated group of corporations filing consolidated returns for the tax year). References to the "Enron consolidated group" are to the consolidated group of which Enron is the parent.

for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Each of the entities listed in the preceding two sentences holds assets having a fair market value of at least $10 million. In addition, each of Enron, Enron Pipeline, ECTR, EDC, Liquids, and OPI has been in existence for at least two years and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons.

7. It is anticipated that Partnership will remain in place for at least five years. While additional stock of Liquids held by Partnership may be sold or redeemed over time, it is anticipated that at least 40 percent of the preferred stock of Liquids will be retained by Partnership for at least two years after March 27, 1997.

8. Enron Pipeline's current and accumulated earnings and profits for the taxable year ending December 31, 1997 will exceed the aggregate amount of the Purchase Price plus any distributions made or deemed made by Enron Pipeline to its shareholders during such year.

9. Enron Pipeline will not, during any 85 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all dividends resulting from such purchases ("Purchase Dividends") were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 85 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 85 day period is greater than 10 percent of the shareholder's basis in such share.

10. Enron Pipeline will not, during any 365 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all Purchase Dividends were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 365 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 365 day period is greater than 20 percent of the shareholder's basis in such share.

11. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. A federal income tax deduction or loss described in the previous sentence is considered to produce a net tax benefit if the present value (computed using a discount rate that is less than or equal to the after-tax

weighted average cost of capital of the Enron consolidated group during the relevant period) on the date of the Purchase of the aggregate of all such federal income tax deductions or losses ultimately claimed by the taxpayer will equal or exceed the present value (computed using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period) on the date of the Purchase of any federal income tax liability incurred by the taxpayer and attributable to the dividend resulting from the Purchase.

12. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the recapitalization of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, the operations and investments of OPI and Partnership, and the Purchase. These transactions are considered to produce a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, if the sum of the present values (computed using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period), on March 20, 1997, of the hypothetical federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, determined as if the transactions had not occurred, exceeds the sum of the present values (computed using a discount rate that is less than or equal to the after-tax weighted average cost of capital of the Enron consolidated group during the relevant period), on March 20, 1997, of the actual federal income tax liabilities of the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates.

13. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Purchase on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any.

14. The Purchase will not (i) alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Purchase) by members of the Enron consolidated group to nonmembers of the Enron consolidated group that are treated as made out of earnings and profits or (ii) result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Purchase on the earnings and profits of members of the Enron consolidated group.

15. No member of the Enron consolidated group will dispose of any stock of Liquids or Enron Pipeline except to another member of the Enron consolidated group. Neither Enron nor any

Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Purchase.

16. OPI will have taxable income from nondividend sources that exceeds its deductible expenses.

For purposes of rendering this opinion, you have also consented to our reliance on the additional information that we have obtained through consultation with officers, employees or legal representatives of OPI, Enron GP, Partnership, and members of the Enron consolidated group, as specifically set out in this letter.

IV. OPINION

Based upon our analysis of the pertinent authorities as they apply to the information relied upon, it is our opinion that, for federal income tax purposes:

1. Enron's adjusted basis in the stock of Enron Pipeline should be increased by the aggregate amount of Enron's adjusted basis in the ECTR Note and the EDC Note immediately before Enron's contribution of those notes to Enron Pipeline.

2. Under section 304, the payment by Enron Pipeline to Partnership for the Purchase of the Liquids preferred stock should be treated as a distribution (the "Deemed Distribution") in redemption of the stock of Enron Pipeline for purposes of sections 302 and 303.

3. The Deemed Distribution should be treated as a distribution subject to section 301 and as a dividend under section 301(c)(1).

4. The adjusted basis of the Liquids preferred stock retained by Partnership should be increased by an amount equal to Partnership's adjusted basis in the Liquids stock sold to Enron Pipeline.

5. The adjusted basis of OPI's interest in Partnership should be increased by its distributive share of the Deemed Distribution.

6. OPI should be treated, for purposes of section 243, as having received its distributive share of the Deemed Distribution from Enron Pipeline and should be treated as having satisfied the holding period requirement of section 246(c).

7. Section 246(b) should not limit OPI's section 243 deduction with respect to its distributive share of the Deemed Distribution.

8. It is more likely than not that OPI will be treated as owning 20 percent or more of the stock of Enron Pipeline for purposes of section 243(c)(2).

9. Section 1059 should not be applicable to reduce Partnership's basis in the retained Liquids preferred stock, to reduce OPI's basis in its interest in Partnership, or to trigger gain on the Deemed Distribution.

For purposes of providing you with information that may be relevant in connection with sections 6662 and 6664, we specifically state, without modifying the strength of the opinion set forth above, that in reaching the opinion set forth above we concluded, based on our analysis of the pertinent facts and authorities in the manner described in Treasury Regulation § 1.6662-4(d)(3)(ii), that there is substantial authority (within the meaning of Treasury Regulation § 1.6662-4(d)) for the tax treatment of the items as set forth above and there is a greater than 50 percent likelihood that the tax treatment of the items as set forth above will be upheld in litigation if challenged by the Internal Revenue Service (the "IRS").

V. LEGAL ANALYSIS

A. Basis of Enron Pipeline Stock

Pursuant to the Enron/Enron Pipeline Contribution Agreement, Enron transferred the $600 Million ECTR Note and the EDC Note to Enron Pipeline on April 29, 1997. Enron did not receive any stock in exchange for its contribution of these assets to Enron Pipeline. Given Enron's ownership of 100 percent of the common stock of Enron Pipeline, the issuance of additional shares of common stock to Enron would have been meaningless. See Commissioner v. Morgan, 288 F.2d 676 (3d Cir. 1961); King v. United States, 79 F.2d 453 (4th Cir. 1935). Under such circumstances, we believe that the federal income tax consequences of the contribution by Enron to Enron Pipeline should be determined as if Enron had received stock of Enron Pipeline in exchange for the contributed assets. See Lessinger v. Commissioner, 85 T.C. 824 (1985), rev'd on other issues, 872 F.2d 519 (2d Cir. 1989); Rev. Rul. 64-155, 1964-1 C.B. 138.

Generally, gain or loss is not recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the transferee corporation. Section 351(a). Control, for these purposes, means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. Sections 351(a), 368(c). Immediately after

the contribution, Enron owned all of the stock of Enron Pipeline. Accordingly, we believe the contribution by Enron to Enron Pipeline should be treated as a transfer described in section 351.

In general, the basis of stock received by a transferor in a section 351 transaction equals the basis of the property exchanged for such stock, decreased by the amount of any liabilities transferred to the issuing corporation. Sections 358(a)(1), 358(d), Treas. Reg. § 1.358-2(b)(2). In general, the basis of property received by a corporation in exchange for its stock in a section 351 transaction equals the basis of the property in the hands of the transferor immediately before the exchange. Section 362(a).

Accordingly, we believe that (1) Enron's adjusted basis in the common stock of Enron Pipeline should be increased by an amount equal to Enron's aggregate adjusted bases in the $600 Million ECTR Note and the EDC Note immediately before Enron's contribution of those assets to Enron Pipeline and (2) Enron Pipeline's adjusted basis in each of the $600 Million ECTR Note and the EDC Note immediately after the contribution should equal Enron's adjusted basis in each of those assets immediately before the contribution.[4]

B. The Deemed Distribution

1. In General

Under section 304, if one person controls each of two corporations, and in return for property one of the corporations (the acquiring corporation) acquires stock of the other corporation from the person so in control, then such property is treated for purposes of sections 302 and 303 as a distribution in redemption of the stock of the acquiring corporation. Section 304(a)(1). Control for these purposes is defined as ownership of 50 percent of the vote or value of all classes of stock. Section 304(c)(1). A modified version of the constructive ownership rules of section 318 is applied to determine ownership. Section 304(c)(3).

Enron owns all of the outstanding stock of Enron Pipeline. Enron owns in excess of 50 percent of the value of all of the shares of OPI. OPI is a partner in Partnership. Applying the constructive ownership rules of sections 304(c) and 318, Partnership constructively owns all of the outstanding stock of Enron Pipeline that is directly owned by Enron. Sections 304(c)(3), 318(a)(3)(A), 318(a)(3)(C). Similarly, Partnership constructively owns all of the stock of Liquids that is directly owned (whether before or after the Purchase) by Enron, Enron Pipeline, or OPI. Sections 304(c)(3), 318(a)(2)(C), 318(a)(3)(A), 318(a)(3)(C). Accordingly, we believe that

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[4] We believe that the tax consequences should be the same if the transfer were treated as a contribution to capital rather than an exchange for stock. See Sections 118, 362, 1012; Rev. Rul. 83-73, 1983-1 C.B. 84.

Partnership owns, directly or constructively, all of the stock of both Enron Pipeline and Liquids, and therefore controls both of those corporations for purposes of section 304. Absent the application of a rule that overrides section 304, we believe the acquisition of stock of Liquids by Enron Pipeline from Partnership should be subject to section 304(a)(1) and the property transferred from Enron Pipeline to Partnership should be treated as a distribution (the "Deemed Distribution") in redemption of stock of Enron Pipeline.[5]

The determination of whether the Deemed Distribution in redemption of stock of Enron Pipeline is treated as a capital transaction under section 302(b) or as a distribution subject to section 301 is made by reference to the stock of Liquids. Section 304(b)(1). Applying the relevant constructive ownership rules, Enron Pipeline's, Enron's, and OPI's direct ownership of Liquids stock should be attributed to Partnership, with the result that Partnership should be treated as owning all of the stock of Liquids both before and after the Purchase for purposes of applying section 302(b). Sections 304(b)(1), 318(a)(2)(C), 318(a)(3)(A), 318(a)(3)(C). Because Partnership's ownership of Liquids is not diminished by the Purchase, we believe the transaction should be treated as subject to section 301. See Sections 302(b), 302(d); United States v. Davis, 397 U.S. 301 (1970).

Under section 301(c)(1) and section 316, the Deemed Distribution will be treated as a dividend to the extent of the earnings and profits of the distributing corporation. Under section 304, the determination of whether the Deemed Distribution is a dividend is made as if the Deemed Distribution were made by Enron Pipeline to the extent of its earnings and profits, and then by Liquids to the extent of its earnings and profits. Section 304(b)(2). Given current and accumulated earnings and profits of Enron Pipeline for the 1997 taxable year in excess of the aggregate amount of the Purchase Price plus all other actual or deemed distributions by Enron Pipeline in 1997, the full amount of the Purchase Price should be treated as a dividend from Enron Pipeline.

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[5] If a subsidiary acquires stock of its parent from a shareholder of the parent, section 304(a)(2) treats the property transferred to the shareholder of the parent as a distribution in redemption of the stock of the parent. Prior to the Purchase, the stock of Enron Pipeline could be attributed to Liquids under the constructive ownership rules of section 304(c), making Enron Pipeline a subsidiary of Liquids. Literally read, the parent/subsidiary rules of section 304(a)(2) take precedence over brother/sister rules of section 304(a)(1). We believe that section 304(a)(1) rather than section 304(a)(2) should apply where a parent/subsidiary relationship exists only by reason of constructive ownership. See Treas. Reg. § 1.304-2(c) *Example 1* (applying section 304(a)(1) to a brother-sister sale); Rev. Rul. 92-86, 1992-2 C.B. 199 (applying section 304(a)(1) to a brother-sister sale); Broadview Lumber Co. v. United States, 561 F.2d 698, 709 (7th Cir. 1977) (stating, in dicta, that section 304(a)(2) should only apply when the parent corporation controls the subsidiary without relying on constructive ownership). If the statute were construed so as to allow for the application of section 304(a)(2) in brother-sister sales, section 304(a)(1) would become extremely narrow in scope. We believe that Congress did not intend such a result. See S. Rep. No. 83-1622, at 239 (1954) (stating section 304(a)(1) applies to brother-sister sales).

2. Consequences of Dividend Treatment

Enron Pipeline should reduce its earnings and profits by the amount of the section 304 dividend. See H.R. Rep. No. 98-861, at 1223 (1984).

Under section 304(a)(1), Partnership should be treated as making a capital contribution of the purchased Liquids stock to Enron Pipeline. For purposes of determining the tax consequences to Enron Pipeline of this deemed contribution to capital, the IRS appears to take the position that Partnership should be treated as having made the contribution as a shareholder of Enron Pipeline, without regard to the fact that it does not actually own any stock in Enron Pipeline. See Treas. Reg. § 1.304-2(a) (referring to section 362(a) for the determination of the basis of the stock that is deemed contributed to the acquiring corporation); Rev. Rul. 71-563, 1971-2 C.B. 175 (applying Treasury Regulation § 1.304-2(a) and section 362(a) to determine the basis of stock in the hands of the acquiring corporation, selling corporation did not directly own any stock of the acquiring corporation); Rev. Rul. 70-496, 1970-2 C.B. 74 (same); compare Section 362(a) (general rule providing carryover basis for contributions to capital) with Section 362(c)(1) (special rule providing for zero basis in property other than money received as a contribution to capital that is not contributed by a shareholder as such). Accordingly, we believe that Enron Pipeline should take a carryover basis in the Liquids stock.

If Partnership were an actual shareholder of Enron Pipeline, we believe Partnership's basis in its Enron Pipeline stock should be increased by an amount equal to its basis in the Liquids stock deemed contributed to Enron Pipeline. Treas. Reg. § 1.304-2(a). In the absence of any direct ownership of Enron Pipeline stock, it is not entirely clear what happens to the basis of the transferred Liquids stock. See Coyle v. United States, 415 F.2d 488, 493 (4th Cir. 1968) (in dicta, the court noted that increasing the basis of the constructively held stock of the acquiring corporation or increasing the basis of the directly held stock of the issuing corporation would be reasonable solutions to the potential basis allocation problem created by the taxpayer's lack of any direct ownership of the acquiring corporation in a section 304 transaction). Where the transferor retains shares of the transferred corporation, the IRS has adopted the position that the basis of the transferred shares attaches to the basis of the retained shares. Rev. Rul. 71-563, 1971-2 C.B. 175. But cf. Priv. Ltr. Rul. 8710035 (Dec. 9, 1986), revoked by Priv. Ltr. Rul. 9437004 (June 10, 1994) (basis of transferred issuing corporation stock disappears where seller had only constructive ownership of stock of purchaser; no mention of potential for adding basis to the single share of issuing corporation stock retained by the seller). Given the rejection of alternative approaches by either the IRS or the

courts,[6] we believe that Partnership should increase its basis in the retained shares of Liquids stock by the amount of its basis in the Liquids stock deemed contributed to Enron Pipeline in the section 304 transaction.[7]

Finally, we believe that each partner's distributive share of Partnership's dividend income from the Purchase should increase the basis of such partner's interest in Partnership without reduction for

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[6] One alternative approach would be to increase the basis of the Enron Pipeline stock in the hands of Enron. See Coyle, 415 F.2d at 493; see also Treas. Reg. § 1.302-2(c) *Example (2)* (in the case of a direct redemption from a shareholder of all stock held by that shareholder, if the redemption is treated as a dividend because of constructive ownership by the shareholder, the basis in the redeemed shares is allocated to the shares held by the person from whom ownership was attributed); Levin v. Commissioner, 385 F.2d 521, 528 n.29 (2d Cir. 1967) (citing Treasury Regulation § 1.302-2(c) for the proposition that taxpayer's basis in redeemed shares would attach to constructively held shares). The IRS, however, has consistently taken the position that no basis adjustments attributable to deemed distributions and contributions resulting from a section 304 transaction are made with respect to constructively held stock. See Rev. Rul. 70-496, 1970-2 C.B. 74 (no adjustments to parent's basis in stock of its wholly-owned subsidiary for deemed distribution by the subsidiary in excess of earnings and profits or for the deemed contribution to capital of the subsidiary in connection with subsidiary's purchase of stock from another subsidiary that was 70 percent-owned by parent; basis of transferred stock disappears where transferor does not own any stock of the acquiring corporation or of the acquired corporation after the transfer); Priv. Ltr. Rul. 8710035 (Dec. 9, 1986), revoked, Priv. Ltr. Rul. 9437004 (June 10, 1994) (section 304 transaction has no effect on parent's basis in stock of consolidated wholly-owned subsidiary that acquired stock from another consolidated subsidiary); cf. Rev. Rul. 71-563, 1971-2 C.B. 175 (basis of transferred shares of issuing corporation added to basis of retained shares of issuing corporation where transferor did not directly own any shares of the acquiring corporation).

Another approach would be to allow the basis in the transferred shares to disappear. The IRS has adopted this approach where the transferor does not directly own any stock of either the acquiring corporation or the issuing corporation. Rev. Rul. 70-496. The courts, however, have rejected the proposition that basis simply disappears in a transaction. See Coyle, 415 F.2d at 493 ("In any event, it is clear that taxpayer's basis [in the shares transferred in a section 304 transaction] will not disappear ")(dicta); Levin, 385 F.2d at 528 n.29 (in rejecting as without merit taxpayer's argument that dividend treatment of a redemption imposed a tax on gross receipts, court stated that "[h]er basis does not disappear; it simply is transferred to her son.").

[7] Legislation has been proposed that would amend section 304(a)(1) to treat Enron Pipeline's purchase of Liquids stock as if Partnership had transferred the Liquids stock to Enron Pipeline in exchange for stock of Enron Pipeline in a section 351(a) transaction and Enron Pipeline had then redeemed the stock issued in the exchange. The effective date of this amendment, as proposed, would be for distributions and acquisitions after June 8, 1997. The fictional issuance of stock created by this amendment may be inconsistent with the positions taken by the IRS in Revenue Ruling 70-496 and Revenue Ruling 71-563. While the Treasury Department explanations of similar proposals by the President state that the amendment would "clarify" the treatment of a section 304 transaction, the committee reports on the pending legislation make no reference to the provision being a clarification. We do not believe that a statement in a Treasury Department explanation of Presidential proposals is effective to revoke outstanding revenue rulings. Accordingly, we do not believe that current law, including the published positions of the IRS, has been changed by the proposal of this legislation.

any dividends received deduction that may be allowable to such partner. Section 705(a)(1)(A) and (B); Treas. Reg. § 1.705-1(a)(2)(ii) (a partner's basis is increased by tax-exempt receipts of the partnership).

3. Substance Over Form Doctrine

The above analysis is based on the form of the Purchase. If the form of the Purchase were not respected, the tax consequences could be different. For the reasons set forth below, we believe that the substance over form doctrine should not apply to adversely affect the conclusions reached in this opinion.

The tax consequences of a transaction are generally based on the substance of the transaction. Where the form reflects the substance, the tax consequences of the form are generally recognized. Where the form of a transaction does not reflect its substance, however, a variety of judicial approaches have been used to determine the tax consequences of the transaction. These approaches may include refusing to recognize a participant in a transaction as a separate taxable entity, disregarding a transaction as a sham, and disregarding the transitory ownership of property.

a. Separate Taxable Entity

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the Supreme Court established the test for determining whether a corporation will be recognized as a separate taxable entity, stating that "so long as [the purpose for forming the corporation] is the equivalent of a business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Id. at 439. The level of activity necessary to constitute the "carrying on of business" within the meaning of the Moline Properties test appears to be quite minimal.[8] In practice, it seems to require little more than the observance of bookkeeping formalities, maintenance of separate bank accounts, having employees, executing contracts where appropriate, and representing the corporation to third parties as an independent organization. The separate entity tests set forth in Moline Properties have been applied to partnerships. Campbell County State Bank, Inc. v. Commissioner, 37 T.C. 430, 441-42 (1961) (acq.), rev'd on another issue, 311 F.2d 374 (8th Cir. 1963).

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[8] See Britt v. United States, 431 F.2d 227, 235 (5th Cir. 1970); Hospital Corp. of America v. Commissioner, 81 T.C. 520, 579 (1983) (nonacq. on other issues); Strong v. Commissioner, 66 T.C. 12, 24 (1976), aff'd without published opinion, 553 F.2d 94 (2d Cir. 1977); see also, B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 2.07[2] (6th ed. 1994).

Each of Enron, Enron Pipeline, ECTR, EDC, Liquids, OPI, and Enron GP will at all times represent itself to third parties as a separate entity in all transactions, observe all corporate and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Partnership will at all time represent itself to third parties as a separate entity in all transactions, observe all partnership and bookkeeping formalities, maintain separate bank accounts, have employees and/or pay fees for services that would otherwise be rendered by employees, and execute contracts in a manner consistent with its status as a separate entity. Each of the entities listed in the preceding two sentences holds assets having a fair market value of at least $10 million. In addition, each of Enron, Enron Pipeline, ECTR, EDC, Liquids, and OPI has been in existence for at least two years and either is engaged in the active conduct of a trade or business or has engaged in financial or business transactions with unrelated persons. OPI and Enron GP entered into a substantial joint venture (Partnership) with an unrelated person (EN-BT). Partnership has entered into financial transactions with unrelated parties. Transactions with third parties are generally considered sufficient business activity to satisfy the Moline Properties test. For example, obtaining a loan from third parties has been found to be sufficient business activity to prevent taxpayers from disavowing the separate status of a corporation that admittedly served no business purpose. See Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945). Based on the above facts, we believe that each corporation described above and Partnership should be respected as a separate entity for federal income tax purposes.

b. Sham

The sham transaction doctrine is a judicially created theory under which a transaction can be ignored for tax purposes if, in effect, the transaction affects nothing but tax consequences to the parties. The most recent Supreme Court discussion of the sham transaction doctrine is the case of Frank Lyon Co. v. United States, 435 U.S. 561 (1978), in which the Court upheld the sale and leaseback of a building against the government's argument that the transaction was really a financing. Modern sham transaction theory originated in the Court's frequently quoted defense of a "genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . ." Lyon, 435 U.S. at 583-84.

A two-pronged test for sham transactions emerged from that quotation. In order to find a sham, a court must determine both that the taxpayer was motivated by no business purposes other than obtaining tax benefits and that the transaction had no economic substance, independent of its tax consequences. See Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985). The business purpose test is a subjective analysis of the taxpayer's state of mind, while the economic substance test is objective, based upon the particular facts and circumstances.

Transactions between parent and subsidiary corporations and among other related persons are subject to a heightened level of scrutiny by the IRS and are often the focus of sham transaction attacks. While transactions among related corporations often are suspect, they are not *per se* subject to recharacterization under the sham transaction doctrine. Indeed, the consolidated return regulations promulgated under section 1502 set forth myriad rules prescribing the treatment to be accorded transactions among members of a consolidated group. Such transactions may result in items of income, deduction, gain, or loss being eliminated, deferred, or disallowed, but such items are not disregarded on the basis that they arise from sham transactions.

In order to fail the business purpose portion of the sham test in Rice's Toyota World, a taxpayer can have no motive other than tax purposes. The predominant purpose for the Purchase is to generate income for financial accounting purposes. This effect of the Purchase provides Enron and its Affiliates with significant and material benefits. The formation and capitalization of Partnership and the Purchase were structured to achieve the desired accounting benefits without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements.

Improving a company's balance sheet has been recognized as a valid business purpose. See Lyon, 435 U.S. at 577-78 (effect of debt on company's balance sheet has "distinct element of economic reality"); Newman v. Commissioner, 902 F.2d 159, 163 (2d Cir. 1990) (business purposes in entering into operating agreement rather than lease for balance sheet purposes); Priv. Ltr. Rul. 9017061 (Jan. 31, 1990) (improvement of balance sheet for company's lenders is business purpose for section 355); Tech. Adv. Mem. 8803001 (Sept. 29, 1987) (movement of assets from non-member to member corporation of affiliated group to improve consolidated balance sheet is business purpose for section 368(a)(1)(C)), revoked by Tech. Adv. Mem. 8941004 (July 11, 1989) (based on insufficiency of facts submitted at time of examination). While the accounting benefits in the instant case are derivative of the tax consequences of the Purchase, we believe that the purpose to obtain accounting benefits without either increasing or decreasing tax liability on a present value basis should be sufficient to satisfy the business purpose portion of the sham test in Rice's Toyota World.

The economic substance test depends upon all of the facts and circumstances. Following the Purchase, 1,980 shares of Liquids preferred stock is held by Enron Pipeline and Partnership holds the $198 Million ECTR Note. The economics to Partnership and its partners, including EN-BT will reflect this change in the assets owned by Partnership. We believe that this shift in investments should be sufficient to satisfy the economic substance portion of the test.

c. Transitory Ownership

The IRS might argue, given the short period of time that Partnership owned the Liquids preferred stock that was acquired by Enron Pipeline in the Purchase, that Partnership's ownership of such shares should be disregarded. Presumably, in order to account for the actual positions of the parties, such an argument would rely on a recharacterization of the transactions relating to the recapitalizations of Liquids and OPI on March 21, 1997, the capitalization of Partnership on March 27, 1997, and the Purchase as follows: (1) an acquisition by Enron of the Liquids preferred stock from Liquids in exchange for the note of Houston Pipe Line Company, dated as of March 21, 1997 (the "Houston Pipe Note"); (2) a sale by Enron of 1,980 shares of Liquids preferred stock to Enron Pipeline for the $198 Million ECTR Note; (3) a contribution by Enron of the $198 Million ECTR Note and the remaining shares of Liquids preferred stock to OPI; and (4) a contribution of the $198 Million ECTR Note and the Liquids preferred stock by OPI to Partnership.

We believe an attempt to recharacterize the transactions in such a manner should not succeed. Such a recharacterization would reorder, but not reduce the number of, the steps relative to the transaction as actually structured. Where two different routes are equally consistent with the substance of the transactions, produce the equivalent end result, and have the same number of steps, the courts have generally rejected attempts to substitute hypothetically equivalent steps for the steps actually taken in the absence of an inconsistency between the tax consequences of the form of the transaction and the policy underlying the applicable statutory provision. See Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989), and cases cited therein. Moreover, in the instant case, a reordering of the steps would not duplicate the economics of the transactions as structured, because the ownership of all of the Liquids preferred shares by Partnership gave EN-BT (as a partner in Partnership) and EN-BT and PCI (as shareholders of OPI) an interest in the benefits and burdens of ownership of all of that stock, albeit for a short period of time.

The IRS has taken the position that a reordering of steps is appropriate under some circumstances. See Rev. Rul. 91-47, 1991-2 C.B. 16 (substance of transaction, which would be reflected in reordered steps, controls to prevent avoidance and carry out the clear policy underlying enactment of section 108(e)(4)); Rev. Rul. 87-66, 1987-2 C.B. 168 (contribution of foreign corporation's stock to a domestic corporation followed by liquidation of the foreign corporation treated as transfer of foreign corporation's assets to domestic corporation followed by liquidation of foreign corporation for purposes of applying section 897 to transactions; in a letter to a lawyer who criticized the ruling, then Associate Chief Counsel D. Kevin Dolan defended the effects of the resequencing based on the policy of Congress to impose recognition unless there is basis preservation in the interest subject to taxation under section 897(a)); Priv. Ltr. Rul. 8823056 (Mar. 10, 1988) (reordering of successive section 351 steps, apparently at the request of, or possibly without the

objection of, the taxpayer); Priv. Ltr. Rul. 8351136 (Sept. 23, 1983) (same). Thus it appears that, where there is a policy justification for resequencing steps, or where the taxpayer consents to the resequencing, the IRS considers the creation of steps that never took place to be permissible.

In the instant case, respecting the steps as actually undertaken does not appear to violate any clear principle of tax policy. Gain or loss, if any, to Enron on a sale of Liquids stock to Enron Pipeline would be deferred under the consolidated return regulations, and would remain deferred following a contribution of the $198 Million ECTR Note by Enron to OPI. Treas. Reg. §§ 1.1502-13, -80(b). In contrast, the Purchase generates a tax liability on the resulting section 304 dividend and increased bases in the Liquids stock retained by Partnership and in the interests of the partners in Partnership. As discussed below, we do not believe these results, under the facts of the instant case, should be considered to be inconsistent with the principles established in the consolidated return regulations, with the principles of subchapter K, or with the objectives of section 1059. Accordingly, we believe the transactions as structured should not be considered to violate any clear tax policy principles and should not be resequenced to produce a different tax result from that of the actual transactions.

4. Consolidated Return Regulations

The consolidated return regulations, in some circumstances, may alter what would otherwise be the tax consequences of a transaction where the transaction involves one or more members of a consolidated group. For the reasons set forth below, we believe that the consolidated return regulations should not apply to adversely affect the conclusions reached in this opinion.

a. Inapplicability of Section 304 Within a Consolidated Group

Treasury Regulation § 1.1502-80(b) provides that section 304 does not apply to the acquisition of a corporation's stock in an intercompany transaction occurring on or after July 24, 1991. A sale of Liquids stock from Enron to Enron Pipeline would be an intercompany transaction and therefore would not be subject to section 304. A sale between Partnership and Enron Pipeline, however, is not an intercompany transaction because Partnership is not a member of the Enron consolidated group.[9] We do not believe the principles underlying Treasury Regulation § 1.1502-80(b) have any application to transactions that actually occur between persons who are not members of the same consolidated group.

[9] Even if Partnership were treated, under Treasury Regulation § 1.701-2(e), as an aggregate rather than an entity for purposes of applying Treasury Regulation § 1.1502-80(b), Treasury Regulation § 1.1502-80(b) should not be applicable because none of OPI, Enron GP, and EN-BT should be a member of the Enron consolidated group.

The rule of Treasury Regulation § 1.1502-80(b) was adopted as "the simplest way to implement the purposes of section 304(b)(4) for a consolidated group. . . ." T.D. 8402, 1992-1 C.B. 302, 303. Section 304(b)(4) requires that "proper adjustments" be made to the adjusted basis of stock of a member of an affiliated group that is held by the group, and to the earnings and profits of members of the group, to the extent necessary to carry out the purposes of the section. Section 304(b)(4) was adopted to prevent the use of section 304 transactions within an affiliated group to shift built-in gain within the group, allowing the disposition of appreciated stock of a subsidiary outside the group without the payment of the corporate level tax on the appreciation. See H.R. Conf. Rep. No. 100-495, at 969-70 (1987); H.R. Rep. No. 100-391, pt. 2, at 1084 (1987). Where stock is never held by a member of the affiliated group, the concerns addressed by section 304(b)(4) would not appear to be present. Accordingly, we do not believe the issuance of the Liquids preferred stock to OPI and the contribution of such stock to Partnership followed by the sale of some of the Liquids preferred stock to Enron Pipeline subject to section 304 should be considered inconsistent with the principles underlying Treasury Regulation § 1.1502-80(b).

b. Intercompany Transaction Rules

In general, Treasury Regulation § 1.1502-13, which contains the intercompany transaction rules of the consolidated return regulations (the "intercompany transaction rules"), applies to transactions between corporations that are members of the same consolidated group immediately after the transaction. Treas. Reg. §§ 1.1502-13(a)(1), -13(b)(1). Partnership is not a member of the same consolidated group as Enron Pipeline at any time. Therefore, the Purchase is not an intercompany transaction and, absent the application of the anti-avoidance rule of Treasury Regulation § 1.1502-13(h), the intercompany transaction rules should not be applicable.

The intercompany transaction anti-avoidance rule of Treasury Regulation § 1.1502-13(h) provides as follows: "If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section." The purpose of the intercompany transaction rules is "to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)." Treas. Reg. § 1.1502-13(a)(1). The examples under the intercompany transaction anti-avoidance rule provide the only available guidance on the types of transactions that have a principal purpose to avoid the purposes of the intercompany transaction rules. Treas. Reg. § 1.1502-13(h)(2). These examples suggest that a transaction may be considered to avoid the purposes of the intercompany transaction rules if it (i) invokes or avoids the effects of those rules, either by interposing an unnecessary intercompany transaction or by avoiding an equivalent and more direct intercompany transaction, for the purpose of altering the consolidated taxable income or consolidated tax liability of the group as

compared to an equivalent alternative transaction (Examples 1, 3, 4) or (ii) is structured to affirmatively use the intercompany transaction rules for the purpose of altering the taxable income of a nonmember and the relationship between the transaction and consolidated taxable income or consolidated tax liability is artificially created (Example 2). See also Prop. Treas. Reg. § 1.1502-13(h)(2) *Example 2* (1994) (proposed example deleted in final regulations; would have applied anti-avoidance rule to transaction that did not involve an intercompany transaction and that did not avoid a more direct intercompany transaction).

Even if, despite the economic differences, the acquisition of the Liquids stock by OPI and Partnership followed by the sale of the Liquids stock to Enron Pipeline were viewed as an indirect route adopted to avoid an intercompany transaction in which Enron invests in the Liquids preferred stock, Enron Pipeline purchases a portion of such stock from Enron, and the $198 Million ECTR Note and the remaining Liquids preferred stock are contributed to OPI and then to Partnership, the transactions as structured do not, under the facts as we understand them, alter the consolidated taxable income or consolidated tax liability of the Enron consolidated group as compared to an intercompany sale between Enron and Enron Pipeline. Where no member of the Enron consolidated group disposes of stock of Liquids or Enron Pipeline outside the group and no action is taken to utilize high basis in the stock of Liquids or Enron Pipeline that may result from the Purchase, the taxable income and tax liability of the consolidated group should not be affected by the investment in the Liquids preferred stock and the Purchase of a portion of such stock by Enron Pipeline, without regard to whether it is Enron or OPI that makes the investment or whether it is Enron or Partnership that is the seller of the shares.

The issuance of preferred stock by Liquids in exchange for the Houston Pipe Note should not be a taxable event, whether the investment is made by Enron or OPI. Under the transactions as structured, the section 304 dividend by Enron Pipeline does not affect the group's taxable income or tax liability, and Enron Pipeline takes the Liquids stock with a carryover basis. Under the intercompany transaction alternative, Enron's gain or loss, if any, on the sale of Liquids stock directly to Enron Pipeline would be deferred under the intercompany transaction rules. No member of the Enron consolidated group will dispose of any stock of Liquids or Enron Pipeline except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. Although the reduction in Enron Pipeline's earnings and profits attributable to the section 304 dividend may prevent subsequent distributions by Enron Pipeline to Enron from constituting dividends, these dividends would be eliminated in the consolidated return, and thus would not affect taxable income. We believe that, under these facts, there should be no difference in the tax liability or taxable income of the Enron

consolidated group resulting from the Purchase and resulting from a hypothetical intercompany transaction in which Enron invests directly in Liquids preferred stock and then sells a portion of such stock to Enron Pipeline.

In the absence of any alteration in the consolidated taxable income or the consolidated tax liability of the Enron consolidated group, we believe any application of the intercompany transaction anti-avoidance rule would have to be based on the effects of the Purchase on the separate taxable income or tax liability of a nonmember. In Example 2 under the intercompany transaction anti-avoidance rule, a nonmember holds an obligation of a member with an unrealized loss. The holder becomes a member of the group temporarily, triggering the loss in the obligation under the rules of Treasury Regulation § 1.1502-13(g) when the obligation becomes an intercompany obligation. While the transaction also results in the inclusion of discharge of indebtedness income on the consolidated return, this effect appears to be ignored in determining the applicability of the anti-avoidance rule. Rather, it is a principal purpose to accelerate the loss, which is carried to the holder's separate return years, that is cited as the reason for applying the anti-avoidance rule to treat the obligation as not becoming an intercompany obligation. This example suggests that, under some circumstances, the affirmative use of the intercompany transaction rules to alter the separate taxable income of a nonmember may be inconsistent with the purposes of the intercompany transaction rules (i.e., to provide rules to clearly reflect consolidated taxable income). We believe that Example 2 should be strictly limited to factual situations in which (i) a transaction is structured to affirmatively use the intercompany transaction rules for the purpose of altering the taxable income of a nonmember and (ii) the relationship between the transaction and consolidated taxable income or consolidated tax liability is artificially created (e.g., because the status of a participant as a member of the group is transitory).

In the case of the Purchase, there is no affirmative application of the intercompany transaction rules. Rather, the tax consequences of the Purchase are determined without the application of any consolidated return rules because Partnership is not a member of the Enron consolidated group. Based on the absence of either an alteration of consolidated taxable income or consolidated tax liability or a positive use of the intercompany transaction rules to alter a nonmember's separate taxable income or tax liability, we believe the intercompany transaction anti-avoidance rule should not be applicable to the Purchase.

c. Earnings and Profits Rules

Treasury Regulation § 1.1502-33 contains rules (the "earnings and profits rules") for adjusting the earnings and profits of members of the group where one member owns stock of another member. These rules may require adjustments to the earnings and profits of members of the Enron consolidated group in connection with the Purchase. We have not analyzed the specific earnings and profits

adjustments that would be required under these rules. We have, however, considered whether the earnings and profits effects of the Purchase could trigger the application of the anti-avoidance rule contained in the earnings and profits rules.

Treasury Regulation § 1.1502-33(g) provides as follows:

> If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

The purpose for the modifications made by the earnings and profits rules is to treat a parent and a subsidiary as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent. Treas. Reg. § 1.1502-33(a)(1). The preamble to the regulations describes the earnings and profits system as "fundamentally concerned with measuring dividend paying capacity. . . ." T.D. 8560, 1994-2 C.B. 200, 201.

The primary earnings and profits effects of the Purchase on members of the Enron consolidated group is the reduction under section 312 in the earnings and profits of Enron Pipeline attributable to the section 304 dividend by Enron Pipeline. The potential for distortions of earnings and profits from a section 304 transaction has been specifically considered and addressed by Congress. In the case of a section 304 transaction between members of an affiliated group, section 304(b)(4) requires that "proper adjustments" be made to the earnings and profits of members of the group to the extent necessary to carry out the purposes of section 304. The consolidated return regulations implement this directive in the context of members of a consolidated group by denying the application of section 304 to intercompany transactions. Treas. Reg. § 1.1502-80(b). Since Enron Pipeline and Partnership are not affiliates, section 304(b)(4) and Treasury Regulation § 1.1502-80(b) should not be applicable. Given provisions which specifically deal with potential earnings and profits distortions produced within an affiliated group by section 304 transactions, we believe a court would be reluctant to create further exceptions under a more general anti-avoidance provision.

Moreover, the Purchase will not (i) alter the amount of actual or deemed distributions (excluding actual or deemed distributions attributable to the Purchase) by members of the Enron consolidated group to nonmembers of the Enron consolidated group that are treated as made out of earnings and profits or (ii) result in any tax benefit to the Enron consolidated group or its shareholders attributable to the effects of the Purchase on the earnings and profits of members of the

Enron consolidated group. Accordingly, we believe the earnings and profits adjustments required by the transactions considered herein should not be considered to produce a result that is contrary to the purpose of the earnings and profits rules or that avoids the effect of the earnings and profits rules or any other provision of the consolidated return regulations.

d. Investment Adjustment Rules

Treasury Regulation § 1.1502-32 contains rules (the "investment adjustment rules") for adjusting the basis of stock of a subsidiary member of the group that is owned by another member. These rules modify the otherwise applicable basis rules by adjusting the shareholder/member's basis in the subsidiary's stock to reflect the subsidiary's distributions and items of income, gain, deduction, and loss taken into account for the period that the subsidiary is a member of the consolidated group. Treas. Reg. § 1.1502-32(a)(1). The amount of adjustments is the net amount of the subsidiary's taxable income or loss, tax-exempt income, noncapital, nondeductible expenses, and distributions with respect to the subsidiary's stock. Treas. Reg. § 1.1502-32(b)(2). Distributions with respect to the subsidiary's stock are allocated to the shares of the subsidiary's stock to which they relate. Treas. Reg. § 1.1502-32(c)(1).

As discussed above, the IRS has consistently taken the position that basis adjustments attributable to the deemed distributions and contributions resulting from a section 304 transaction are made with respect to stock held directly by the taxpayer receiving the deemed distribution or making the deemed contribution, but not with respect to stock that is held constructively by such taxpayer. See Rev. Rul. 71-563, 1971-2 C.B. 175; Rev. Rul. 70-496, 1970-2 C.B. 74. Based on this authority, we believe that distributions and contributions that are deemed to occur under section 304 with respect to stock that is constructively held by a taxpayer should not be treated as being made through the shareholder from whom ownership is attributed (the "direct" shareholder) for purposes of determining the federal tax effects of such deemed transactions on the direct shareholder. Accordingly, we believe Enron should not be treated as having either received a distribution from or made a contribution to Enron Pipeline in connection with the Purchase for purposes of applying the investment adjustment rules (or other applicable basis rules of the Code).

We have not analyzed the specific earnings and profits adjustments that would be required under the investment adjustment rules. We have, however, considered whether the basis effects of the Purchase could trigger the application of the anti-avoidance rule contained in the investment adjustment rules. This anti-avoidance rule calls for adjustments to be made to carry out the purpose of the investment adjustment rules if a person acts "with a principal purpose which is contrary to the purpose of [the investment adjustment rules], to avoid the effect of [the investment adjustment rules], or to apply [the investment adjustment rules] to avoid the effect of any other provision of the consolidated return regulations." Treas. Reg. § 1.1502-32(e)(1). The purpose of the investment

adjustment rules is to treat the shareholder/member and the subsidiary as a single entity so that consolidated taxable income reflects the group's income. Treas. Reg. § 1.1502-32(a)(1).

The examples under the investment adjustment anti-avoidance rule suggest that it is applicable where stock ownership or affiliated status is manipulated in order either to obtain the benefits of positive investment adjustments without bearing the burden of corresponding negative investment adjustments (Examples 1, 4, 5) or to shift basis among group members or among classes of stock, thereby reducing gain recognition on an anticipated sale (Examples 2, 3). Treas. Reg. § 1.1502-32(e)(2) *Examples 1-5*. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Purchase on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any. No member of the Enron consolidated group will dispose of any stock of Liquids or Enron Pipeline except to another member of the Enron consolidated group. Neither Enron nor any Affiliate of Enron will take any action to obtain any tax benefit from any investment adjustments attributable, directly or indirectly, to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. Based on these facts, we believe that neither Enron nor any of its Affiliates should be considered to have a principal purpose which is contrary to the purposes of the investment adjustment rules, to avoid the effect of the investment adjustment rules, or to apply the investment adjustment rules to avoid the effect of any other provision of the consolidated return regulations.

C. Dividends Received Deduction

Subject to certain limitations, a corporation is allowed a deduction for a percentage of the amount "received as dividends" from a domestic corporation which is subject to taxation under Chapter 1 of Subtitle A of the Code. Section 243.

1. Receipt of Dividend from a Domestic Corporation

In determining its income tax, each partner must take into account separately, as part of the dividends received by it from domestic corporations, its distributive share of dividends received by the partnership with respect to which the partner is entitled to a deduction under part VIII of subchapter B (currently sections 241-250). Section 705(a)(2); Treas. Reg. § 1.701-1(a)(5). The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of section 701(a) is determined as if such item were realized directly from the source from which realized by the partnership. Section 702(b); Treas. Reg. § 1.702-1(b). Based on this authority we believe that each partner in a partnership should be treated,

for purposes of section 243, as having received its distributive share of a partnership's dividend income directly from the source from which the partnership received the dividend.

Section 304 was amended in 1984 to clarify, among other things, the source of deemed distributions. Pursuant to those amendments, section 304(b)(2) provides that the determination of the amount which is a dividend and the source thereof is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. The effect of this amendment was described in the legislative history as follows:

> [I]n all cases . . . the characterization of a distribution as a dividend, and the source of the dividend will be determined by treating the distributions as made by the acquiring corporation directly to the selling shareholder to the extent of the earnings and profits of the acquiring corporation and then as made by the issuing corporation directly to the selling shareholder to the extent of its earnings and profits. Thus, any dividend received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the corporation which is treated as having made the distribution.

H.R. Rep. No. 98-861, at 1223 (1984). The fiction of a dividend made directly to the seller by the acquiring corporation to the extent of the acquiring corporation's earnings and profits has been respected by the IRS for purposes of section 243 where the seller has only constructive ownership of stock of the acquiring corporation. See Priv. Ltr. Rul. 8609054 (Dec. 3, 1985), modified on another issue, Priv. Ltr. Rul. 8737027 (June 12, 1987) (dividends received deduction allowed to seller that had only constructive ownership of stock of acquiring corporation). Accordingly, we believe that, for purposes of section 243, Partnership should be treated as having received the Deemed Distribution directly from Enron Pipeline and OPI should be treated as having received its distributive share of the Deemed Distribution directly from Enron Pipeline.

2. Section 246(c)

No deduction is allowed in respect of any dividend on any share of stock which is held by the taxpayer for 45 days or less. Section 246(c)(1)(A). For purposes of determining the period for which the taxpayer has held any share of stock, any day which is more than 45 days after the date on which such share becomes ex-dividend is not taken into account. Section 246(c)(3)(B). The holding period is reduced for periods where the taxpayer's risk of loss is diminished. Section 246(c)(4).

Implicit in the provisions of section 702, which contemplate that a partner may be entitled to a dividends received deduction with respect to dividends received by a partnership, is that the holding period requirements of section 246(c)(1) can be satisfied with respect to stock that a corporation

owns indirectly through a partnership. It is unclear whether this holding period requirement should be applied at the partner or the partnership level. Treating a partnership as an entity, it would appear to be the holding period of the partnership in the stock that should be taken into account. Treating a partnership as an aggregate, it would appear that the holding period of the partner with respect to its interest in the partnership also should be taken into account. Cf. Treas. Reg. § 1.856-3(g) (real estate investment trust deemed to own its proportionate share of assets of partnership in which it is a partner; holding period with respect to sale of property by partnership is shorter of partnership's holding period in asset or partner's holding period in partnership interest); Priv. Ltr. Rul. 9615004 (Dec. 19, 1995) (extending aggregate treatment prescribed by statute for purposes of section 851(b)(2) to determine satisfaction by regulated investment company of section 854 requirements relating to sections 243, 246, and 246A; holds regulated investment company will be deemed to hold its proportionate share of assets of a partnership for the period that the partnership held the assets or for the period the regulated investment company has held its interest in the partnership, whichever is shorter).

In addition to the lack of certainty as to how the holding period requirement of section 246(c) is applied to a dividend received through a partnership, in the context of a section 304 transaction involving constructive ownership, the identity of the stock on which the dividend is paid is not clear. In the instant case, prior to the Purchase, Enron had a holding period in the common stock of Enron Pipeline and Liquids, OPI had a holding period in the common stock of Liquids, Partnership had a holding period in the preferred stock of Liquids, and each partner had a holding period in its interest in Partnership in excess of the 45 days required by section 246(c)(1). Accordingly, whether one looks to the holding period of the stock of the acquiring corporation (Enron Pipeline) or to the holding period of the stock of the issuing corporation (Liquids), whether one considers directly held stock or constructively held stock, and whether or not one takes into account the holding period of the partners in their partnership interests, we believe the holding period requirement of section 246(c)(1) should be satisfied.

In the case of stock having a preference in dividends, the required holding period is extended to 90 days if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days. Section 246(c)(2). If the section 304 dividend were treated as paid on the Liquids preferred stock, the IRS might argue that the 90 day holding period is applicable if the earnings and profits that support the dividend were accrued over a period of more than 366 days. The IRS might further argue that the disposition in the Purchase of some of the Liquids preferred shares prevented those shares from satisfying the 90 day holding period requirement, triggering the application of section 246(c) to deny the dividends received deduction. Such an argument requires that the section 304 dividend be treated as paid on the transferred Liquids preferred stock, which is inconsistent with the directive of section 304(b)(2) and its legislative history that the section 304 distribution be treated as made first by Enron Pipeline to the extent of its earnings

and profits. Moreover, where the basis of the redeemed shares is added to the basis of the retained shares, and assuming the 90 day holding period will be satisfied with respect to the retained shares prior to any disposition of those shares, we believe the case for applying section 246(c)(2) to deny the dividends received deduction would be weak.

3. Section 246(b)

Section 246(b) imposes limits on the aggregate amount of section 243 deductions, based on the taxable income of the taxpayer, computed with certain adjustments. Section 246(b)(2). In essence, section 246(b) denies a taxpayer the benefit of the dividends received deduction to the extent the dividend is offset by other deductions. OPI will have taxable income from nondividend sources that exceeds its deductible expenses. Accordingly, we believe section 246(b) should not limit OPI's section 243 deduction.

4. Section 243(c)

Section 243(a)(1) provides for a deduction equal to 70 percent of the dividend amount, with certain exceptions that are not applicable to the instant case. Section 243(c) increases this percentage to 80 percent in the case of any dividend received from a 20 percent-owned corporation. A 20 percent-owned corporation is defined as any corporation if 20 percent or more of the stock of such corporation (by vote and value) is "owned" by the taxpayer. Section 243(c)(2). This definition raises the issues of whether a partner is treated as "owning" stock owned by a partnership and whether constructive ownership under section 304 is taken into account in determining "ownership."

With respect to the issue of whether a partner should be treated as owning stock owned by a partnership, the IRS has taken the position that ownership through a partnership is ownership for purposes of the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation. See Rev. Rul. 71-141, 1971-1 C.B. 211 (allowing section 902 credit to partners who hold 20 percent interests, indirectly through a partnership, in foreign corporation); T.D. 8708, 1997-10 I.R.B. 14 (amending Treasury Regulation § 1.902-1(a)(1) to change the definition of a domestic shareholder from one that "owns directly" the requisite stock to one that "owns" such stock). Based on this authority, we believe that it is more likely than not that, for purposes of section 243(c), OPI will be treated as owning 98 percent (its share of profits and capital) of any stock that Partnership is treated as owning.

With respect to the issue of whether constructively held stock will be taken into account in determining ownership of the payor corporation in a section 304 transaction, we again look to the statement in the legislative history of the 1984 amendment to section 304 that any dividends received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made

directly by the acquiring corporation (to the extent of its earnings and profits). The IRS has cited this legislative history in ruling that a section 304(a)(1) dividend qualifies for the section 902 foreign tax credit, which applies to a domestic corporation that "owns" 10 percent or more of the voting stock of a foreign corporation, even though the transferor corporation did not own directly any stock in the acquiring corporation. Rev. Rul. 92-86, 1992-2 C.B. 199. Of particular importance is the fact that section 902, like section 246(c), does not invoke the constructive ownership provisions of section 318. See First Chicago Corporation v. Commissioner, 96 T.C. 421 (1991) (corporation not allowed to aggregate its ownership with that of its affiliated members so as to meet the requisite ownership of section 902); Rev. Rul. 85-3, 1985-1 C.B. 222 (section 902 does not allow indirect ownership through subsidiaries to satisfy the section 902 ownership requirement). Nevertheless, Revenue Ruling 92-86 explicitly holds that the transferor corporation's constructive ownership as determined under section 304(c) is counted for purposes of determining the existence and amount of direct ownership under section 902. Based on the legislative history of section 304 and the IRS's position in Revenue Ruling 92-86, we believe that Partnership should be treated as "owning" the stock of Enron Pipeline that it constructively owns for purposes of section 304.

D. Section 1059

Section 1059 provides for the reduction (but not below zero) of a corporation's basis in stock by the amount of the dividends received deduction allowable with respect to certain "extraordinary" dividends received with respect to such stock. Extraordinary dividends that trigger the application of section 1059 include (i) a dividend that equals or exceeds 10 percent of the corporation's adjusted basis in the stock of the payor and that is received on stock that the corporation has not held for more than two years before the dividend announcement date or (ii) any amount treated as a dividend in the case of any redemption of stock which is non pro rata as to all shareholders. Sections 1059(a)(1), 1059(e)(1). The reduction occurs immediately before any sale or disposition of the stock. Section 1059(d)(1). Any excess of the dividends received deduction over the basis of the stock is treated as gain upon disposition of the stock. Section 1059(a)(2). The IRS takes the position, and we assume for purposes of this discussion, that a partnership is treated as an aggregate for purposes of applying section 1059, with each partner treated as owning its share of the stock owned by the partnership. Treas. Reg. § 1.701-2(f) *Example 2*. The discussion refers to Partnership and the application of section 1059 to Partnership, with the understanding that the dividends received deduction that causes a portion of the dividend to be nontaxable is that of its partners.

While Treasury has been given broad regulatory authority by section 1059(g), to date there have been no regulations or other administrative authorities addressing the application of section 1059 to a section 304 transaction. The difficulties in determining whether section 1059 should be applied in the instant case arise from the fact that Partnership does not own directly any stock of the payor of the dividend, Enron Pipeline. Section 1059 assumes that the recipient of a dividend owns stock

of the payor with a basis and holding period that can be referenced to determine whether the dividend is extraordinary and with a basis that could be reduced if the dividend is extraordinary.

Pending legislation includes a proposal that would treat a section 304(a)(1) transaction as if (1) the seller had transferred the stock of the issuing corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation then redeemed the shares it was treated as issuing. Under this fiction, the acquiring corporation is treated for all purposes (including basis determinations and the application of section 1059) as redeeming the stock issued to the selling corporation. The legislation also proposes to amend section 1059 so that a section 304 dividend would be treated as an extraordinary dividend (without regard to the holding period of the stock of the payor or the amount of the dividend) and that only the basis of the transferred shares would be taken into account for purposes of section 1059.

The committee reports relating to the proposed legislation explain that the concerns addressed by section 304:

> are most relevant where the shareholder is an individual. Different concerns may be present if the shareholder is a corporation, due in part to the presence of the dividends received deduction. . . . [I]n some situations where the selling corporation does not own any stock of the acquiring corporation before or after the transaction (except by attribution), it is possible that current law may lead to inappropriate results.
>
> As one example, in certain related party sales, the selling corporation may take the position that its basis in any shares of stock it may have retained (or possibly any shares of the acquiring corporation it may own) need not be reduced by the amount of the dividends received deduction. This can result in an inappropriate shifting of basis.

H.R. Rep. No. 105-148, at 465 (1997); S. Rep. No. 105-33, at 143 (1997).

We believe that the proposed legislation reflects (1) a change in view of the proper application of the policies of section 304 in the context of corporate sellers, (2) a change in view of the proper manner for applying section 1059 in the context of a section 304 transaction, and (3) a change in the view of appropriate shares to look to in making basis adjustments under section 1059. We believe that the law relating to the interaction of sections 304 and 1059 prior to the effective date of the pending proposals, if and when they are enacted, should be determined by reference to the policies of sections 304 and 1059 as reflected in their past legislative histories, and should not be influenced by the changes of view reflected in the proposed legislation. Furthermore, in the absence of any direct ownership by the seller of stock of the acquiring corporation in a section 304 transaction, we

believe that it is questionable whether section 1059 is applicable. Nevertheless, in the absence of any clear authority on the issue of whether section 1059 can be applied in such a situation, we have analyzed the issue of how the extraordinary dividend determination might be made if section 1059 were applicable.

1. Pro Rata Redemption

A threshold question in the case of a redemption of stock is whether the redemption is pro rata as to all shareholders. No guidance has been issued on the meaning of "pro rata" for these purposes. The application of section 304, and the resulting deemed redemption of stock of Enron Pipeline from Partnership, is based on Partnership's constructive ownership of all of the stock of Enron Pipeline. Where the only ownership by a taxpayer of stock of the redeeming corporation is constructive, we believe the "non pro rata" test of section 1059(e) should be applied by reference to this same constructive ownership.

In other contexts, a redemption from a shareholder that owns 100 percent of the stock of a corporation by attribution is treated as being pro rata. See United States v. Davis, 397 U.S. 301 (1970) (application of attribution rules make 25 percent shareholder a 100 percent shareholder; treated as "sole shareholder" for purposes of section 302; Congress clearly mandated that pro rata distributions be treated under rules of section 301 rather than under section 302; redemption was essentially equivalent to a dividend); Rev. Rul. 81-289, 1981-2 C.B. 82 (describing the distribution in Davis as "precisely pro rata"). Based on Partnership's constructive ownership of 100 percent of all of the stock of Enron Pipeline, we believe Partnership should be viewed as the sole shareholder of Enron Pipeline for purposes of testing whether a deemed redemption from Partnership of stock of Enron Pipeline is "pro rata as to all shareholders." Accordingly, we believe the deemed redemption of Enron Pipeline stock from Partnership should be treated as pro rata for purposes of section 1059(e).

2. Two-Year Holding Period

Where a redemption is pro rata, a second threshold question for application of section 1059 is whether the stock with respect to which the dividend is received has been held by the corporation for more than two years. For this purpose, the holding period of stock is determined under rules similar to the rules of sections 246(c)(3) and 246(c)(4). Section 1059(d)(3). For the reasons discussed below, we believe it is the holding period in the Enron Pipeline stock that should be relevant in applying section 1059. Accordingly, we believe that to the extent that, on the date of the Purchase, Enron had a holding period in excess of two years with respect to the stock of Enron Pipeline, section 1059 should not be applicable.

Enron Pipeline is the corporation that is treated as redeeming its stock under section 304(a)(1) and as the payor of the section 304 dividend under section 304(b)(2)(A). The legislative history of section 1059 states that "if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to stock of the shareholder which is not redeemed." H.R. Conf. Rep. No. 98-861, at 817 (1984). Accordingly, we believe the stock with respect to which the Deemed Distribution is made should be stock of Enron Pipeline that is owned by Partnership and that remains outstanding after the transaction. Where a taxpayer does not directly own any stock of the redeeming corporation, we believe that the holding period test of section 1059 should be applied by looking to the holding period of stock that is constructively held by the taxpayer.

We believe that looking to the holding period of the Enron Pipeline stock in applying the threshold rules of section 1059 is consistent with the purpose of section 304 to ensure that Code provisions relating to dividend treatment of direct redemptions are not circumvented through the use of indirect redemptions. It is the common ownership by Enron of Enron Pipeline and Liquids that results in the application of section 304, and it is the earnings and profits of Enron Pipeline that support the dividend characterization of the deemed redemption. Under these facts, we believe that the direct redemption, the tax consequences of which section 304 is intended to mimic, should be considered to be a redemption by Enron Pipeline of its stock from Enron. If Enron Pipeline had redeemed a portion of its stock directly from Enron, section 1059 would not have been applicable to the extent that Enron's holding period in the stock of Enron Pipeline exceeded two years. Similarly, in a purchase by Enron Pipeline of Liquids stock directly from Enron, we believe it would be the holding period in the stock of Enron Pipeline that would be considered relevant for purposes of determining whether section 1059 would be applicable to such a transaction.

Section 1059 was enacted to address certain tax arbitrage opportunities presented by the effective rate of tax on dividend income as compared to the effective rate of tax on income that could be offset by a capital loss. See H.R. Rep. No. 98-432, pt 2, at 1186 (1984). Section 1059 is concerned with the creation of a noneconomic tax loss where a corporation purchases stock in anticipation of an extraordinary dividend, receives the dividend, and then sells the stock for a loss (resulting from the decline in value of the stock attributable to the payment of the dividend). See H.R. Rep. No. 98-432, pt. 2, at 1184 (1984); S. Prt. No. 98-169, vol. I, at 170 (1984). The IRS may argue that, despite the technical satisfaction of the two-year holding period requirement with respect to the stock of Enron Pipeline, application of section 1059 is necessary to effectuate the intent of Congress to prevent tax arbitrage because the recipient of the dividend (Partnership) holds an asset (the retained Liquids stock) with respect to which a potential noneconomic tax loss (i.e., an excess of basis over value) has been created in connection with the section 304 transaction. The IRS might argue further that, to the extent Partnership has a holding period of less than two years in the Liquids

stock, the literal language of section 1059 should yield to the underlying purpose of the statute to prevent tax arbitrage and section 1059 should be applicable.

While this argument has some initial appeal, an examination of the facts indicates that the distortion between basis and economics in the instant case is created by the combined fictions of sections 304 and 318, which treat a sale of stock as if it were a dividend from, and a contribution to the capital of, a corporation in which the taxpayer has no direct ownership of stock, rather than by the effects of an extraordinary dividend addressed by section 1059. The excess of basis over value in the stock of Liquids retained by Partnership is not attributable to a reduction in the value of Liquids due to a dividend distribution, but rather to an increase in the basis of the retained Liquids stock with respect to a deemed contribution to capital to another corporation (Enron Pipeline). Moreover, where it is the earnings and profits of Enron Pipeline that support the dividend characterization of the section 304 deemed redemption, we believe the holding period with respect to the Liquids stock should be considered irrelevant in the context of the objectives of section 1059.

The lack of any distortion caused by the dividend portion of a section 304 transaction (as opposed to the basis adjustment relating to the deemed capital contribution) can be demonstrated by comparing the economic and tax consequences of a direct dividend, a direct redemption, and a section 304 transaction in which the stock of the acquiring corporation and the stock of the issuing corporation are held directly by a common parent. Assume the following facts:

Initially X, a corporation unrelated to Parent, owns all 100 outstanding shares of Acquiring;

At the beginning of Year 1, Parent purchases 75 shares of the stock of Acquiring from X for their fair market value of $75;[10]

During Years 1 through 3, Acquiring accumulates $20 of earnings and profits and the fair market value of Parent's 75 shares of Acquiring's stock increases to $90;

At the end of Year 3, Parent purchases 75 shares of the 100 outstanding shares of Issuing from an unrelated party for their fair market value of $75.

At the beginning of Year 4, Acquiring does one of the following three things:

(i) pays a dividend of $20 pro rata to Parent and X;

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[10] The example assumes 75 percent ownership because special rules alter the effects of sections 304 and 1059 in the case of transactions between affiliates. See Sections 304(b)(4), 1059(e)(2).

(ii) redeems $20 worth of its stock pro rata from Parent and X; or

(iii) purchases 15 shares of Issuing stock from Parent for their fair market value of $15 (i.e., the value of the Issuing stock has not changed since the purchase by Parent).

Economically, each of the first two transactions (the direct dividend and the direct redemptions) would result in a $20 reduction in the overall value of Acquiring and no change in the relative ownership of Acquiring by Parent and X. The value and basis of Parent's stock in Acquiring is $75 after the distribution. The distribution does not create any potential tax loss for Parent, because the value of the earnings and profits on which the dividend characterization of those distributions is based is not reflected in Parent's basis before the distribution. Consistent with the absence of any potential for tax arbitrage at which section 1059 is directed, section 1059 is not applicable, based on Parent's two-year holding period in its 75 shares of Acquiring stock.

The economics of the third transaction above (the paradigm section 304 transaction) are different from those of the direct dividend and the direct redemptions. In the paradigm section 304 transaction, the overall value of Acquiring and the relative interests of Parent and X in Acquiring are unchanged. There is no net reduction in the value of Parent's 75 shares of Acquiring, but the basis of those shares is increased by the deemed capital contribution of the Issuing shares with a $15 basis. As a result, Parent holds 75 shares of Acquiring with a value and basis of $90. As with the direct dividend and the direct redemption transactions discussed above, the paradigm section 304 transaction does not create any potential tax loss for Parent where the value of the earnings and profits on which the dividend characterization of the section 304 deemed redemption is based is not reflected in Parent's basis before the transaction. Consistent with the absence of any potential for tax arbitrage at which section 1059 is directed, the threshold requirement of section 1059 of a holding period of two years or less would not be met based on Parent's two-year holding period in its 75 shares of Acquiring stock.[11]

Given that none of what might be considered economically equivalent transactions (a direct dividend distribution from Enron Pipeline to Enron, a direct redemption of Enron Pipeline stock from Enron, and the dividend portion of a section 304 transaction in which Enron Pipeline purchases stock of Liquids from Enron (with no affiliation among the parties)) would be subject to section 1059 to the extent that Enron had a holding period of more than two years in the Enron Pipeline stock, and that none of those transactions appears to violate the spirit of section 1059, we believe a court should not consider the holding period of the retained Liquids stock to be relevant to the application of

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[11] Some redemption from X might be required to avoid section 1059(e)(1)(B), which overrides the two-year threshold requirement in the case of non pro rata redemptions. It is unclear how one would determine whether a section 304 deemed redemption is pro rata for purposes of section 1059(e).

section 1059 to the Purchase. Rather, we believe a court should recognize that the distortions between basis and value created in the retained Liquids stock are attributable to the fictions created by section 304 and section 318 in which there is a deemed capital contribution to a corporation in which the contributor has no direct ownership.[12]

Congress viewed acquisitions of stock in anticipation of the payment of an extraordinary dividend as the acquisition of two assets: the right to distributions to be made with respect to the stock and the underlying stock itself. In such cases, Congress concluded that it was appropriate to reduce the basis of the underlying stock to reflect the value of the distribution that was not taxed to a corporate distributee. See H.R. Rep. No. 98-432, pt. 2, at 1186 (1984); S. Prt. No. 98-169, vol. I, at 172 (1984).

Congress used objective rather than subjective criteria to identify transactions that were appropriately treated as "two asset" acquisitions (i.e., those acquisitions in which a portion of the basis of the shareholder is attributable to the value of an anticipated distribution). The statute provides a dual test for its application, requiring both a holding period of two years or less as of the dividend announcement date (presumably as an indication that the dividend might have been

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[12] In the event that, contrary to our conclusion above, a court were to accept the IRS's argument that it is appropriate to apply section 1059 to the Purchase, two approaches to a liberal application of section 1059 might be suggested by the IRS, consistent with the positions it has adopted in Revenue Rulings 70-496 and 71-563. The IRS might argue that section 1059 should be applied to reduce the basis of the Liquids stock retained by Partnership (which was increased by the basis of the Liquids stock transferred to Enron Pipeline) with a corresponding reduction in the bases of the partners' interests in Partnership. Alternatively, the IRS might argue that, while basis reductions cannot be made in constructively held stock, the section 1059 consequences of an extraordinary dividend could be visited on the constructive owner/dividend recipient by treating the nontaxed portion of an extraordinary dividend as an amount that did not reduce basis by reason of the limitation on reducing basis below zero. Section 1059(a)(2).

Of these two approaches, we believe the reduction of basis in the retained Liquids stock should be more appealing to a court, because it does not require the application of any further fictions. If and when the Liquids stock is disposed of, the basis adjustment would be triggered. The section 1059(a)(2) approach, under existing law, would require expansion of the nonliteral interpretation of section 1059 and the fictions of section 304 to identify a disposition of stock that would trigger gain under section 1059(a)(2). While the IRS might argue that the fictionally redeemed stock of Enron Pipeline is owned by Partnership (with a zero basis) and is disposed of in the section 304 deemed redemption, such an approach would be inconsistent with the view of the courts that the fictions created by section 304 "do not change the reality that . . . stock is not actually redeemed." Broadview Lumber Co., 561 F.2d at 702 (quoting Webb v. Commissioner, 67 T.C. 293, 307 (1976), aff'd, 572 F.2d 135 (5th Cir. 1978)). Moreover, we believe a court should consider triggering gain recognition at the time of the section 304 transaction, based on a deemed disposition of fictional stock having a zero basis, as being inconsistent with the purposes of section 1059. Section 1059 was enacted to deal with the potential for tax arbitrage based on the differing treatment of dividend income and capital losses on the sale of stock. No loss could ever be recognized on the deemed disposition of fictional zero basis stock.

anticipated at the time of the acquisition and thus reflected as a separate asset in the acquisition transaction) and a dividend in excess of a specified percentage of the basis in the stock (presumably to exclude regular dividends, the tax arbitrage potential of which is addressed by section 246(c)). Subject to certain express statutory exceptions, where the objective two-year holding period requirement is not met, the statute does not apply, regardless of whether the shareholder in fact anticipated an extraordinary dividend or whether the value of an extraordinary dividend is in fact reflected in the shareholder's basis in the stock. In effect, there is an irrebuttable presumption that the distortion between basis and economics created by a dividend distribution and addressed by section 1059 is not present where a shareholder has a holding period in excess of two years as of the dividend announcement date.

We believe the holding period threshold in section 1059 serves as an objective substitute for an inquiry into whether an extraordinary dividend distribution is made with respect to stock having a basis that reflects the value of the earnings and profits that fund the extraordinary dividend. We believe that it is consistent with the purposes of section 1059 to look to the holding period in the stock of the corporation having the earnings and profits that fund a dividend to determine whether the two-year threshold of section 1059 is satisfied. Accordingly, we believe that to the extent that, on the date of the Purchase, Enron had a holding period of more than two years with respect to the stock of Enron Pipeline, section 1059 should not be applicable to the Purchase.

3. Threshold Percentage

The IRS might argue that the relevant holding period for Partnership is the shorter of the period for which it has constructively owned Enron Pipeline stock and Enron's holding period in the Enron Pipeline stock. We believe that the period of constructive ownership by Partnership of Enron Pipeline stock should not be considered relevant for the purposes of applying section 1059. Accordingly, we believe such an argument should be rejected by a court. If such an argument were, nevertheless, accepted, or if Enron did not have a holding period in excess of two years in the stock (or some portion of the stock) of Enron Pipeline on the date of the Purchase, then the characterization of the dividend resulting from the Purchase as extraordinary would become significant.

In general, the term "extraordinary dividend" means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds 10 percent (5 percent in the case of stock which is preferred as to dividends) of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends received within an 85 day period, or exceeds 20 percent of the taxpayer's adjusted basis in such share of stock when aggregated with all other dividends having ex-dividend dates within a 365 day period. Section 1059(c).

Enron Pipeline will not, during any 85 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all Purchase Dividends were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 85 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 85 day period is greater than 10 percent of the shareholder's basis in such share. Enron Pipeline will not, during any 365 day period that includes the date of the Purchase, purchase Liquids preferred stock in amounts such that, if all Purchase Dividends were treated as made pro rata with respect to all stock of Enron Pipeline, the sum for any share of stock of Enron Pipeline of all Purchase Dividends that are treated as made with respect to such share of Enron Pipeline stock during such 365 day period plus all other dividends on such share that are received or that have an ex-dividend date during such 365 day period is greater than 20 percent of the shareholder's basis in such share. Based on these facts, we believe a dividend attributable to the Purchase and deemed made with respect to stock of Enron Pipeline should not be treated as exceeding the threshold percentage.[13]

E. Section 269

Under certain circumstances, section 269 may alter what would otherwise be the tax consequences of a transaction. For the reasons set forth below, we believe section 269 should not apply to adversely affect the conclusions reached in this opinion.

Section 269 applies to the acquisition of control of a corporation or the acquisition of property from a corporation (other than a subsidiary or a sister corporation) with a carryover basis when the principal purpose of such acquisition is the "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which . . . would not otherwise [be]

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[13] The IRS might argue that the threshold tests of section 1059 should be applied by reference to the retained stock of the issuing corporation (Liquids) where that is the only stock that the dividend recipient (Partnership) owns directly. In support of such a position, the IRS might point to the fact that the determination of whether the redemption is a sale or exchange is made by reference to the ownership of stock of the issuing corporation, without regard to the identity of the corporation that is deemed to have made the redemption or to have paid the dividend, and that the basis attributable to the deemed capital contribution of the redeemed shares to the acquiring corporation attaches to the retained shares of the issuing corporation, in the absence of any direct ownership of stock of the acquiring corporation. As discussed in the text, we believe that the threshold test of section 1059 should be applied by reference to the stock of the acquiring corporation (Enron Pipeline), where such corporation is treated as making the redemption under section 304(a)(1) and as having made the section 301 distribution under section 304(b)(2)(A). In the event that, contrary to our views, a court were to apply the threshold tests of section 1059 by reference to the stock of the issuing corporation (Liquids), the dividend attributable to the Purchase would exceed the 5 percent/85 day threshold percentage requirement of section 1059 relating to dividends on preferred stock.

enjoy[ed]." For this purpose, control is defined as 50 percent of vote or value. The following acquisitions of control or carryover basis property (from a corporation other than a subsidiary or a sister corporation) occurred in connection with the formation of Partnership and the Purchase:

Enron acquired control of Enron Cayman;

Enron and Enron Cayman acquired control of Enron GP;

Partnership and OPI acquired control of Liquids;

Liquids acquired control of Enron Operations Corp.;

OPI acquired the Houston Pipe Note and real estate from Enron; and

Enron Pipeline acquired the $600 Million ECTR Note and the EDC Note from Enron.

In order to apply section 269, it is necessary first to identify the benefit of a deduction, credit, or other allowance that stems from, and could not have been obtained in the absence of, the specified acquisition of control or the carryover of basis. See Zanesville Investment Co. v. Commissioner, 335 F.2d 507, 512 (6th Cir. 1964); Cromwell Corp. v. Commissioner, 43 T.C. 313, 320 (1964) (acq.); Commodores Point Terminal Corp. v. Commissioner, 11 T.C. 411, 417 (1948) (acq.); Tech. Adv. Mem. 9134003 (May 6, 1991); Gen. Couns. Mem. 39472 (Aug. 2, 1985). We question whether any such deduction, credit, or other allowance is made available by any of the acquisitions listed above.

Obtaining the desired accounting benefits does not depend on any of the acquisitions of control described above. It might be argued that the acquisition of the $600 Million ECTR Note and the EDC Note by Enron Pipeline potentially allows Enron to obtain the benefit of a deduction on the ultimate disposition of the Liquids stock retained by Partnership if section 1059 would have been applicable to the Purchase in the absence of such contributions. The carryover basis in those notes, however, is irrelevant to the application of section 1059. The basis increase in Enron's stock of Enron Pipeline, which may have relevance to the application of the section 1059 threshold percentage test, could have been achieved by a contribution of cash. We believe that the availability of an alternative means to obtain the same results suggests that the benefits are "otherwise available" to Enron.

Even if the required deduction, credit, or other allowance could be identified, it is necessary to show that tax avoidance or evasion by obtaining the benefit of such item was the principal purpose for an acquisition of control. The predominant purpose for the formation of Partnership and the

Purchase was to generate income for financial accounting purposes. Additional purposes for the formation of Partnership included risk shifting and raising minority equity capital. While the accounting benefits are derivative of the tax consequences of the Purchase, the formation of Partnership and the Purchase were structured to achieve these purposes without either increasing or decreasing, on a present value basis, the aggregate federal income tax liability of the Enron consolidated group and those Affiliates that are included on Enron's consolidated financial statements. We believe that these facts present a strong case for refuting any claim that the principal purpose of any of these transactions was the evasion or avoidance of tax.

Accordingly, we believe that section 269 should not be applicable to any of these acquisitions.

F. Partnership Anti-abuse Rule

The IRS, in regulations promulgated under section 701, has stated that it has the power, under certain circumstances, to alter what would otherwise be the tax consequences of transactions involving partnerships. Treas. Reg. § 1.701-2 (the "partnership anti-abuse rule"). For the reasons set forth below, we believe the regulations under section 701 should not apply to adversely affect the conclusions reached in this opinion.

Under the partnership anti-abuse rule:

> [I]f a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of Subchapter K.

Treas. Reg. § 1.701-2(b).

In the absence of any purpose to reduce the present value of the aggregate federal tax liability of the partners of Partnership, the partnership anti-abuse rule should not be applicable. In order to apply this threshold test, it is necessary to determine a baseline aggregate federal tax liability of the partners in order to determine whether a transaction reduces the present value of the partners' aggregate federal tax liability. In determining the tax reduction purpose of a transaction, it seems logical to look at the tax position the taxpayer would have been in if it had not done the transaction. In order to do this, one must determine the scope of a "transaction" in order to determine the tax effects of not doing the transaction.

The maximum scope of a transaction for these purposes would include a particular step that produces a tax benefit (the "goal step") and all other steps ("related steps") that would not have been done if the goal step were not done. In the instant case, the goal step would be creating the potential for deductions with respect to tax basis in excess of the book value of assets ("excess basis"). The related steps would be all elements of the creation of the structure, including the recapitalization of OPI and Liquids and the formation and capitalization of Enron GP and Partnership. Under this view of what constitutes the transaction, two of the partners of Partnership (Enron GP and EN-BT) would not exist if the transaction were not done. Moreover, the assets held by OPI would not have been owned by OPI if the transaction were not done. It seems reasonable to believe that the tax liability of a partner that does not exist or that would not have held its assets in the absence of the transaction would be determined by looking to the tax liability of the persons that initially owned the assets that were actually transferred to the partner. Under this view, the baseline would be the present value of the aggregate tax liability of the Enron consolidated group and the consolidated group of which EN-BT is a member (the "EN-BT consolidated group") if no steps were taken to recapitalize OPI or Liquids or to form and capitalize Partnership, Enron GP, and EN-BT.

Given a baseline that includes the tax liability of the Enron consolidated group, it would seem that any comparison of (i) the aggregate tax liability of the partners to (ii) the baseline tax liability should include the effects of the transaction on the tax liabilities that are included in the baseline, including the tax liability of the Enron consolidated group. Thus, the effects on the Enron consolidated group tax liability of transferring assets (and related income) from the Enron consolidated group to OPI and of transactions between the Enron consolidated group and OPI or Partnership (e.g., the interest payments from Enron to Partnership on Partnership investments in Enron securities) would have to be taken into account along with the net tax liability of OPI and changes in the tax liability of the EN-BT consolidated group attributable to the transaction.

A more limited view of what constitutes a "transaction" would include the goal step and those other steps ("enabling steps") that are required in order to make the goal step possible. In the instant case, the enabling steps would be the steps required to create the excess basis (e.g., the Purchase) and any steps taken to utilize that basis (e.g., section 732(c) distributions). Under this view, the baseline would be the tax liability of the partners if all transactions except the Purchase occurred. (In the absence of excess basis attributable to the Purchase, the effects of any steps taken to utilize such excess basis should become neutral.) The effects on the Enron consolidated group of the recapitalization of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, and investments by OPI and Partnership would be the same in the baseline as in the actual transaction, and accordingly would be irrelevant under this view. The change in tax liabilities as compared to the baseline would be attributable to the transaction increasing the income of the partners by the amount of the dividend income in excess of the dividends received deduction and decreasing the income of

the partners by the amount of the deductions attributable to excess basis. The timing of these effects would be affected by the time at which the partners trigger deductions attributable to the excess basis.

A minimum view of what constitutes a "transaction" would treat each separate step as a transaction. In the instant case, under this view, each step of the related transactions (e.g., the recapitalization of OPI and Liquids, the formation of Partnership, the Purchase, a section 732(c) distribution, or a triggering of deductions attributable to excess basis) would be a transaction. The baseline could be the tax liability of the partners determined as if any one step was not done. Under this view, reductions in the aggregate tax liability of the partners could be caused by transactions that invoke specific provisions of subchapter K to create a tax benefit (e.g., a section 732(c) distribution that converts basis in one asset into basis in another asset that has a greater tax benefit to the partners), or by the triggering of a deduction of excess basis.

In the absence of any authority indicating which of these approaches is most appropriate, we have considered the potential application of the partnership anti-abuse rule under each approach. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the partners of Partnership, in the aggregate, to the Enron consolidated group, or to any Affiliate of Enron from a federal income tax deduction or loss with respect to basis in any asset that is attributable, directly or indirectly, to the Purchase. Neither Enron nor any Affiliate of Enron will take any action that results in a net tax benefit to the Enron consolidated group, OPI, Enron GP, EN-BT, PCI, and their Affiliates, in the aggregate, from the recapitalization of OPI and Liquids, the formation and capitalization of Enron GP and Partnership, any investments by OPI and Partnership, and the Purchase. None of Enron and its Affiliates is aware of or anticipates any direct or indirect federal income tax effect of the Purchase on members of the Enron consolidated group other than the section 312 earnings and profits effects, investment adjustments, if any, and earnings and profits adjustments, if any. Accordingly, we believe that under either the maximum or a limited view of the meaning of the term "transaction" in the partnership anti-abuse regulation, the regulation should not be applicable.

Under a minimum view of what constitutes a transaction, certain transactions (e.g., the triggering of a deduction, a liquidating distribution subject to section 732(c)), when viewed in isolation, may reduce the tax liability of the partners. If it were determined that a transaction reduced the present value of the partners' aggregate tax liability, it would be necessary to determine whether that effect is inconsistent with the intent of subchapter K.

The tax reduction effects of a transaction that triggers a deduction attributable to the Purchase could be duplicated without the use of a partnership (although the accounting benefits of the transaction could not be duplicated without a partnership). We believe that tax results that could be

achieved without the use of a partnership should not be considered to be inconsistent with the intent of subchapter K.

The analysis of transactions that invoke specific provisions of subchapter K (e.g., section 732(c)) to create a tax benefit is more difficult if such benefits would not be available in the absence of Partnership. The anti-abuse rule includes a list of factors that may be indicative of the proscribed effect. The first negative factor is that the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. Treas. Reg. § 1.701-2(c)(1). This factor is apparently applied as if all transactions occur. See Treas. Reg. § 1.701-2(d) *Example 6*, *Example 7*, *Example 8*. Assuming transactions that result in a reduction of the partners' aggregate federal tax liability as compared to direct ownership of the assets (e.g., transactions that invoke section 732(c) to convert a capital deduction into a more beneficial ordinary deduction), we believe there is a risk that the IRS would argue that the transaction produces results that are inconsistent with the intent of subchapter K.

The partnership anti-abuse rule provides little guidance on when the application of a provision of subchapter K in accordance with its terms should be viewed as producing results that are inconsistent with the intent of subchapter K. While the text of the abuse-of-subchapter K rule is illustrated by a series of eleven examples, these examples confuse as much as elucidate the interpretation of the abuse-of-subchapter K rule. All three of the "bad" examples (i.e., examples that permit the Commissioner to recast the transactions) involve a partnership that was formed with a view to achieving a particular tax result, a partner who became a partner with a view to achieving such a result, and/or property that is introduced into the transaction to achieve the desired result, suggesting that these factors cause a literal application of the rules of subchapter K to produce results that are inconsistent with the intent of subchapter K. Several of the "good" examples (i.e., examples where the abuse-of-subchapter K rule is not violated), however, also involve partnerships that were formed with a view to achieving a favorable (sometimes very favorable) tax result. The conclusory statements in the examples provide no substantive analysis distinguishing the "good" tax planning examples from the "bad" tax planning examples. In the absence of a transaction that is virtually identical to an example in the regulations, we believe the anti-abuse rule should not be interpreted to alter the application of a mechanical rule of subchapter K.

The IRS might argue that the mechanical rules of subchapter K should not be applied literally based on general factors rather than particular examples, and in particular based on a substantial tax avoidance purpose at the time the partnership is formed, or on the magnitude of the tax benefits created by its application. Absent clearly expressed legislative intent to the contrary, the unambiguous language of a statute is controlling under all but rare and exceptional circumstances. See Crooks v. Harrelson, 282 U.S. 55, 60 (1930). If the intent of Congress in drafting a rule (e.g., to allocate basis in proportion to the relative bases of the distributed property under section 732(c))

is clear, the regulation cannot change that rule. If the statute is silent or ambiguous, then the regulation may fill the gap with a reasonable interpretation. See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-43 (1984); see also National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 476-77 (1979). We believe the intent of Congress to have the mechanical rules of subchapter K apply without regard to tax motivations is clear. In view of this Congressional intent, we believe a regulatory interpretation of a mechanical rule that alters its application based on the presence or absence of tax motivation or the magnitude of tax benefits should not be considered a reasonable interpretation.

The overriding purpose of the drafters of subchapter K in 1954 was to eliminate confusion. The "vital need" was "clarification." S. Rep. No. 83-1622, at 89 (1954). Beyond the need for clarification, the drafters cited the principles of "simplicity, flexibility and equity as between the partners." Id. Conditioning the application of the literal language of provisions of subchapter K on the presence or absence of a tax avoidance motive would operate to defeat these stated legislative purposes. Moreover, the contemporary legal context in 1954 indicates that tax avoidance motives were not relevant, unless specifically made so by statute. Prior to 1954, the Supreme Court had clearly stated that the tax motivation of taxpayers does not alter what would otherwise be the result of the application of the tax law to a transaction. See Gregory v. Helvering, 293 U.S. 465, 469 (1935); Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-96 (1930). The Supreme Court had also implicitly extended this principle to partnerships. See Commissioner v. Culbertson, 337 U.S. 733 (1940); see also Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935). The issue of the effect of a tax avoidance motivation on the validity of partnerships had been clearly presented to and considered by Congress prior to 1954 in the context of family partnerships. The Congressional response was to disregard tax motivation. See Sections 191 and 3797(a)(2) of the Internal Revenue Code of 1939. Congress, when it wanted to, clearly knew how to address the issue of tax avoidance in general, and in the context of partnerships. See Section 129 of the Internal Revenue Code of 1939; Section 704(b)(2) as enacted in 1954. Moreover, despite repeated examples of tax motivated uses of partnerships since 1954, Congress has failed to enact a broad, general, subjective intent based limitation on the literal application of the provisions of subchapter K. Instead, Congress has repeatedly addressed tax avoidance transactions involving partnerships by enacting specific rules which generally are applied based on objective factors. See, e.g., Sections 704(c)(1)(B), 707(a)(2), 737.

The examples in the abuse-of-subchapter K rule suggest that the rule is also intended to expand upon judicial doctrines, primarily by requiring that the tax motivation for a transaction be taken into account in applying those doctrines. Generally, the courts have not taken tax motivation into account in determining whether a transaction is a sham, a transaction has a substantial business purpose, the step transaction doctrine is applicable, or the substance of a transaction matches its form. See, e.g., Knetsch v. United States, 364 U.S. 361, 365 (1960); Gregory v. Helvering, 293 U.S. 465,

469 (1935). But cf. Sheldon v. Commissioner, 94 T.C. 738 (1990). In contrast to the virtual unanimity in the courts with respect to the role of tax avoidance motivation under these doctrines, some controversy has arisen in recent years with respect to the issue of the role of tax motives in the determination of whether the profit motive requirement of various Code provisions (e.g., sections 162, 165(c)(2), 183, and 212) has been satisfied. While the test is often described as requiring a primary purpose of realizing a profit, the cases generally have considered the relative weight of profit motive only in comparison to personal motives. See Portland Golf Club v. Commissioner, 497 U.S. 154 n.16 (1990); Snyder v. United States, 674 F.2d 1359 (10th Cir. 1982). In commercial transactions, where personal motives are not at issue, in some cases the courts have analyzed the facts of the transaction to determine whether a profit motive existed. In general, the finding of a profit motive has been sufficient for the courts to hold in favor of the taxpayer without further analysis. See, e.g., Lyon v. United States, 435 U.S. 561 (1978); Levy v. Commissioner, 91 T.C. 838 (1988). There have, however, been some tax shelter cases in which the courts have expanded their inquiry to consider the primacy of the profit motive as compared to the tax motive. See, e.g., Estate of Baron v. Commissioner, 83 T.C. 542 (1984), aff'd, 798 F.2d 65 (2d Cir. 1986); Fox v. Commissioner, 82 T.C. 1001 (1984). It remains to be seen whether tax motivation will play a significant role in the determination of whether a profit motive requirement within a particular Code provision is satisfied.

It has long been settled case law that tax motivation does not affect the qualification of an organization as a partnership. See Culbertson, 337 U.S. 733. Furthermore, to date there has been no decision applying a "primarily for profit" requirement to the definition of partnerships or to any provision of subchapter K. But see Brannen v. Commissioner, 78 T.C. 471 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984) (dissent by J. Whitaker, suggesting that profit motive identical to that required under section 162 would be required for a partnership to be recognized for tax purposes). Sixty years of case law consistently denies any relevance of a tax avoidance motivation in applying the substance over form doctrine and in determining whether there is a valid business purpose for a transaction. Moreover, case law and legislation consistently have denied relevance to tax avoidance motivation in determining whether an organization is a partnership for tax purposes. Finally, there have been repeated reenactments of the entire Code in the context of that case law. Based on this legal history, we believe that the partnership anti-abuse rule should not be considered a reasonable interpretation of the statute to the extent that it requires that what would otherwise be the tax consequences of a transaction be modified based on the presence of a tax motivation for a partnership transaction.

We believe that a court should not interpret the partnership anti-abuse rule as overriding specific mechanical rules provided in subchapter K in the absence of an example that cannot reasonably be distinguished from the transaction on its facts. In the event that the partnership anti-abuse rule were nevertheless interpreted as being applicable to a particular transaction, we

believe that a court should find the regulation to be invalid to the extent that it alters the clear rules of subchapter K based on the presence of a tax motivation.

G. Application of Section 482

Section 482 gives the IRS the authority, under certain circumstances, to alter what would otherwise be the tax consequences of a transaction. For the reasons set forth below, we believe section 482 should not apply to adversely affect the conclusions reached in this opinion.

Section 482 grants broad authority to the Secretary of the Treasury to allocate gross income, as necessary to clearly reflect income, among two or more entities that are controlled by the same interests. We assume, for purposes of discussion, that Enron and Partnership are under common control by virtue of Enron's control over Partnership's managing partner, Enron GP.

The threshold requirement for application of section 482 is that a transaction does not reflect arm's-length dealing between the parties. See Simon J. Murphy Co. v. Commissioner, 231 F.2d 639, 644-45 (6th Cir. 1956) (describing limits of predecessor of section 482, court stated that allocation not permitted where related parties deal with each other at arm's length; in case before court, failure of return to clearly reflect income was inherent in accrual method, not due to control over related parties); Haag v. Commissioner, 88 T.C. 604, 615 (1987), aff'd, 855 F.2d 855 (8th Cir. 1988) (to determine whether a reallocation is necessary to clearly reflect income or to prevent the evasion of taxes, court must decide whether the agreement reflected arm's-length dealing); Van Dale Corp. v. Commissioner, 59 T.C. 390, 398 (1972) (unless the tax benefit stems from less than arm's-length dealings, the threshold point for applying section 482 is simply not reached); Seminole Flavor Co. v. Commissioner, 4 T.C. 1215, 1229-31 (1945) (nonacq.) (court rejected government's argument that contract was for purpose of evading tax based on finding that terms of contract were arm's length); Treas. Reg. § 1.482-1(b)(1) (purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer; standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer); Tech. Adv. Mem. 7927009 (Mar. 22, 1979) (conditioning application of section 482 on finding that control relationship was utilized to effect the transaction at bargain sale price). Given EN-BT's interest in Partnership, and terms of the Purchase Agreement that were, at the time the transaction was entered into, commercially reasonable terms to which unrelated parties dealing at arm's length and with no compulsion to enter into the transaction could reasonably agree, we believe that section 482 should not be applicable to reallocate the section 304 dividend or the basis adjustments resulting from the Purchase among the entities.

VI. CONCLUSION

This opinion letter is based upon existing statutory, regulatory, judicial and administrative authority in effect as of the date of this opinion letter, any of which may be changed at any time with retroactive effect. In addition, our analysis is based solely on the documents we have examined, the representations you have made, the facts that we have assumed with your consent, and the additional information that we have obtained. If any of the facts contained in these documents or in such additional information are, or later become, inaccurate, or if any of the representations you have made or any of the assumptions that we have made are, or later become, inaccurate, our conclusions could well be different and this opinion cannot be relied upon. Similarly, our opinion is qualified by the preceding discussion and analysis and cannot be relied upon if we have not been informed of any material or relevant fact that would adversely affect our analysis.

Our opinion is rendered solely for your benefit and is not to be relied upon by any other person without our prior written consent. Finally, our opinion letter is limited to the specific issues described above.

Sincerely,

KING & SPALDING

By: Abraham N.M. Shashy, Jr.
Abraham N.M. Shashy, Jr.
for himself and William S. McKee