ERNST & YOUNG

Ernst & Young LLP
One Houston Center
Suite 2100
1221 McKinney Street
Houston, Texas 77010-2007

Phone: [illegible]
Fax: [illegible]
www.ey.com

Tax Advisor/Client Communication
Privileged And Confidential

November 16, 1999

Mr. R. Davis Maxey
Vice President -- Tax Planning
Enron Corp.
1400 Smith Street
Houston, TX 77002-7361

Redetermination of Earnings and Profits of Enron Liquids Holding Corporation

This letter sets forth our views concerning the redetermination of the earnings and profits ("E&P") of Enron Liquids Holding Corp. ("ELHC") following the contribution of Enron Pipeline Company ("EPC") to Enron Operations Corp. ("EOC").

FACTS

In reaching the conclusions stated herein, we have made certain assumptions based on the facts Alicia Goodrow, Jim Holman and you have presented to us orally and in writing. Any changes to the facts or invalidity of these assumptions may affect the conclusions stated herein. We have made no independent determination regarding such facts and circumstances.

ELHC has issued both preferred and common stock. The preferred stock is held 80.20% by Enron Leasing Partners, LP (limited partnership for federal income tax purposes); 10.45% by EPC; and 9.35% by Enron. The common stock is held 80% by Enron and 20% by Organizational Partner, Inc., a deconsolidated subsidiary of Enron. ELHC joins in the filing of Enron's consolidated federal income tax return.[1] The Enron consolidated group files its returns on a calendar year basis.

ELHC has redeemed a portion of both its preferred and common stock quarterly since March 1998. For federal income tax purposes, you have indicated that these redemptions will be treated as distributions with respect to stock (e.g., dividends) by reason of Section 302(d). The

[1] We understand that the preferred stock is described under Section 1504(a)(4) and accordingly is excluded from the 80% vote and value test under Section 1504(a)(2) because it is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock, and is not convertible into another class of stock.

AUTHENTICATED U.S. GOVERNMENT INFORMATION GPO

following schedule illustrates both the redemptions and dividends either made or expected to be made during the 1999 calendar year:

	Redemptions			Cash Dividends on Preferred Stock		
Date	Preferred Stock	Common Stock	Total	ELHC	EOC	Total
3/31/99	29,575,240	16,551,145	46,126,385	12,745,518		12,745,518
6/30/99	21,675,000	12,345,936	34,020,936	10,885,906		10,885,906
9/30/99	29,950,000	17,357,858	47,307,858	11,138,075		11,138,075
12/31/99	29,600,000	16,692,687	46,292,687	11,083,319	17,446,358	28,509,677
	110,800,240	62,947,625	173,747,865	45,812,818	17,446,358	63,258,176

As of December 31, 1998, ELHC has accumulated E&P of approximately $19,980,151. (See attached schedule for all numerical references.) ELHC is expected to generate approximately $37,072,554 of current E&P for the taxable year ended December 31, 1999. ELHC's E&P has been adjusted for the E&P derived by EOC, Enron Gas Liquids, Inc. ("EGLI"), Enron Louisiana Transportation Company ("ELTC"), Enron Products Pipeline, Inc. ("EPPI"), and EOTT Energy Corporation ("EOTT"), wholly owned subsidiaries of ELHC.

EPC is a wholly owned subsidiary of Enron with accumulated E&P of $968,753,074 at December 31, 1998. EPC is expected to generate approximately $184,616,953 of current E&P for the December 31, 1999 year.

TRANSACTION

The following transaction has been proposed:

- EPC will sell its 10.45% preferred stock interest in ELHC to Enron in exchange for an interest bearing note of equal value.
- Following the sale of EPC's preferred stock interest in ELHC, Enron will contribute 100% of the common stock of EPC to EOC in exchange for 1,000 shares non-voting, perpetual preferred stock with a stated dividend rate of 7% per annum of equal value.
- Incident to the transaction, in an attempt to reorganize along business lines, EGLI; ELTC; EPPI; and EOTT will be disposed of through intercompany sales or liquidations.

ISSUE

Upon the contribution of the stock of EPC to EOC, to what extent will EPC's current and accumulated E&P be replicated under Reg. §1.1502-33(f)(2) to the E&P of EOC and ELHC?

DISCUSSION AND ANALYSIS

Federal Income Tax Treatment of Distributions with Respect to Stock

Sections 301(a) and (c) provide, in part, that: (1) the portion of a distribution of property made by a corporation to a shareholder with respect to its stock which is a dividend shall be included in the shareholder's gross income; (2) the portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock; and (3) the portion of which is not a dividend to the extent that it exceeds the adjusted basis of the stock shall be treated as gain from the sale or exchange of property.

The term "dividend" means any distribution of property made by a corporation to its shareholders out of its E&P accumulated after February 28, 1913, or out of its E&P of the taxable year, without regard to the amount of E&P at the time the distribution was made.[2] Included as dividends are certain distributions in redemption of stock.[3]

Reg. §1.316-2(a) provides that a distribution with respect to stock is made, first, from the distributing corporation's E&P for the taxable year during which the distribution occurs. The determination of current E&P is made as of the end of the taxable year, without adjustment for any distributions made during the year and without regard to the amount of E&P on hand at the beginning of the taxable year or at the time of distribution.[4] If the total distributions made during the taxable year exceed the current E&P of that year, the excess amount is considered a taxable dividend to the extent of the distributing corporation's E&P accumulated after February 28, 1913.[5]

Consolidated Return Provisions

The consolidated return regulations provide a system for tiering up the E&P of the members of a consolidated group to each of the higher tier members and ultimately to the common parent. Each owning member adjusts its own E&P for its share of the E&P of its subsidiaries, using the principles applied to adjust the basis of a subsidiary's stock under Reg. §1.1502-32.[6] E&P

---

[2] Section 316(a).

[3] Section 302(d).

[4] Section 316(a)(2); Reg. §1.316-2(b); Rev. Rul. 74-164, 1974-1 C.B. 74.

[5] Reg. §1.316-2(a) and (b).

[6] Reg. §1.1502-33(b).

adjustments are made as of the close of each consolidated return year, and as of any other time if a determination at that time is necessary to determine the earnings and profits of any person.[7]

The consolidated return regulations also contain special rules for determining the E&P of a member upon a restructuring of the consolidated group. Reg. §1.1502-33(f)(2) requires that if a member's location within a group changes, appropriate adjustments must be made to the E&P of the members to prevent E&P from being eliminated. Although the scope of this rule is not entirely clear, two examples are given to illustrate its meaning: if *P* transfers all of *S*'s stock to another member in a transaction to which Section 351 and Reg. §1.1502-13 apply, the transferee's E&P is adjusted immediately after the transfer to reflect *S*'s E&P immediately before the transfer from consolidated return years. On the other hand, if the transferee purchases *S*'s stock from *P*, the transferee's E&P is not adjusted.

Based on rule set forth in Reg. §1.1502-33(f)(2), it appears that both EOC and ELHC's E&P should be adjusted for EPC's current year E&P following the contribution of 100% of EPC's stock to EOC by Enron. Reg. §1.1502-33(f)(2) does not specify the *manner* in which EPC's E&P is replicated to EOC and to ELHC. Presumably, the replication occurs as if the stock of EPC had always been owned by EOC, and EPC's E&P is tiered up under the normal consolidated return E&P system under Reg. §1.1502-33(b).[8] Although not free from doubt, due to the issuance of the preferred stock by EOC to Enron, it appears that some portion of EPC's E&P which is replicated to EOC should be allocated to the preferred stock held by Enron. Because the preferred stock was not outstanding prior to the contribution of the stock of EPC to

---

[7] Reg. §1.1502-33(b)(1). Because the Enron group's consolidated return year does not close as a result of the transaction, and EPC's individual year likewise does not close, Reg. §1.1502-33 should not operate to convert EPC's current E&P generated before the date of the proposed transaction to accumulated E&P.

[8] Note that Reg. §1.1502-33(f)(2) makes no distinction between current and accumulated E&P. Under Reg. §1.1502-33(f)(1), if there is a group structure change as defined in that section, the E&P of the new common parent is adjusted to reflect the E&P of the old common parent. Reg. §1.1502-33(f)(1) specifically states that this adjustment is made as if the new corporate parent succeeds to the E&P of the old common parent in a Section 381(a) transaction. In general, Section 381(c)(2) requires an acquiring corporation, in a transaction to which Section 381(a) applies, to succeed to, and take into account, the E&P of the target corporation as of the close of the date of distribution or transfer. Reg. §1.381(c)(2)-1(a)(1). Although the acquiring corporation inherits the target corporation's E&P on the date of the transaction under Section 381(c)(2), this E&P will be treated as accumulated E&P rather than current E&P of the acquiring corporation. Reg. §1.381(c)(2)-1(a)(2) and -1(a)(7), Example 1. Because Reg. §1.1502-33(f)(2) does not state that the E&P replication is deemed to occur in a deemed Section 381(a) transaction as does Reg. §1.1502-33(f)(1), there does not appear to be a specific provision that requires EPC's E&P to be treated as accumulated in EOC's and ELHC's hands. Thus, it appears that EPC's E&P would retain its character as current and accumulated, as the case may be, in EOC's and ELHC's hands.

EOC, no allocation of EPC's replicated E&P to the EOC preferred stock appears to be necessary prior to the date the contribution occurs.[9]

It is estimated that EPC will generate approximately $184,616,953 of current E&P for the taxable year ended December 31, 1999. Assuming that the contribution of EPC stock to EOC occurs on December 1, 1999, approximately $1,076,932 ($184,616,953 x 7% x 1/12) should be allocated to the preferred stock interest owned by Enron following the tier up to EOC. The remaining current year E&P of $183,540,021 ($184,616,953 less $1,076,932 allocated to the preferred interest) generated by EPC should be allocated to the common stock interest owned by ELHC following the tier up to EOC. This amount, $183,540,021 should likewise be tiered up to ELHC as of the date of the contribution.

Availability of EPC's E&P

As previously discussed, Reg. §1.316-2(a) dictates that any corporate distribution comes, first, from the corporation's E&P for the taxable year during which the distribution occurs. The taxpayer makes the determination of current E&P as of the end of the taxable year, without adjustment for any distributions made during the year and without regard to the amount of E&P on hand at the beginning of the taxable year or at the time of distribution.[10] As such, at the end of the year, ELHC will have current year E&P of approximately $220,612,574 ($183,540,021 generated by EPC plus $37,072,554 generated by ELHC and subsidiaries) without taking into consideration any distributions throughout the year.

The priority-sequencing of corporate distributions need only occur where the aggregate amount of the distributions exceeds current E&P for the taxable year. Moreover, where such excess exists, IRS regulations render inconsequential the order of priority of distributions for purposes of applying current E&P. Under Reg. §1.316-2(b), the year's E&P is apportioned to all distributions on a pro rata basis, regardless of when they occurred during the year. The excess is deemed to come from post-February 28, 1913 E&P on hand as of the date of the particular distribution.[11] Because EPC's E&P presumably is not replicated under Reg. §1.1502-33(f)(2) until the date of the contribution of the EPC stock to EOC, only the current E&P (i.e., during calendar 1999) generated by EPC is available to offset the distributions occurring in March, June, and September, 1999. According to the distribution schedule above, total distributions for the year will exceed ELHC's current E&P. Thus, priority-sequencing must be performed.

---

[9] Note that Reg. §1.1502-33(f)(2) provides, by way of illustration, that the adjustment to the higher tier members' E&P occurs *immediately after* the transaction.

[10] Rev. Rul. 74-164, 1974-1 C.B. 74.

[11] Section 316(a)(1); Reg. §§1.316-2(b) and (c).

Neither the parenthetical language of Section 316(a)(2) nor the regulations which require pro rata apportionment of the year's current E&P reflect any distinction between distributions made with respect to the same or different classes of stock. The IRS, nonetheless, takes the position that in determining the extent to which distributions made during the year with respect to different classes of stock come from current E&P, the taxpayer should consider any preferential rights of a particular class. Distributions made with respect to stock of the preferred class take priority over other distributions coming from current E&P.[12]

Based on the distribution schedule above, $174,059,416 of the total distributions relates to preferred stockholders. In completing the priority-sequencing, this amount should be treated as coming out of the current year E&P of $220,612,574. The remaining current year E&P of approximately $46,553,158 should then be apportioned to all remaining distributions on a pro-rata basis, regardless of when they occurred during the year. As such, approximately $11,638,290 ($46,553,158 divided by 4) of each distribution would be allocated to current year E&P. The excess would be deemed to come from post-February 28, 1913 accumulated E&P on hand as of the date of the particular distribution. Because EPC's E&P presumably does not replicate until the date of contribution of the EPC stock to EOC (which is currently scheduled to be December 1, 1999), only the $19,980,151 of accumulated E&P attributable to ELHC as of the beginning of the year should be allocable to the distributions occurring in March, June, and September, 1999. However, EPC's accumulated E&P of $968,753,074 should be available for any distribution subsequent to the contribution of the EPC stock to EOC.

CONCLUSION

Upon the contribution of the stock of EPC to EOC, it is more likely than not that EPC's current and accumulated E&P will be replicated under Reg. §1.1502-33(f)(2) to the E&P of EOC and ELHC. As described in detail above, a portion of EPC's current year E&P, upon tiering up to EOC, would be allocated to the preferred stock interest owned by Enron with the remainder being allocated to ELHC's common stock interest.

Therefore, ELHC should have sufficient E&P to treat the preferred dividends and preferred and common stock redemptions made for the tax year ended December 31, 1999, totaling $237,007,041, as dividends for purposes of Section 301.

Our comments, as stated above, are based upon the analysis of the Code, the Regulations thereunder, current case law, and published rulings. The foregoing are subject to change, and such change may be retroactively effective. If so, our views, as set forth above, may be affected and may not be relied upon. Further, any variation or differences in the facts as orally represented to us and recited herein, for any reason, might affect our conclusions, perhaps in an

[12] Rev. Rul. 69-440, 1969-2 C.B. 46.

adverse manner, and make them inapplicable. In addition, we have undertaken no obligation to update this letter for changes in facts or law occurring subsequent to the date thereof.

This letter represents our views as to the interpretation of existing law and, accordingly, no assurance can be given that the Service or courts will agree with the above analysis. Furthermore, we have not undertaken any analysis of foreign, state, or local tax consequences in the above.

This letter is addressed to your particular inquires and is not intended to be distributed to, or used by, third parties without our prior knowledge.

Thank you for the opportunity to work with you on this project. If you have any questions or would like to like to discuss this letter further, please call me at 713/750-8366 or Witland LeBlanc at 713/750-5947.

Very truly yours,

Kevin A. Duvall
Partner