Vinson & Elkins
ATTORNEYS AT LAW
VINSON & ELKINS L.L.P.
2300 FIRST CITY TOWER
1001 FANNIN STREET
HOUSTON, TEXAS 77002-6760
TELEPHONE (713) 758-2222
FAX (713) 758-2346
Web: www.velaw.com

February 9, 2001

Enron Corp.
1400 Smith Street
Houston, Texas 77002
Attn: R. Davis Maxey

Privileged Attorney-Client Communication

Subject: ***Enron Finance Partners, LLC***

Ladies and Gentlemen:

You have requested our opinion with respect to certain United States federal income tax consequences of a transaction involving the creation of certain entities, the contribution of assets to those entities and a related financing effected with various banks. Our opinion is based upon: (i) the Limited Liability Company Agreement of Enron Finance Partners, LLC ("EFP LLC") dated July 21, 2000, and subsequent amendments (the "EFP Agreement"); (ii) the Limited Liability Company Agreement of Enron Asset Holdings LLC ("EAH LLC"), dated November 3, 2000 and subsequent amendments (the "EAH Agreement"); (iii) the Limited Liability Company Agreement of Zephyrus Investments, LLC ("Zephyrus LLC"), dated November 28, 2000 (the "Zephyrus Agreement"); (iv) the Assignment and Assumption Agreements, the Supplemental Assignment and Assumption Agreements and other instruments related to the assumption of certain liabilities of Enron Corp. ("Enron"); (vi) the Zephyrus LLC Funding Agreement dated November 28, 2000; (vi) the Indemnification Agreement between EFP LLC and Enron dated November 28, 2000; and (vii) certain assumptions and representations by management of Enron as to the existence of certain facts. Capitalized terms not defined herein have the meanings set forth in the EFP Agreement or in the referenced document.

FACTS

A. Parties to the Transaction

EC2 000034142

1. Enron Finance Partners LLC

EFP LLC is a Delaware limited liability company that was formed on July 14, 2000. Enron, an Oregon corporation, Smith Street Land Company, a Delaware corporation ("Smith Street"), Enron Capital Investments Corp., a Delaware corporation ("ECIC"), and Enron Global Exploration & Production Inc. (formerly EOGI-India, Inc.), a Delaware corporation ("Global"), were admitted to EFP LLC as the initial Members, effective as of July 21, 2000. Enron

Caribbean Basin LLC ("Caribbean"), a Delaware limited liability company that is treated for federal income tax purposes as an entity disregarded as separate from its sole owner, Atlantic Commercial Finance, Inc. ("ACFI"), a Delaware corporation, was admitted as a Member pursuant to an amendment and restatement to the EFP Agreement dated October 4, 2000. Each of Smith Street, ECIC, Global and Caribbean (through its owner ACFI) is a member of the affiliated group of corporations filing a consolidated federal income tax return of which Enron is the common parent (the "Enron Group").

Enron, Enron Finance Management, LLC ("EFM LLC"), Smith Street, ECIC, Global and Caribbean entered into a second amendment and restatement to the EFP Agreement, dated November 21, 2000, in order to permit an additional capital contribution by Enron, to reclassify the membership interests of EFP LLC into Class A Membership Interests and Class B Membership Interests, to admit EFM LLC as a Class A Member, and to exchange and convert the membership interests held by Enron, Smith Street, ECIC, Global and Caribbean into Class B Membership Interests. On November 28, 2000, the EFP Agreement was amended and restated for a third time to reclassify and convert the membership interests in EFP LLC into three classes consisting of Class A Members, Class B Members and Class C Members, and to evidence (i) EFM LLC as the Class A Member, (ii) Enron, Smith Street, ECIC, Global and Caribbean as Class B Members, and (iii) the admission of Zephyrus LLC as the initial Class C Member. The EFP Agreement was further amended on December 11, 2000 and on January 2, 2001 to admit Boreas Holdings Corp., a Delaware corporation that is a member of the Enron Group ("Boreas"), as an additional Class B Member, and to provide that the Class B Member interests could not be assigned (other than to an Enron Affiliate) without the consent of the Class C Member, respectively.

2. Enron Asset Holdings, LLC

EAH LLC is a Delaware limited liability company that was formed on October 17, 2000. EFP LLC was admitted on November 3, 2000 as its initial Member pursuant to the EAH Agreement. The EAH Agreement was amended and restated on November 20, 2000 to provide that (i) Enron Intermediate Holdings, LLC ("EIH LLC") would replace EFP LLC as a Member; (ii) the membership interests in EAH LLC would be reclassified and converted into two classes consisting of Class A Membership Interests and Class B Membership Interests; (iii) the membership interest held by EIH LLC would be exchanged and converted into a Class B Membership Interest; and (iv) EFM LLC would be admitted as a Class A Member in consideration for a capital contribution of $20 million.

3. Enron Finance Management, LLC

EFM LLC is a Delaware limited liability company that was formed on October 23, 2000 to act as the Managing Member of EFP LLC and EAH LLC. Enron became the sole Member of EFM LLC pursuant to the Limited Liability Company Agreement of EFM LLC dated November 15, 2000. EFM LLC is treated for federal income tax purposes as an entity that is disregarded as separate from its sole owner, Enron.

4. Enron Intermediate Holdings, LLC

EIH LLC is a Delaware limited liability company that was formed on November 14, 2000 to hold the Class B Membership Interest in EAH LLC. EFP LLC was admitted as its sole Member on November 20, 2000. EIH LLC is treated for federal income tax purposes as an entity that is disregarded as separate from its sole owner, EFP LLC.

5. Zephyrus Investments, LLC

Zephyrus LLC is a Delaware limited liability company formed on November 17, 2000. Its initial Members, admitted as of November 28, 2000, were Chase Equipment Leasing, Inc. (as a Member and the Managing Member), Bank of America, N.A., BNP Paribas and Fleet National Bank. Royal Bank of Scotland subsequently was admitted as a Member. The Members contributed to Zephyrus LLC an aggregate of $481,725,000 in their capacities as "Lenders" and $18,275,000 in their capacities as "Certificate Purchasers." The Certificates represent the equity interests in Zephyrus LLC.

B. Summary of Transactions

Enron and its affiliates entered into the following series of transactions in order to create a flexible structure through which it could hold certain assets and obtain third-party financing that would be classified as a "minority interest" for financial accounting purposes. It is understood that the Enron Group historically has utilized similar structures to raise such financing, and that the aggregate principal amount of $500 million initially raised through the structure is consistent with amounts raised in such other financings. The term of the initial financing is five years, and it is has been represented that the financing structure described below will remain in existence for not less than five years and will hold assets in connection with its business or the business of the Enron Group, or for investment.

1. Contributions to EFP LLC

From the time of the formation of EFP LLC in July 2000 through November 28, 2000, the Class B Members contributed the following assets to EFP LLC ("Enron Assets") and in connection with such contributions EFP LLC assumed the following amounts of debt that had previously been assumed from Enron by the contributing Class B Member ("Enron Debt"):

(i) Enron contributed 11,500,000 shares of common stock of EOG Resources, Inc., a Delaware corporation ("EOGR"), with an agreed fair market value of $485,875,000, pursuant to an irrevocable stock power. The stock of EOGR is regularly traded on the New York Stock Exchange. In connection with this contribution, EFP LLC assumed approximately $460 million of Enron Debt; following the contribution and assumption, however, Enron remained liable on such Enron Debt.

(ii) Smith Street executed an Option Agreement with EFP LLC pursuant to which it granted EFP LLC an option to purchase for $1.00 all of the capital stock of Enron

Renewable Energy Corp. ("EREC"), with an agreed fair market value of $550,000,000 (the "EREC Option"). The EREC Option was intended to transfer tax ownership of the EREC stock to EFP LLC prior to regulatory approval of the transfer to EFP LLC of legal title to such stock. In connection with this contribution, EFP LLC assumed approximately $524 million of Enron Debt; following the contribution and assumption, however, Smith Street remained liable on such Enron Debt.

(iii) Global contributed all of the outstanding stock of Enron Oil & Gas India Ltd. ("EOGIL"), a Cayman Islands company, with an agreed fair market value of $550,000,000. In connection with this contribution, EFP LLC assumed approximately $523 million of Enron Debt; following the contribution and assumption, however, Global remained liable on such Enron Debt.

(iv) Caribbean contributed all of the outstanding stock of Enron LNG Power (Atlantic) Ltd. ("LNG"), a Cayman Islands company, with an agreed fair market value of $125,000,000. In connection with this contribution, EFP LLC assumed approximately $119 million of Enron Debt; following the contribution and assumption, however, ACFI (the owner of Caribbean) remained liable on such Enron Debt.

(v) On December 11, 2000, Boreas contributed partnership interests in Enron Capital Management III Limited Partnership (the "ECM Interests"), with an agreed fair market value of $99,083,880.[1] In connection with this contribution, EFP LLC assumed approximately $94 million of Enron Debt; following the contribution and assumption, however, Boreas remained liable on such Enron Debt.

(vi) ECIC contributed a Demand Promissory Note, dated July 21, 2000, in the principal amount of $200,000,000, payable by Enron to ECIC (the "Demand Promissory Note"). Enron also contributed a demand note in the principal amount of $125 million (the "Enron Overfunding Note") to ECIC, which in turn contributed that note to EFP LLC.

Following their respective contributions, each of Enron, Smith Street, Global, Caribbean and Boreas contributed 95 percent of their respective Class B Membership Interests in EFP LLC to ECIC in exchange for stock of ECIC. Each contributor remained liable on the portion of the Enron Debt that previously had been assumed by such contributor. It has been represented that EFP LLC will not make an election to adjust the basis of its assets pursuant to section 754 of the Code[2] in connection with the transfers of such membership interests.

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[1] All of the contributions could not be made prior to the closing of the financing transaction on November 28, 2000. Accordingly, Enron agreed in Section 3.01(b) of the EFP Agreement that it would make or cause an Enron Affiliate to make a Capital Contribution, in cash or in kind in any form of property, tangible or intangible (including a promissory note), having a value not less than $5,000,000 on or before December 31, 2000. The contribution by Boreas was made in satisfaction of this covenant. Failure to make such a contribution would have allowed the parties providing the financing to have their interests redeemed in February 2001.

[2] References to the "Code" are to the Internal Revenue Code of 1986, as amended, and references to sections are to sections of the Code unless the context requires otherwise.

2. Contributions to EIH LLC and EAH LLC

EFP LLC contributed its sole member interest in EAH LLC plus the Enron Assets (excluding the Enron Overfunding Note) to EIH LLC in exchange for the sole member interest in EIH LLC. Pursuant to certain Supplemental Assignment and Assumption Agreements, EIH LLC assumed the Enron Debt that had been assumed by EFP LLC in connection with the contributions described above, and EFP LLC was released from such obligations. The Enron Overfunding Note was released as collateral on the Enron Debt assumed by EIH LLC. As described above, EIH LLC is disregarded as an entity for tax purposes and thus, for tax purposes, EFP LLC remained liable on the Enron Debt.

Thereafter, EIH LLC contributed all of its assets (excluding the Demand Promissory Note) to EAH LLC and the membership interests in EAH LLC were reclassified into Class A and Class B Membership Interests. In connection with the contribution of EIH LLC and the reclassification, (i) EFM LLC contributed a $20 million Enron demand note to EAH LLC and became the Class A Member of EAH LLC (the "Class A Member"), and (ii) EIH LLC became the Class B Member of EAH LLC (the "Class B Member"). EAH LLC did not assume any of the Enron Debt in connection with such contributions.

The EAH Agreement provides that Profits shall be allocated (i) to the Class A Member, until the cumulative amount of Profits allocated to the Class A Member for the current taxable year and all prior taxable years equals the cumulative amount of Losses allocated to the Class A Member for all prior taxable years; (ii) to the Class B Member, until the cumulative amount of Profits allocated to the Class B Member for the current taxable year and all prior taxable years equals the cumulative amount of Losses allocated to the Class B Member for all prior taxable years; and (iii) thereafter, 75% to the Class B Member and 25% to the Class A Member.

Losses are allocated under the EAH Agreement (i) to the Class B Member, until the cumulative amount of Losses allocated to the Class B Member for the current taxable year and all prior taxable years equals an amount equal to 10% of the initial Capital Contributions of the Class B Member plus the cumulative amount of Profits allocated to the Class B Member for all prior taxable years; (ii) to the Class A Member to the extent of its Adjusted Capital Account; and (iii) thereafter, to the Class B Member.

3. Admission of Zephyrus as a Class C Member of EFP LLC

On November 28, 2000, in exchange for a capital contribution of $500 million, Zephyrus was admitted as the initial Class C Member and was issued 10 membership units ("Class C Units") evidencing the Class C Membership Interest. Each such Class C Unit represented a capital contribution of $50 million. The Class C Membership Interest entitles the Class C Member to a Preferred Return with respect to each Quarterly Period generally equal to the Preferred Applicable Rate (LIBOR for such Quarterly Period plus 1.0202 percent per annum) times the Liquidation Preference ($500 million, as increased or decreased periodically). The EFP Agreement contemplates that EFP LLC will acquire certain Financial Assets, including certain "Core Permitted Assets," and will maintain its holding of Core Permitted Assets

sufficient to provide the Class C Members with coverage on their Aggregate Liquidation Preference equal to 1.25:1. Failure to maintain such a Core Permitted Assets Coverage Ratio will result in the payment by EFP LLC of a higher rate of Preferred Return (the "Specified Event Rate") on the Class C Units.

Pursuant to the EFP Agreement, Enron recognized that EFP LLC would not be permitted to own the Enron Assets (with the exception of the Demand Promissory Note and the Enron Overfunding Note) unless Enron indemnified EFP LLC against any and all losses, costs, liabilities, damages or expenses that may arise from EFP LLC's acquisition, ownership or disposition of the Enron Assets. In fulfillment of this obligation, Enron entered into an Indemnification Agreement with EFP LLC pursuant to which Enron agreed to indemnify EFP LLC and each Class C Member from and against any such claims related to the Enron Assets.

The EFP Agreement provides that EFP LLC may cause a full or partial redemption of the Class C Units on any Distribution Date on or after the second anniversary of the Closing Date. The EFP Agreement also provides certain redemption rights to holders of the Class C Units, including the right to have the Class C Member's interest redeemed on the Distribution Date occurring in February, 2001.[3] In addition, a holder of Class C Units has the option to have such Units redeemed on the Distribution Date occurring in November, 2005 and on any Distribution Date thereafter, provided that the Class C Member has complied with certain notice requirements. The Class C Member may require EFP LLC to make Full Redemption (or to cause one of its Affiliates to make Full Redemption) of all of the Class C Units held by such Class C Member at a price equal to the Specified Price (*i.e.*, the Liquidation Preference plus the amount of any unpaid Preferred Return).

The EFP Agreement provides that upon redemption of the Class C Membership Interest, EFP LLC (or another acquirer) is required to pay to the disposing Class C Member an amount equal to the Specified Price, except that if EFP LLC is effecting the redemption, no amounts that represent the proceeds of certain of the Enron Assets may be used to effect the redemption until certain percentages of such proceeds have been distributed to or set aside for distribution to Enron or any Member that is a wholly-owned Enron affiliate.

4. Allocations Under the EFP Agreement

The EFP Agreement provides that Profits shall be allocated to the Capital Accounts of the Members as follows: (a) the first 12.5% of all Sub Asset No. 1 Items[4] shall be allocated to ECIC

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[3] This redemption right came into existence only if the capital contribution required to be made pursuant to Section 3.01(b) of the EFP Agreement (*i.e.*, the additional $5 million) was not made on or before December 31, 2000. This right was terminated by the contribution made by Boreas of the ECM Interests on December 11, 2000, as set forth in the First Amendment to Third Amended and Restated Limited Liability Company Agreement of EFP, dated December 11, 2000.

[4] References to Sub Asset No. 1 through Sub Asset No. 4 refer to certain of the stock and partnership interests transferred to EIH LLC and thereafter to EAH LLC. These include the contributions initially made by Caribbean, Global, Boreas and Smith Street to EFP LLC, respectively.

and any transferee of ECIC's Class B Unit; (b) the first 51% of all Sub Asset No. 2 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit; (c) the first 95% of all Sub Asset No. 3 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit, and the remaining 5% of all Sub Asset No. 3 Items shall be allocated to the Class A Member and any transferee of the Class A Member's Class A Unit; (d) if the Class A Member determines that any such allocation is necessary for EFP LLC or any "Company Subsidiary" to comply with any agreements to which such Company Subsidiary or any of its direct or indirect Subsidiaries is bound or by which it is effected, the requisite percentage of Sub Asset No. 4 Items shall be allocated to ECIC and any transferee of ECIC's Class B Units; (e) all other Profits shall be allocated as follows: (i) first, 100% to the Class C Members to reverse Losses previously allocated to the Class C Members under Section 6.02(e)(ii) pro rata in accordance with Losses previously allocated to each Class C Member; (ii) second, 100% to the Class A Member and the Class B Members to reverse Losses previously allocated to the Class A Member and the Class B Members pursuant to Section 6.02(e)(i) and (iii); (iii) third, 100% to each Class C Member up to the Preferred Distribution Amount for each Class C Unit held by such Class C Member; and (iv) the balance to the Class A Member and the Class B Members in proportion to their Sharing Ratios.[5]

The EFP Agreement provides that Losses shall be allocated to the Capital Accounts of the Members as follows: (a) the first 12.5% of all Sub Asset No. 1 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit; (b) the first 51% of all Sub Asset No. 2 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit; (c) the first 95% of all Sub Asset No. 3 Items shall be allocated to ECIC and any transferee of ECIC's Class B Unit, and the remaining 5% of all Sub Asset No. 3 Items shall be allocated to the Class A Member and any transferee of the Class A Member's Class A Unit; (d) if the Class A Member determines that any such allocation is necessary for EFP LLC or any Company Subsidiary to comply with any agreements to which such Company Subsidiary or any of its direct or indirect Subsidiaries is bound or by which it is effected, the requisite percentage of Sub Asset No. 4 Items shall be allocated to ECIC and any transferee of ECIC's Class B Units; (e) all other Losses shall be allocated as follows: (i) first, 100% to the Class A Member and the Class B Members to the extent of, and in proportion to, their respective Adjusted Capital Accounts; (ii) second, 100% to each Class C Member to the extent of, and in proportion to, its Adjusted Capital Account; and (iii) the balance to the Class A Member and the Class B Members in proportion to their Sharing Ratios.

5. Other Transactions

Enron contemplates that some or all of the Enron Assets will be sold by EAH LLC and the proceeds of such sales used to purchase long-lived assets such as the new Enron office building that is currently under construction (the "Enron Building") and possibly stock or securities of Enron or other members of the Enron Group. It is understood that if the Enron

[5] It is assumed that EFP LLC will adopt the remedial allocation method pursuant to Treas. Reg. § 1.704-3(d).

Building is purchased as planned, the building will be owned by EAH LLC for a period of not less than five years. Thereafter, the building may be distributed in complete redemption of ECIC's interest in EFP LLC. Following such distribution or the complete dissolution of EFP LLC, it is understood that the Enron Building will continue to be owned by a member of the Enron Group.

Other than loans with respect to which repayment is required, it is assumed that no distributions will be made to any of the EFP LLC Members within the two-year period following the date of their respective contributions. In addition, it is assumed that neither EFP LLC nor EAH LLC will own unrealized receivables or inventory items (as those terms are defined in section 751 of the Code). To date, none of the Enron Assets have been sold nor are any such assets subject to a contract for sale.

AUTHORITIES

A. Transfers of Property to EFP LLC

1. General Nonrecognition Rules of Section 721

Section 721(a) of the Code provides that no gain or loss shall be recognized to a partnership or to any of its partners on a contribution of property to the partnership in exchange for an interest in the partnership. Section 721(b) of the Code provides that the nonrecognition rules of section 721(a) will not apply to gain realized on the transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated.

A transfer of property will be considered to be a transfer to an investment company if (i) the transfer results directly or indirectly, in diversification of the transferors' interests, and (ii) the transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80% of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) consist of stocks and securities.[6] Section 351(e) states that for purposes of this rule, items such as money, stock and other equity interests in a corporation and evidences of indebtedness are treated as stock and securities. Treasury Regulation § 1.351-1(c)(2) provides that the determination of whether a corporation is an investment company will ordinarily be made by reference to the circumstances in existence immediately after the transfer in question. However, where circumstances change thereafter pursuant to a plan in existence at the time of the transfer, the determination will be made by reference to later circumstances.

Treasury Regulation §1.351-1(c)(4) provides that in determining whether more than 80% of the value of a transferee corporation's assets are held for investment, stock and securities of subsidiary corporations are disregarded and the parent corporation is deemed to own its ratable share of the subsidiaries' assets. A corporation is considered a subsidiary if the parent

[6] Section 351(e) and Treas. Reg. § 1.351-1(c)(1).

corporation owns 50% or more of (i) the combined voting power of all classes of stock entitled to vote or (ii) the total value of shares of all classes of stock outstanding.

As described above, the Members of EFP LLC will transfer assets consisting of cash, stock of EOGR, the ECM Interests, a $200 million Demand Promissory Note, a $125 million Enron Overfunding Note and the stock (or, with respect to EREC, an option to acquire the stock) of EREC, EOGIL and LNG. Under the regulations described above, EFP LLC (and subsequently EAH LLC) will be considered to hold directly all of the assets held by EREC, EOGIL and LNG. It is assumed that each of these companies is an operating company or holds interests in operating companies that would be treated as "subsidiaries" for purposes of this analysis. Thus, based on the types of assets and assuming the accuracy of the valuations described above, at the time of the contribution of the Enron Assets, more than 80% of EFP LLC's assets should not be treated as consisting of stocks and securities. Accordingly, the general nonrecognition rule of section 721(a) of the Code should apply to the transfers of the Enron Assets to EFP LLC and ultimately to EAH LLC.

Although Enron contemplates that certain of the Enron Assets may be sold and other assets acquired with the proceeds, it is assumed that there is no present plan by Enron or its affiliates to cause EFP LLC or EAH LLC to acquire and hold readily marketable stocks and securities in amounts that would cause either such company to be treated as an investment company under the rules described above.

2. *Disguised Sale Treatment*

Notwithstanding the general nonrecognition rule of section 721(a) of the Code, section 707(a)(2)(B) provides that if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers when viewed together are properly characterized as a sale or exchange of property, then the transfers shall be treated as a transaction between a partnership and one who is not a partner or as a transaction between two or more partners acting other than in their capacity as members of the partnership.

Treasury Regulation § 1.707-3(b) provides that a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, only if based on all of the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of property, and in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. The determination of whether a transfer of property by a partner to a partnership and a transfer of money or other consideration by the partnership to the partner will constitute a sale is made based on all the facts and circumstances in each case.[7] The weight to be

[7] Treas. Reg. § 1.707-3(b)(2).

given each of the facts and circumstances will depend on the particular case. Generally, however, the facts and circumstances existing on the date of the earliest of the transfers are the ones determining the existence of a sale.[8]

Treasury Regulation § 1.707-3(c)(1) provides that if a transfer of property to the partnership and a transfer of money or other consideration to the partner occur within a two-year period, the transfers are presumed to be a sale unless the facts and circumstances clearly establish that the transfers do not constitute a sale. Conversely, transfers made more than two years apart are presumed not to be a sale.

Treasury Regulation § 1.707-5(a)(1) provides that if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability. The regulations provide that a partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations thereunder.[9] A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under Treasury Regulation § 1.752-1(a)(1). Pursuant to that regulation, a partnership liability is a recourse liability to the extent that any partner or a related person bears the economic risk of loss for that liability under Treasury Regulation § 1.752-2.

Treasury Regulation § 1.752-2(b)(1) provides that a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or a related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or a related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. The regulation provides further that upon a constructive liquidation of the partnership, the following events would be deemed to occur simultaneously: (i) all of the partnership's liabilities would become payable in full; (ii) with the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, would have a value of zero; (iii) the partnership would dispose of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership); (iv) all items of income, gain, loss, or deduction would be allocated among the partners; and (v) the partnership would liquidate.

The determination of the extent to which a partner or related person has an obligation to make a payment under the liquidation scenario described above is based on the facts and circumstances at the time of the determination. For this purpose, all statutory and contractual obligations relating to the partnership liability are taken into account, including (i) contractual obligations outside the partnership agreement such as guarantees, indemnifications,

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[8] *Id.*

[9] Treas. Reg. § 1.707-5(a)(2)(i).

reimbursement agreements and other obligations running directly to creditors or to other partners or to the partnership; (ii) obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and (iii) payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law.

As described above, in connection with the contributions of Enron Assets, Enron Debt was assumed by EFP LLC and subsequently assumed by EIH LLC. As EIH LLC is disregarded, for tax purposes EFP LLC remained liable on the Enron Debt. It is assumed that the Enron Debt does not constitute a qualified liability. With respect to each transfer, the Member contributing assets to EFP LLC remained personally liable on the debt. Accordingly, if EFP LLC were deemed to liquidate in the manner described in the regulations and the value of all of its assets were deemed to be zero, it would be unable to repay the Enron Debt and the contributing Members would be liable under their respective Assumption Agreements to repay such indebtedness. Accordingly, in each case the amount of the Enron Debt assumed by EFP LLC does not exceed the Member's share of that liability immediately after the assumption of the liability by EFP LLC. Therefore, none of the Members should be treated as receiving consideration in connection with the transfers of the Enron Assets.

It is possible that proceeds from sales of the Enron Assets may be loaned or distributed to Enron or its affiliates. To the extent that the party receiving such an amount is obligated to repay that amount, the provisions of section 707 will not be applicable. However, to the extent that Enron or one of its affiliates that is a Member of EFP LLC receives a distribution for which no obligation to repay exists, such distribution would need to be analyzed based on the facts and circumstances existing at the time of the distribution to determine if the provisions of section 707 would cause the initial transfer of property and later distribution to be treated as a sale. To the extent any such distribution is made more than two years after the date of the transfer of the relevant Enron Asset, such transfer and distribution will be presumed not to be a sale.

B. Transfers of EFP LLC Member Interests to ECIC

1. General Nonrecognition Rules of Section 351

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock of such corporation if immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of determining control in connection with a transfer pursuant to section 351, stock owned by all members of an affiliated group filing a consolidated income tax return is taken into account.[10] Section 357(c) provides that in an exchange to which section 351 applies, if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred in such exchange, then such excess shall be considered as gain from the sale or exchange or property. Where the property transferred to a controlled

[10] Treas. Reg. § 1.1502-34.

corporation is a partnership interest, a transferor is treated as transferring liabilities to the transferee corporation to the extent that partnership liabilities previously allocated to the transferor are allocated to such corporation and the transferor is relieved of that liability.[11]

Pursuant to section 722 of the Code, the adjusted basis of a partner's interest in a partnership is equal to the amount of money plus the basis of any property contributed by such partner to the partnership. Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership. As described above, a partner's share of a recourse liability of the partnership equals the portion of that liability for which the partner or a related person bears the economic risk of loss.[12]

In the transaction, Enron and certain other Members of EFP LLC transferred 95% of their Member Interests to ECIC in exchange for stock of ECIC and met the general requirement for nonrecognition of gain or loss under section 351(a). Each tranferor Member's basis in its Membership Interest includes such Member's share of the Enron Debt for which it has remained liable. However, because Enron and the other transferors will continue to be Members of EFP LLC and will remain fully liable on the Enron Debt, upon transfer of those Membership Interests to ECIC the transferor Member's share of the Enron Debt will not be decreased. Accordingly, no gain should be recognized pursuant to section 357(c).

2. *Business Purpose Requirement for Section 351 Transfer*

There is no specific requirement in section 351 or the regulations thereunder that a transfer to a controlled corporation be carried out for a non-tax business purpose. The Internal Revenue Service ("IRS") has taken the position in older published rulings that a transfer to a controlled corporation must serve a business purpose or alternatively, that it not be carried out merely to gain a tax advantage.

In Rev. Rul. 55-36, 1955-1 C.B. 340, a shareholder holding 1/6 of the stock of a corporation transferred that stock to a new corporation and then contributed the stock of the new corporation to a charity, which liquidated the new corporation. The IRS held that the transaction did not qualify under the predecessor of section 351 because it served no corporate business purpose as the new corporation did not conduct any business or remain in existence except for the brief time necessary to effect the donation. Moreover, the shareholder did not meet the control requirement of the statute.

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[11] *See* Rev. Rul. 80-323, 1980-2 C.B. 124 (a transferring limited partner's share of nonrecourse liabilities of the partnership is treated as a liability to which the partnership interest is subject for purposes of section 357(c)); *see also* Treas. Reg. § 1.752-2(h), which provides that if a partnership interest is sold or exchanged, the reduction in the transferor's share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder.

[12] Treas. Reg. § 1.752-2(a).

In Rev. Rul. 60-331, 1960-2 C.B. 189, individuals who transferred their stock in a personal holding company to another wholly-owned corporation after receiving information relating to the personal holding company tax but before the distribution of a deficiency dividend were taxable on the dividend. The ruling states that the transaction was effected solely to gain the advantage of the corporate dividends received deduction and therefore would be ignored. Rev. Rul. 68-349, 1968-2 C.B. 143, held that the transfer by an individual of property to a newly-formed corporation did not qualify under section 351. In the ruling, another corporation (which wanted to acquire the property) simultaneously transferred its assets to the new corporation for the purpose of qualifying the individual's transfer and then distributed the stock of the new corporation to its shareholders in redemption of their stock. The ruling held that the new corporation was treated as merely a continuation of the old corporation.

In Rev. Rul. 70-140, 1970-1 C.B. 73, a transfer of assets by an individual to a controlled corporation was disregarded where, pursuant to a prearranged plan, the stock of the new corporation was to be acquired by another corporation. However, Rev. Rul. 76-123, 1976-1 C.B. 94, reached a different result. In the ruling, the stock of two wholly-owned corporations was transferred by their sole shareholder to a new corporation, and thereafter, the new corporation caused the liquidation of one of the transferred corporations. The IRS held that the transfers qualified for nonrecognition under section 351 and section 368(a)(1)(C). The new corporation remained in existence and conducted the business of the liquidated corporation; the ruling held that the arrangement was therefore not employed solely to allow the transfer of stock without the recognition of gain but rather effected the combination of the businesses.

The courts have not strictly imposed a business purpose requirement and generally have disregarded a transfer purporting to be tax-free under section 351 only where either the existence of the corporation or its ownership of the assets is transitory. *See West Coast Marketing Corp. v. Comm'r*, 46 T.C. 32 (1966) (transfer of land to a new corporation followed by exchange of stock and subsequent liquidation of the corporation did not qualify for tax free treatment; existence of corporation was transitory); *cf. Weikel v. Comm'r*, 51 T.C.M. 432 (1986) (individual transferred assets to a controlled corporation and approximately four months later executed a definitive agreement under which the corporation was to be acquired in a reorganization qualifying under section 368(a)(1)(B); transfer to new corporation was not disregarded as the new corporation held the assets and conducted business for almost three years and the definitive agreement was not signed until several months after the incorporation); *Caruth v. United States*, 688 F. Supp. 1129 (N.D. Tex. 1988), *aff'd on other grounds*, 865 F.2d 644 (5th Cir. 1989) (in which the IRS challenged the contribution of stock of one corporation to another wholly-owned corporation several days before a dividend was declared; the court held that the business purpose doctrine applied but found that the taxpayer did establish a valid business purpose for the transfer and there was no evidence that the transferee corporation was used merely for tax avoidance purposes).

Although the authorities described above indicate that some business purpose is required for a transfer to qualify under section 351, the standard applied to such transactions does not appear to be as stringent as that applied in the reorganization context. Moreover, in almost every

instance in which tax-free treatment or some other benefit (*e.g.*, the dividends received deduction) has been denied, the transfer to the controlled corporation has been effected immediately prior to the specific event giving rise to the benefit or the existence of the corporation is transitory. Where no immediate tax savings or other tax advantage is realized, the courts generally have been reluctant to disregard the transaction. In this case, ECIC is an existing corporation that currently holds assets and is a member of the Enron Group. The transaction is not being effected to avoid the recognition of gain on assets as any gain recognized by EFP LLC will be fully taxable to the members of the Enron Group to whom such gain is allocated. Moreover, ECIC will receive and hold the EFP LLC interests for at least five years and EFP LLC, through its ownership in EAH LLC, will continue to maintain an interest in the assets underlying those interests. At the time of the transfers, there were no existing agreements to sell the Enron Assets or to exchange the interests in EFP LLC or the stock of ECIC. Accordingly, the transfer of 95% of the EFP Member interests to ECIC is distinguishable from the authorities described above and should be respected as tax-free under section 351 of the Code.

C. Application of Section 704(c) to the Transaction

1. General Allocation Rules

Section 704(c) provides that under regulations prescribed by the Secretary, income, gain, loss and deduction with respect to property contributed to a partnership by a partner shall be shared among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of the contribution.[13] The purpose of Section 704(c) is to prevent the inappropriate shifting of tax consequences among partners with respect to precontribution gain or loss on property contributed to the partnership.[14] Except for certain types of property, section 704(c) is to be applied on a property-by-property basis.[15] Treasury Regulation § 1.704-3(a)(7) provides that if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner; if the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.[16]

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[13] Treasury Regulation § 1.704-3(a)(9) provides that if a partnership contributes section 704(c) property to a second partnership (the lower-tier partnership), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss.

[14] Treas. Reg. § 1.704-3(a)(1).

[15] Treas. Reg. § 1.704-3(a)(2); pursuant to Treas. Reg. § 1.704-3(e)(2), depreciable property, zero-basis property and inventory may be aggregated.

[16] The regulations under section 704(c) do not define a partner's interest in a partnership nor do they indicate how the portion of the partner's interest transferred should be computed. Treas. Reg. § 1.704-1(b)(3) states that for purposes of section 704(b), references to the partners' interests in the partnership signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain,

Except for Treas. Reg. § 1.704-3(a)(7), there is no specific authority dealing with the allocation of section 704(c) gain when a portion of a partnership interest is transferred. In Rev. Rul. 84-53, 1984-1 C.B. 160, the IRS prescribed a method for dealing with the allocation of partnership basis in the case of sales or exchanges of partnership interests. The ruling states that when a partner makes a taxable disposition of a portion of an interest in a partnership, the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest. In a situation in which the partnership has recourse debt and the partner's share of all partnership liabilities does not exceed the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the ruling indicates that the transferor partner shall first exclude from the adjusted basis of such partner's entire interest an amount equal to such partner's share of all partnership liabilities, as determined under Treasury Regulation § 1.752-1(e). A part of the remaining adjusted basis (if any) is to be allocated to the transferred portion of the interest according to the ratio of the fair market value of the transferred portion of the interest to the fair market value of the entire interest under authority of Treas. Reg. § 1.61-6(a). The sum of the amount so allocated plus the amount of the partner's share of liabilities that is considered discharged equals the adjusted basis of the transferred portion of the interest.

There is no indication that the method advocated in Rev. Rul. 84-53 with respect to a partner's interest in a partnership has any application to the allocation of precontribution section 704(c) gain nor is there any indication that a partner's share of partnership liabilities is to be considered in allocating section 704(c) gain. To the contrary, in recent instances where allocation of section 704(c) gain has been an issue, the only authority cited is Treas. Reg. § 1.704-3(a)(7). For example, recently finalized regulations dealing with partnership divisions specifically state that section 704(c) gain attributable to an interest deemed purchased by the partnership in a merger is to be apportioned among the remaining partners in accordance with section 704(c) and Treas. Reg. § 1.704-3(a)(7).[17] Further, in the preamble to final regulations issued under section 1223, Treasury explained that when a partner sells a portion of his partnership interest, the amount of section 704(c) gain transferred to a purchaser is relevant in determining a taxpayer's share of collectibles gain or section 1250 gain. To that end, it is necessary to calculate the gain that would be allocated to the interest sold if the underlying collectibles or section 1250 property were sold for their fair market value.[18] The preamble notes that this issue while important is beyond the scope of the regulations.[19] Significantly, the

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loss, deduction or credit (or item thereof) that is allocated. The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances including: (i) the partners' relative contributions to the partnership; (ii) the interests of the partners in economic profits and losses (if different than that in taxable income or loss); (iii) the interests of the partners in cash flow and other non-liquidating distributions; and (iv) the rights of the partners to distributions of capital upon liquidation.

[17] *See* Treas. Reg. § 1.708-1(c)(5), Example 5.

[18] T.D. 8902, I.R.B. 2000-41, p. 324 (Oct. 10, 2000).

[19] The discussion in the preamble apparently was included in response to comments from the American Bar Association Section of Taxation. The comments encouraged the inclusion of specific guidance and suggested that it

preamble discusses Rev. Rul. 84-53 not in the context of the section 704(c) allocation but only with respect to its holding that a partner has a single basis in his partnership interest.

The section 704(c) gain is an amount determined at the time of a contribution that has no relevance to the partner's basis in his partnership interest and does not take into account subsequent events affecting the contributing partner's partnership basis such as the incurrence of debt by the partnership or the allocation of operating income or loss. Moreover, the amount of such section 704(c) gain is unaffected by liabilities allocated to the contributing partner or a transferee partner. There is no indication that section 704(c) gain would be allocated other than pursuant to Treas. Reg. § 1.704-3(c)(9), that is, proportionate to the interest transferred and the interest retained. The Class B Members transferred to ECIC 95% of each of their Membership Interests in EFP LLC. Such interests represent pro rata portions (by percentage and by fair market value) of the Class B Member interests in EFP LLC and, accordingly, the portion of the interest transferred should be equal to 95% of each transferor's total interest. Therefore, based on Treasury Regulation § 1.704-3(a)(7), 95% of each transferor's section 704(c) gain should be allocated to ECIC.

2. *Section 704(c) Anti-Abuse Rule*

The regulations under section 704(c) contain an anti-abuse rule which states that an allocation method (or combination of methods) is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[20] In order to fall within the ambit of this rule, the proscribed shifting of tax consequences must occur as a result of an allocation method and the allocation of tax items pursuant to this method must be made with a view toward inappropriately shifting the tax consequences among the partners.

The preamble to the final regulations indicates that this rule was not intended for broad application to all aspects of the section 704(c) regulations but rather was specifically directed toward abuses in the use of allocation methods:

> The final regulations provide an anti-abuse rule that has been revised to respond to concerns raised in comments and to target more specifically abusive transactions. The rule applies to all methods of making section 704(c) allocations, including the methods described in the final and temporary regulations. Under the rule, an allocation method (or combination of methods) is not reasonable if the contribution (or other relevant event) and the allocations with respect to the property are made with a view to shifting the tax consequences of built-in gain or

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would be appropriate to allocate the section 704(c) gain between the partners based on the fair market value of the partnership interest transferred over the fair market value of the selling partner's entire presale interest. *See* Tax Notes Today, March 23, 2000.

[20] Treas. Reg. § 1.704-3(a)(10).

loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[21]

The examples in the regulations further confirm that the application of Treasury Regulation § 1.704-3(a)(10) occurs when one of the prescribed allocation methods is used inappropriately. In one example, the traditional method is used in an "unreasonable" manner that results in shifting a significant amount of taxable income to a partner with a low marginal tax rate (through the use of expiring net operating losses) and away from a partner with a high marginal tax rate.[22] In another example, curative allocations are held to be unreasonable where they are used with a view to shifting a significant amount of partnership taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate within a period of time significantly shorter than the economic life of the contributed property.[23] There are no examples illustrating the application of the anti-abuse rule to other than the allocation methods provided in the regulations.

Any shift of section 704(c) gain in the assets contributed to EFP LLC results from the contribution of a portion of the various Class B Membership Interests to ECIC rather than from a chosen allocation method. Under Treasury Regulation § 1.704-3(a)(7), section 704 gain inherent in the Enron Assets is required to be allocated to ECIC "as it would have been allocated to the transferor partner." ECIC, in effect, steps into the shoes of the transferor partner as though it had been the original contributor of the assets to the extent of the portions of the Membership Interests transferred to ECIC. Moreover, there has been no shifting of tax consequences between the Members pursuant to an allocation method as described in the regulations and, therefore, the anti-abuse rule contained in Treasury Regulation § 1.704-3(c)(10) should have no application to the EFP LLC transaction.

D. Substance of the Partnership

Notwithstanding the technical nature of the rules described above, the IRS in certain circumstances has challenged the application of those rules to transactions entered into without a business purpose or under the general anti-abuse rules set forth in Treasury Regulation § 701-2.

1. Business Purpose / Sham Transaction

The authorities make clear that taxpayers are free to structure their business transactions as they wish even if the transactions are motivated by tax avoidance considerations.[24] To be accorded recognition for tax purposes, a transaction generally must have economic substance

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[21] T.D. 8500, 1994-1 C.B. 183.

[22] Treas. Reg. § 1.704-3(b)(2), Example 2.

[23] Treas. Reg. § 1.704-3(c)(4), Example 3.

[24] *See Rice's Toyota World, Inc. V. Comm'r*, 81 T.C. 184, 196 (1983), *aff'd* in part, *rev'd* in part and remanded 752, F.2d 89 (4th Cir. 1985).

which is compelled by business realities and is imbued with tax-independent consideration.[25] A sham transaction is one which, though it may be proper in form, lacks economic substance beyond the creation of tax benefits.[26] An evaluation of whether a transaction constitutes a sham transaction generally requires an analysis of the business purpose and a review of the objective economic effect of the transaction.[27] The courts have indicated that a taxpayer may establish that a transaction was entered into for a valid business purpose if the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and economic situation.[28] Although the cases on business purpose are legion, a recent case illustrates that a transaction with economic substance and a significant business purpose will not be disregarded even if there are significant potential tax benefits also associated with it.

In *Salina Partnership LP v. Commissioner*,[29] the Tax Court considered a transaction in which a taxpayer (FPL) invested in a partnership (Salina) in which two foreign limited liability companies owned by an unrelated bank were the other partners.[30] The partnership was promoted by Goldman Sachs as a way to pursue an investment strategy that would allow FPL to earn between 4 and 7 percent over current Treasury bill yields. Goldman Sachs suggested that the transaction be structured through a partnership to achieve favorable "off-balance sheet" financial accounting treatment. In addition, Goldman Sachs was aware that FPL had incurred a substantial capital loss on the sale of certain assets in 1991 (that might expire) and therefore structured the transaction in a manner that would allow FPL to recognize a capital gain and simultaneously create a built-in loss for its partnership interest. On December 28, 1992, FPL purchased a 98 percent interest in Salina, which caused a technical termination of Salina under the existing partnership rules. Through a series of transactions, Salina realized a short-term capital gain in 1992, $337,343,455 of which was reported by FPL and which increased FPL's basis in its partnership interest. On November 30, 1994, Salina made a distribution to FPL of cash and mortgaged-back securities in liquidation of FPL's partnership interest. FPL allocated its adjusted tax basis of $339,631,665 to the mortgage-backed securities. As FPL received payments on these securities during 1994, 1995, 1996 and 1997, it reported ordinary losses of approximately $1.1 million, $14.1 million, $212.3 million and $112 million, respectively. The IRS disallowed the short-term capital gain that FPL reported in 1992, which in turn nearly eliminated the ordinary losses FPL reported on its tax returns for 1994-1997.

The IRS argued that the partnership should be analyzed as two partnerships: one for the period from December 28-31, 1992 and one for the period thereafter. The IRS argued that FPL's investment in Salina during the initial period lacked economic substance because FPL had no

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[25] *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584 (1978).

[26] *See Karr v. Comm'r*, 924 F.2d 1018 (11th Cir. 1991).

[27] *Id.*

[28] *Compaq Computer Corp. & Subs. v. Comm'r*, 113 T.C. 214, 224 (1999).

[29] 80 T.C.M. 686 (Nov. 14, 2000).

[30] FPL is a publicly traded company that owns various subsidiaries the largest of which is Florida Power & Light.

intention to profit from Salina's investment strategy as the intention was always to liquidate the investment held under the initial investment strategy (referred to as "STAMPS") and reinvest under a different strategy (referred to as "MAPS"). The court declined to analyze the economic substance by focusing only on events occurring during the initial period, stating that such approach would violate the principal that the economic substance of a transaction turns on a review of the entire transaction.[31] The court agreed that Goldman Sachs structured FPL's purchase of the Salina partnership interest to provide FPL with a perceived tax benefit but noted that this factor, standing alone, is insufficient to render the transaction a sham in substance. The court concluded that considering all the facts and circumstances, FPL entered into the Salina transaction to achieve a valid business purpose independent of tax benefits. The opinion states that FPL demonstrated that it entered into the Salina partnership for the primary purpose of enhancing the return on its short-term investments and that Salina provided FPL with a reasonable opportunity to earn profits independent of tax benefits. The IRS also argued that while FPL stood to earn approximately $5.3 million on its investment, it had the potential to save up to $118.8 million in taxes, based on the assumption that FPL would have been unable to use any of its existing capital loss. The court disagreed with the IRS' calculation and view of the potential tax benefits but did not attempt to precisely quantify their potential value; rather the court held that the potential profits were not *de minimis* relative to the perceived tax benefit and thus, the partnership was not a sham in substance.[32]

A number of aspects of the *Salina* case are similar to the EFP LLC transaction inasmuch as EFP LLC likely will sell some or all of the Enron Assets, which could generate a large taxable gain. Based on the percentage interests held by the Members and the application of the section 704(c) rules, 95 percent of that taxable gain will be allocated to ECIC. Upon distribution of the Enron Building in a subsequent year in liquidation of ECIC's Membership Interest, ECIC's basis will reflect the gain (including 95% of the section 704(c) gain) allocated to it on these asset sales. Under current partnership rules, ECIC would have a substituted basis in the Enron Building equal to its basis in its Membership Interest, which in turn would generate larger depreciation deductions in the future. However, the fact that there may be future potential tax benefits should not be sufficient to cause EFP LLC to be treated as a sham or to cause the foregoing technical rules not to be applied as written.

Enron and the other Class B Members of EFP LLC entered into the transaction to secure $500 million of financing from unrelated banks through a structure that would provide favorable "minority interest" treatment. This type of financing is consistent with Enron's past practices inasmuch as Enron has contributed assets to other partnership structures in much the same way to secure off-balance sheet financing. Clearly, the transaction serves an important business

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[31] The court cited *Kirchman v. Comm'r*, 862 F.2d 1486 (11th Cir. 1989) *aff'g Glass v. Comm'r*, 87 T.C. 1087 (1986).

[32] While the taxpayer in *Salina* won on the sham argument, the IRS' position was sustained based on the technical issue of whether Salina's short sale of Treasury bills constituted a partnership liability. The court agreed that the short position was a liability that the partnership failed to take into account in computing its substituted basis in the assets treated as received from its partners in the technical termination of the partnership.

purpose as it facilitates the raising of $500 million of funds for use within the Enron Group. As in *Salina*, through use of the partnership structure, Enron is able to raise these funds without negatively affecting the group's consolidated financial statements. This is a significant and no less valid business purpose than that considered by the Tax Court in *Salina*. The fact that Enron might have accomplished the financing through a different structure or by using more, less or different assets to capitalize the partnership is not relevant. Enron is entitled to structure its business transactions in a manner that serves its various business needs and goals even if potential tax benefits are involved. Accordingly, the EFP LLC financing transaction should not be treated as a sham or without substance.

2. *Application of Partnership Anti-Abuse Rule*

In addition to the judicial authorities dealing with sham transactions, the anti-abuse regulations also provide the IRS with another avenue to attack transactions which have no economic substance. Treasury Regulation § 1.701-2(a), which was promulgated for this purpose, states that implicit in the intent of Subchapter K are the requirements that (i) the partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose, (ii) the form of each partnership transaction must be respected under substance over form principles, and (iii) except as otherwise provided in the regulations, the tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partners' income.

The regulations provide that if 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: (i) the purported partnership should be disregarded in whole or in part and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners; (ii) one or more of the partners should not be treated as a partner; (iii) the methods of accounting used by the partnership or a partner should be adjusted to more clearly reflect income; (iv) the partnership's items of income, gain, loss, deduction or credit should be reallocated; or (v) the claimed tax treatment should otherwise be adjusted or modified.[33]

Treasury Regulation § 1.701-2(c) provides a facts and circumstances test that is to be applied in determining whether a partnership is formed or availed of for the proscribed purpose. This test involves a comparison of the claimed business purpose and the claimed tax benefits resulting from the transaction. In addition, the regulation sets forth the following list of seven non-exclusive factors that may indicate, but do not necessarily establish, that a partnership was used in such a manner:

[33] Treas. Reg. § 1.701-2(b).

(1) the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership assets and conducted the partnership's business directly;

(2) the present value of the partners' aggregate federal tax liability is substantially less than would be the case if purported separate transactions that are designed to achieve a particular result are integrated and treated as steps in a single transaction;

(3) one or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from risk of loss, or have little or no participation in the profits from the partnership's activities;

(4) substantially all of the partners are related to each other;

(5) partnership items are allocated in compliance with the literal language of Treasury Regulation §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and such regulations; in this regard, particular scrutiny is paid to partnerships in which income or gain is specially allocated to a partner that is either legally or effectively tax exempt (such as an exempt organization, foreign person, or a taxpayer with certain tax attributes, such as net operating losses);

(6) the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained by the contributing partner or a related person; and

(7) the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part shifted to a distributee partner before or after such property is actually distributed to such distributee partner or a related person.

Treasury Regulation § 1.701-2(a)(3) expressly states that certain provisions of Subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. However, the proper reflection of income requirement may nonetheless be satisfied to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all relevant facts and circumstances, are clearly contemplated by that provision. Two examples in the regulations involve the basis rules under section 732(b) and illustrate the circumstances under which the application of these rules and resulting effects will or will not meet the clear reflection of income standard.

The first example describes a partnership "which has for several years been engaged in substantial bona fide business activities."[34] For valid business reasons, the partners agree that one partner's (A's) interest, which has a basis of $100, will be liquidated and a nondepreciable asset with a value of $60 and a basis to the partnership of $40 and related equipment with two

[34] Treas. Reg. § 1.701-2(d), Example 10.

years of cost recovery remaining and a value and basis of $40 will be distributed to A. Under section 732(b) and (c), A's $100 basis in its partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to the partnership's bases in those assets, or $50 to the nondepreciable asset and $50 to the equipment. Thus, A will have a $10 built-in gain in the nondepreciable asset and a $10 built-in loss in the equipment, which it expects to recover rapidly through cost recovery deductions. The example states that in selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in its partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A with no offsetting detriment to B or C.

The example notes that the transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard, are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. The example holds that in this instance, taking into account the facts and circumstances, the transaction will be treated as meeting the proper reflection of income standard.

Another similar example reaches a different result with respect to a partnership that had been engaged for several years in the development and management of commercial real estate projects.[35] In the example, an unrelated party (X) that wished to acquire and hold land owned by the partnership contributed $100 to the partnership in exchange for an interest. Subsequently (at a time when the value of the partnership's assets had not materially changed), the partnership distributed the land (with a value of $95 and basis of $5) and another asset (with a value and basis of $5) in liquidation of X's interest. The ruling indicates that the second asset was an insignificant part of the economic transaction but was important to achieve the desired tax results. Under section 732(b) and (c), X's $100 basis is allocated between the assets distributed in proportion to their bases to the partnership, or $50 each. X then planned to sell the second asset for its value of $5, recognizing a loss of $45, and thus recovering a substantial portion of the purchase price of the land almost immediately.

The example notes that in selecting the assets to be distributed, the partners had a principal purpose to take advantage of the fact that section 732(b) and (c) would cause a shift of a portion of the partner's basis economically allocable to the land that X intended to retain to an inconsequential asset that X intended to dispose of quickly. The example states that section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. Accordingly, the

[35] Treas. Reg. § 1.701-2(d), Example 11.

example holds that the transaction does not properly reflect income due to the basis distortions caused by shifting a significant portion of the partner's basis to an inconsequential asset.

In the case of EFP LLC, it is not clear that the creation and use of the partnership financing structure will result in an aggregate federal tax liability substantially less, taking into account present value concepts, than had Enron and the other Class B Members owned the partnership assets directly (Factor 1). Factor 2 should not apply because there are no separate transactions that could be integrated to achieve a different result. Factor 3 also should not apply because all Enron Members have an interest in the capital and profits of EFP LLC of not less than five percent and the holder of the Class C Preferred interest has no effect on the basis determinations that may give rise to a future tax benefit. With respect to factor 4, all of the Members of EFP LLC are Enron affiliates except for Zephyrus LLC, the Class C Member. Although it is possible that the IRS could challenge the treatment of the Class C Member as a partner, the presence of this unrelated party confirms that this is not merely an intragroup transaction but rather is subject to outside scrutiny and influence.[36] Accordingly, even if the Class C Member were not treated as a partner, it is nonetheless an important participant in the transaction and this factor should not be applicable. Factors 5, 6 and 7 should not apply as none of the members are effectively tax exempt and the benefits and burdens of the property contributed actually have been transferred to EFP LLC.[37]

In addition, the transaction should not be vulnerable to attack under the foregoing regulation, even if there are significant potential tax benefits, as it was entered into for the valid business purpose of obtaining $500 million of financing in a manner that permits favorable financial accounting treatment. Moreover, to the extent that any of the Enron Assets are sold, such sales will produce taxable gain that will be allocated to members of the Enron Group and will be subject to taxation just as if such sales had been made directly by the Class A Members. As illustrated by Example 10 described above, the fact that the operation of the partnership basis rules may result in a substituted basis for the Enron Building that reflects a substantial part of that gain is not sufficient to disregard the transaction as not satisfying the proper reflection of income standard. Rather, unlike Example 11 which involved an "inconsequential" asset, the Enron Building clearly is a valuable asset that is integral to the operation of the business of the Enron Group. As a result, the anti-abuse provisions of Treas. Reg. § 701-2 should not be applicable to the transaction.

OPINIONS

Based on the initial and continuing accuracy of all of the foregoing facts, assumptions, representations and documents, it is our opinion that for U.S. federal income tax purposes:

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[36] Even if the Class C Member were disregarded as a partner, EFP LLC nonetheless should be treated as a partnership. *See* Rev. Rul. 75-19, 1975-1 C.B. 382.

[37] The Enron Group currently has net operating losses that may be used to offset gain from the sales of assets; however, the gain would be included in the Enron Group's consolidated tax return in exactly the same manner regardless of whether the Enron Assets continued to be held by members of the Enron Group or by EAH LLC.

(i) no gain or loss should be recognized by Enron or the other Class B Members upon the contributions of the Enron Assets to EFP LLC, EIH LLC and EAH LLC;

(ii) no gain or loss should be recognized by ECIC or the Class B Members upon the contribution to ECIC of 95% of the Class B Members' Class B Membership Interests in EFP LLC;

(iii) 95% of the section 704(c) built-in gain with respect to the Enron Assets should be allocable to ECIC by reason of the contribution of 95% of the Class B Membership Interests to ECIC, and upon the sale of any of the Enron Assets, ECIC's basis in its Class B Membership Interest in EFP LLC should be increased by the amount of such built-in gain; and

(iv) the creation and use of EFP LLC as a financing vehicle should not be disregarded as a sham nor subject to the anti-abuse provisions of either Treas. Reg. § 1.704-3(c)(10) or Treas. Reg. § 1.701-2.

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

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

Very truly yours,

Vinson & Elkins L.L.P.

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