DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE
NOTICE OF PROPOSED ADJUSTMENT TO TAXPAYER DURING EXAMINATION
ENRON CORP. & SUBSIDIARIES 1995 & 1996

Entity: Enron International Inc EIN 76-0385191

SAIN: 710-07 ISSUE: Gain on Sale Puerto Quetzal Power Corp. Common Stock

Amount of adjustment for Issue No. ~~98~~ 127

1995: ______ 1996: 2,020,509

Based on the information made available and discussions with the designated taxpayer representative listed iin the Communication Disclosure Agreement, the attached proposed "Explanation of Adjustment" will be included in the Revenue Agent Report. If additional information is available that would alter or reverse this proposal, please furnish such immediately. Taxpayer representative(s) with whom the issue was discussed prior to this written "Notice of Proposed Adjustment":

Name: Ed Coates Title Tax Manager

Name: ______ Title ______

Date the above representative was notified this Notice with attached "Explanation of Adjustment" would be prepared:

Thie notice and attached "Explanation of Adjustment" has been reviewed by the following IRS personnel.

Team Member:	Gerald Richards	Date: 5 May 1999
Team coordinator:	Jack Kotter	Date: 5/6/99
Specialty Manager:	Nieves Narvaez	Date: 5-5-99
Case Manager:	Glenn Gray	Date: 5/6/99

Receipt acknowledged and indication of position by taxpayer representative to whom this notice, with attached "Explanation of Adjustment" is delivered:

X Agreed ______ Unagreed ______ No Decision

Name: Edward L. Coats Title: Vice President-Tax Audits

Subsequent "Explanation of Adjustments" revision(s) were provided as

Rev. 1 Date: ______ Rev. 3 Date: ______
Rev. 2 Date: ______ Rev. 4 Date: ______

Date taxpayer's position on adjustment and written explanation received (if Unagreed and not provided at time of original notice of this adjustment):

______ Agreed __ __ Unagreed ______ No Decision
Written position provided? Yes ___ No ______ Date provided

Senate Finance Committee

EXHIBIT 7

DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE
NOTICE OF PROPOSED ADJUSTMENT TO TAXPAYER DURING EXAMINATION
ENRON CORP. & SUBSIDIARIES 1995 & 1996

Entity: Puerto Quetzal Power Corporation EIN: 76-0381261

SAIN 710-07 ISSUE: Fuel & Power Expenses IRC 162 and Amortization Expense IRC 197

Amount of adjustment for Issue No.

1995: 1,867,872 1996: 800,000

Based on the information made available and discussions with the designated taxpayer representative listed iin the Communication Disclosure Agreement, the attached proposed "Explanation of Adjustment" will be included in the Revenue Agent Report. If additional information is available that would alter or reverse this proposal, please furnish such immediately. Taxpayer representative(s) with whom the issue was discussed prior to this written "Notice of Proposed Adjustment":

Name: Ed Coates Title: Tax Manager

Name: ______ Title: ______

Date the above representative was notified this Notice with attached "Explanation of Adjustment" would be prepared:

Thie notice and attached "Explanation of Adjustment" has been reviewed by the following IRS personnel.

Team Member: Gerald Richards Date: 5 May 1999

Team coordinator: Jack Notter Date:

Specialty Manager: Nieves Narvaez Date: 5-5-99

Case Manager: Glenn Gray Date:

Receipt acknowledged and indication of position by taxpayer representative to whom this notice, with attached "Explanation of Adjustment" is delivered:

______ Agreed ______ Unagreed ______ No Decision

Name: ______ Title: ______

Subsequent "Explanation of Adjustments" revision(s) were provided as

Rev. 1 Date: ______ Rev. 3 Date: ______

Rev. 2 Date: ______ Rev. 4 Date: ______

Date taxpayer's position on adjustment and written explanation received (if Unagreed and not provided at time of original notice of this adjustment):

______ Agreed __ __ Unagreed ______ No Decision

Written position provided? Yes No ______ Date provided

ISSUES:

	1995		1996
	COST OF GOODS SOLD -- Fuel & Power Expenses	OTHER DEDUCTIONS -- Amortization Expense	OTHER DEDUCTIONS - Amortization Expense
Per Return	18,437,704	1,547,933	2,014,600
Per Audit	16,903,165	1,214,600	1,214,600
Adjustment	1,534,539	333,333	800,000

Issue 1: Allowance as ordinary and necessary business expenses of Puerto Quetzal Power Corporation (IRC section 162) expenditures incurred to fund payment obligations to Panamanian Corporation, Sun King Trading Company.

Issue 2: $12,000,000 Termination payment to Sun King Trading -- allowance of amortization expense (IRC section 197).

FACTS

Events Prior to Tax Period 1995 [1]

On 13 January 1992, Texas Ohio Power (TOP), (unrelated to Enron) signed a 15-year Power Sales Agreement with Empresa de Energia de Guatemala (EMPRESA) for power from a 160-MW, oil-fired barge mounted power plant to be built and then sited at Puerto Quetzal on Guatemala's Pacific Coast. EMPRESA is the primary supplier of thermoelectric power to Guatemala, and is 92% owned by the Guatemalan Government.

Under terms of this Power Sales Agreement:

> TOP was required to provide EMPRESA 90 to 110 MW of capacity and the corresponding energy from the Puerto Quetzal power plant.
>
> EMPRESA is obligated to pay for the capacity (not in excess of 10 MW) and to pay for at least 50% of the available energy output.
>
> EMPRESA makes weekly fixed capacity payments (covering a portion of the total capacity payments due for the current month). -and-

[1] Please note, the organizational chart -- **EXHIBIT "A"** should be referenced contemporaneously with any further reading.

4. EMPRESA makes weekly energy payments (covering a portion of the total energy payments due for the previous month).

On 24 February 1992, an Agreement was signed by and between TOP and a Panamanian entity -- Sun King Trading Company (SUN KING) requiring TOP to pay SUN KING 16% of the capacity payments and 21% of the energy payments tendered by EMPRESA.

On 12 March 1992, TOP and SUN KING executed an amendment to the 24 February (Original) Agreement changing the payment to 6% of all revenues.

On the same date -- 12 March 1992, Enron Development Corporation (EDC) -- *formerly: Enron Power Development Corporation* -- entered into an Agreement with TOP whereby in consideration for TOP transferring the Power Sales Agreement to EDC, EDC agreed to pay (among other sums) *"an amount each month equal to 6% of the gross revenues generated by the sales of electricity and payment for contract capacity under the Power Contract"*.

In two (2) letters dated 12 March 1992:

1 TOP notified EDC that the *"right of a monthly payment of 6% of the gross revenues generated by the sales of electricity and payment for contract capacity under the Power Contract..., has been legally and effectively assigned in favor of SUN KING TRADING COMPANY, INC."* Furthermore, the letter set out that monthly payments be directed to Sun King Trading Company, Inc. at 6a avenida 20-25 zona 10, 8th floor, Guatemala City, Guatemala. -AND-

2. EDC informed SUN KING of receipt of the TOP letter and acknowledged that EDC would make the required monthly payments to SUN KING.

On 22 September 1992, Enron Development Corporation (EDC) -- domestic subsidiary of the Enron Corporation --formed a U.S. subsidiary -- PUERTO QUETZAL POWER CORP. (PQPC) -- to build, own and operate a power plant at Puerto Quetzal, Guatemala (through its Guatemalan branch).

On 13 November 1992, <u>two</u> Agreements were signed:

> "Assignment and Assumption Agreement" -- Which sets out that EDC transfers and PQPC assumes, all EDC's title and interest in the "Assets" <u>and</u> all of EDC's liabilities and obligations with respect to the "Assets". The Assets were set out as (a) the Power Contract and (b) any and all other assets owned or held by EDC with respect to the Project.
>
> "Operation and Maintenance Agreement" -- Pursuant to which PQPC ("Owner") appoints Electricidad Enron de Guatemala S.A. (EEG), a related affiliate organized under the laws of Guatemala, as "Operator" of the barge-mounted power plant (the "Project"). Article IV of this "O&M" Agreement sets out that Operator will submit to Owner a <u>monthly invoice for all reimbursable expenses</u>.

In February 1993, the Puerto Quetzal Plant commenced commercial operations. On March 1, 1993, EDC received a letter from SUN KING requesting that moneys be paid into either one of two named bank accounts in Miami for credit to Deutsch - Suedamerikanische Bank A.G. Miami

Agency. This meant Sun King opted to receive payment in U.S. dollars. Additionally, it was also revealed that SUN KING was a Panamanian Corporation not a corporation registered in Guatemala.

On 31 March 1993, three (3) events took place:

1. The "O&M" Agreement was amended to state the Project's fuel oil requirements will be supplied from two (2) contracts held by Assignee -- Enron Power Oil Supply Corporation (EPOS).

2. A "Fuel Supply and Management Agreement" was entered into by and between EEG and EPOS (setting forth that EPOS will supply, or cause to be supplied, fuel oil to the Project in such quantities requested by EEG (as Operator). The term of the Agreement was set at fifteen (15) years. The price for the fuel oil supply and management services provided by EPOS was set at a monthly amount (to be paid by EEG computed as the sum of: (a) an amount equal to six percent (6%) of the gross monthly revenues of Puerto Quetzal ("Monthly Fee"), and (b) the invoice amounts actually paid by EPOS to its fuel oil suppliers.

3. EDC sold 50% of all issued and outstanding stock of PQPC to King Ranch Power Corporation, a U.S. Corporation. Sales Price was $15,500,000, and EDC reported a short-term capital gain of $7,225,000.

In November 1994, Enron Corporation completed a public offering of 48% of Enron Global Power & Pipelines L.L.C. (EPP). [2] EDC transferred it's remaining 50% interest in the issued and outstanding stock of PQPC for an interest in EPP.

On 16 December 1994, King Ranch Power Corporation exercised a option under an existing Agreement, by and between EDC and King Ranch Power Corporation, and sold its 50% interest in PQPC to EDC's designee -- Enron International Inc. -- for cash $15,200,000.

As a result, at 12/31/94, the stockholders of PQPC are Enron's domestic subsidiary -- Enron International, Inc. and Enron Global Power & Pipelines L.L.C.

Events Occurring During 1995 & 1996 Tax Periods

Information Document Request #12-084 (issued 9 February 1999) requested taxpayer to provide a summary of all payments tendered SUN KING during the period 1/1/95 to 8/8/95, by Enron and its consolidated worldwide affiliates. The response to IDR #12-084 (received 15 April 1999) detailed the following payments to SUN KING:

[2] EPP was formed to own and operate most of Enron Corporation's power and pipeline assets in developing countries.

Date SUN KING Payment	Amount SUN KING Payment	Payor	Payor's Accounting SUN KING Payment
2/3/95	249,539	EPFC -- Enron Power Fuels Corp	Acct. Rec. – EEG
3/6/95	7,000	EEG (Operator)	EEG -- Cost of Goods Sold
4/5/95	7,000	EEG	EEG -- Cost of Goods Sold
5/3/95	7,000	EEG	EEG -- Cost of Goods Sold
5/26/95	500,000	EEG	EEG -- Cost of Goods Sold
6/26/95	250,000	EEG	EEG -- Cost of Goods Sold
7/4/95	257,000	EEG	EEG -- Cost of Goods Sold
8/4/95	257,000	EEG	EEG -- Cost of Goods Sold
	1,534,539		

Additionally, Taxpayer's response reconciled the 1995 SUN KING payments to the monthly gross receipts of PQPC as follows: [3]

Month/Yr.	PQPC's Monthly Gross Receipts
Jan. 95	4,291,811
Feb. 95	4,188,890
Mar/Apr. 9	8,368,244
May 95	4,419,503
June 95	4,499,406
	25,767,854
	6%
	1,546,071

Note #2 of the PQPC consolidated financial statements for quarter ended 30 September .995, set out:

> "The prepaid asset of $12 million represents the cost of the buyout of Sun King Trading Company, Inc. and Centrans International, Sociedad Anonima ("Centrans") per the Termination and Release Agreement dated August 22, 1995. The cost is being amortized on a straight -line basis over the remaining life of the project".

[3] Taxpayer noted difference between 1995 payments tendered SUN KING and 6% of the monthly gross receipt: paid PQPC by EMPRESA is due to month-to-month timing differences.

Taxpayer, responding to Information Document Request #12-074, provided the "Termination and Release Agreement". Review of this Agreement, by and between EDC, SUN KING, and CENTRANS, details the following:

Sun King has assigned Centrans its right to receive "Monthly Payments" pursuant to Paragraph 1.D of the EDC/TOP Agreement dated March 12, 1992.

2 Sun King owes EDC a Note Payable (dated 3/11/93) in the amount of $435,000.

3 If EDC pays Centrans (or causes to be paid) U.S. $12,000,000, and cancels the Sun King Note Payable, then Sun King is willing to release EDC and its affiliates from any and all obligations to make the Monthly Payments that have accrued or would accrue on or after 1 August 1995.

4. Sun King nominates the following bank accounts to receive EDC's $12,000,000 payment:

BARNETT BANK OF SOUTH FLORIDA, Miam	FEDERAL RESERVE BANK, Miami
For credit to: Duetsch-Suedamerikanische Bank Ag, Miami Agency	For credit to: Duetsch-Suedamerikanische Bank Ag, Miami Agency
Acct. no. 137 694 2752	Acct. no. 0660 10856
For further credit to	For further credit to
Acct. no. 02-693574	Acct. no. 02-693574
Name: Centrans Internacional, S.A.	Name: Centrans Internacional, S.A

PQPC's 1995 and 1996, Form 1120 reports the $12,000,000 payment to Sun King on the Schedule L (Balance Sheet) as an Intangible Asset. For 1995 and 1996, PQPC has taken amortization expense deductions (per IRC section 197) of $333,333 and $800,000, respectively

AT ISSUE:

Since for 1995

a EEG (Operator) has assumed the obligation to make SUN KING payments.

b. EEG collects monthly, from PQPC, the funds required to make SUN KING payments by charging PQPC its fuel cost as a reimbursable item under the Puerto Quetzal O&M Agreement.

EEG pays EPOS (supplier) an monthly expense equal to 6% of the gross receipts of the Puerto Quetzal power plant.

Then, the <u>first</u> question is: Whether or not the 1995 deductions taken by PQPC for funds transferred to EEG to satisfy the SUN KING obligation are ordinary and necessary business expenses?

2. The <u>second</u> question is in reality two (2) questions:

a. Whether the lump sum ($12,000,000) debt termination payment tendered SUN KING creates an identifiable intangible asset -- a Capital Asset -- for which IRC section 197 allows an amortization deduction? -AND-

b. Whether the 1995 monthly payments tendered SUN KING (if not ordinary and necessary business expenses) constitute an identifiable intangible asset -- a Capital Asset -- for which IRC section 197 allows an amortization deduction?

LAW & ARGUMENT:

IRC SECTION 162

IRC section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

In Lincoln Savings 403 U.S. 352, the Supreme Court determined that, to qualify for deduction under @ 162(a), "an item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense." -- see *Indopco v. Commissioner*, 503 U.S. 79.

The words "ordinary and necessary" have been in the law since 1913, but have still not been precisely defined. The cases and rulings fall into six categories:

1. unusual and extraordinary payments;
2. payments against public policy;
3. fines and penalties;
4. bribes, kickbacks, etc.;
5. treble damages under antitrust law, and
6. lobbying expenses. -- see Bittker & Lokken, <u>Federal Taxation of Income. Estates, and Gifts</u>, 1, 20.3 (2d Ed. 1989).

In *A. Giurlani & Bro. v. Commissioner*, 119 F.2d 852, 41-1 USTC 428, (USCA 9, 1941) the Circuit Court stated:

> It is not sufficient compliance with the statute that the expense sought to be deducted is an ordinary or a necessary expense. "in order that such payments may meet the requirements of the statute, they must be both an ordinary expense and necessary expense." *Lloyd v. Commissioner*, 7 Cir., 55 F. 2d 842, 844 3 USTC 873).

In *Belser v. Commissioner*, 10 TC 1031, the United States Tax Court stated:

> To support the right to a deduction of expenses, the taxpayer should furnish proof as full and definite as is reasonably possible. His mere estimate of amounts claimed and opinion testimony that such amounts are proper business expenses fall short of the full disclosure of facts which is normally requisite to warrant a finding in his favor.

The significance of ordinary is to distinguish between capital expenditures which must be amortized if deductible at all and expenditures for current operations of the business. see *Commissioner v. Teller,* 383 U.S. at 689, 86 S.Ct. 1120 (1966), quoting *Welch v. Helvering,*290 U.S. 111, 113, 54 S. Ct. 8,9, 78 L. Ed. 212 (1933).

IRC SECTION 263

IRC section 263 of the Code allows no deduction for a capital expenditure -- an "amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." @ 263(a)(1).

The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery: While business expenses are currently deductible, a <u>capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise</u>. See *Indopco v. Commissioner 503 U.S. 79.*

Courts more frequently have characterized an expenditure as capital in nature because "the purpose for which the expenditure is made has to do with the corporation's operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year." *General Bancshares Corp. v. Commissioner,* 326 F.2d at 715. See also *Mills Estate, Inc. v. Commissioner,* 206 F.2d 244, 246 (CA2 1953).

IRC SECTION 197

Section 197 was added to the Code by the Omnibus Budget Reconciliation Act of 1993 and affects taxpayers that acquired intangible property after August 10, 1993, or made a retroactive election to apply the 1993 law to intangibles acquired after July 25, 1991. Section 197(a) permits an amortization deduction with respect to the capitalized costs of a "section 197 intangible" that is acquired by the taxpayer and held in connection with the conduct of a trade or business or for the production of income. The amount of the deduction is determined by amortizing the adjusted basis of the intangible ratably over a 15-year period. Section 197(g) of the Code grants authority to the Secretary of the Treasury to prescribe appropriate regulations.

A "section 197 intangible" includes goodwill, going concern value, workforce in place, information base, know-how, customer-and supplier-based intangibles, governmental licenses, permits, covenants not to compete and other similar arrangements, franchises, trademarks, trade names, and contracts for the use of the foregoing assets --defined in Prop. Reg. [sections] 1.197-2(b). [4]

CONCLUSION:

IRC Section 162

Taxpayer has presented documentation to establish that it purchased a Power Sales Agreement from Texas Ohio Power Co., a unit of Houston-based gas pipeline operator and marketer Texas Ohio Gas. As the front-end developer, TOP assigned its rights in the 15-year Power Sales Agreement to EDC. The Agreement by and between EDC (assignee) and TOP (assignor) did not address the existence of a separate contract by and between TOP and the Panamanian corporation -- Sun King Trading.

As a result of the EDC/TOP Agreement dated 12 March 1992, EDC assumed TOP's previous obligation to SUN KING.

Therefore, the question turns on the nature of the services performed by SUN KING for and on behalf of TOP. Information has been developed that:

1. The services performed by the SUN KING group can be characterized as a " finder fee" arrangement.

2. SUN KING is not a formal business group, but instead a group of individuals which individually, or as a group, represented certain interests of TOP leading up to EMPRESA's signature on the 15-year power sales agreement.

As a result, as to the <u>first</u> question before the Government: *Whether it is "ordinary" for PQPC to pay a "finders fee", and take such payment as a current period expense for carrying on the business of operating an electrical power plant?*. The Government takes the position:

While PQPC did not directly pay the 1995 monthly obligation to SUN KING, it directly provided the funds, and took a current period deductions for all funds so transferred to payor -- EEG. (billed by EEG to PQPC as reimbursable fees)

- Nothing has been presented which suggests this "finders fee" is an "ordinary" expenditure benefiting only the current (1995) period operations of PQPC's power plant.

Any benefit attaching to the 1995 monthly SUN KING payments benefits more than just the current tax period.

[4] The proposed regulations were published in the FEDERAL REGISTER on January 16. 1997 (62 Fed. Reg. 2336) and in the INTERNAL REVENUE BULLETIN on March 31, 1997 (1997-13 I.R.B. 12).(1) A public hearing was held on the regulations on May 15, 1997.

Taxpayer can argue inheritance of the SUN KING obligation was "necessary" for EDC to secure the Power Sales Agreement from TOP.

- But, in order for the SUN KING payments to meet the requirements of IRC section 162, they must be both an ordinary and a necessary expense.

  Therefore, any expenditure incurred by PQPC (period 1/1/95 to 8/22/95), to fund the "finders fee" obligation to SUN KING is disallowed under the authority of IRC section 162.

IRC Section 197:

Given the position that PQPC's monthly expenses incurred to fund SUN KING payments are disallowed under IRC 162, the inquiry shifts to taxpayer's position that the $12,000,000 lump sum payment releasing EDC (and assignee PQPC) from its obligation to SUN KING is a capital expenditure creating a "section 197 intangible".

IRC section 197 and the proposed regulations thereunder do not provide an asset classification for the expenditure in question. IRC section 197(d)(1)(D) provides "section 197 intangible" status for any license, permit or right granted by a governmental unit, agency or instrumentality thereof.

Finder's fees are not enumerated as capital expenditures qualifying as a "section 197 intangible", so a provision for amortization is not provided by IRC section 197(a) for either:

(a) the $12,000,000 lump sum payment, or

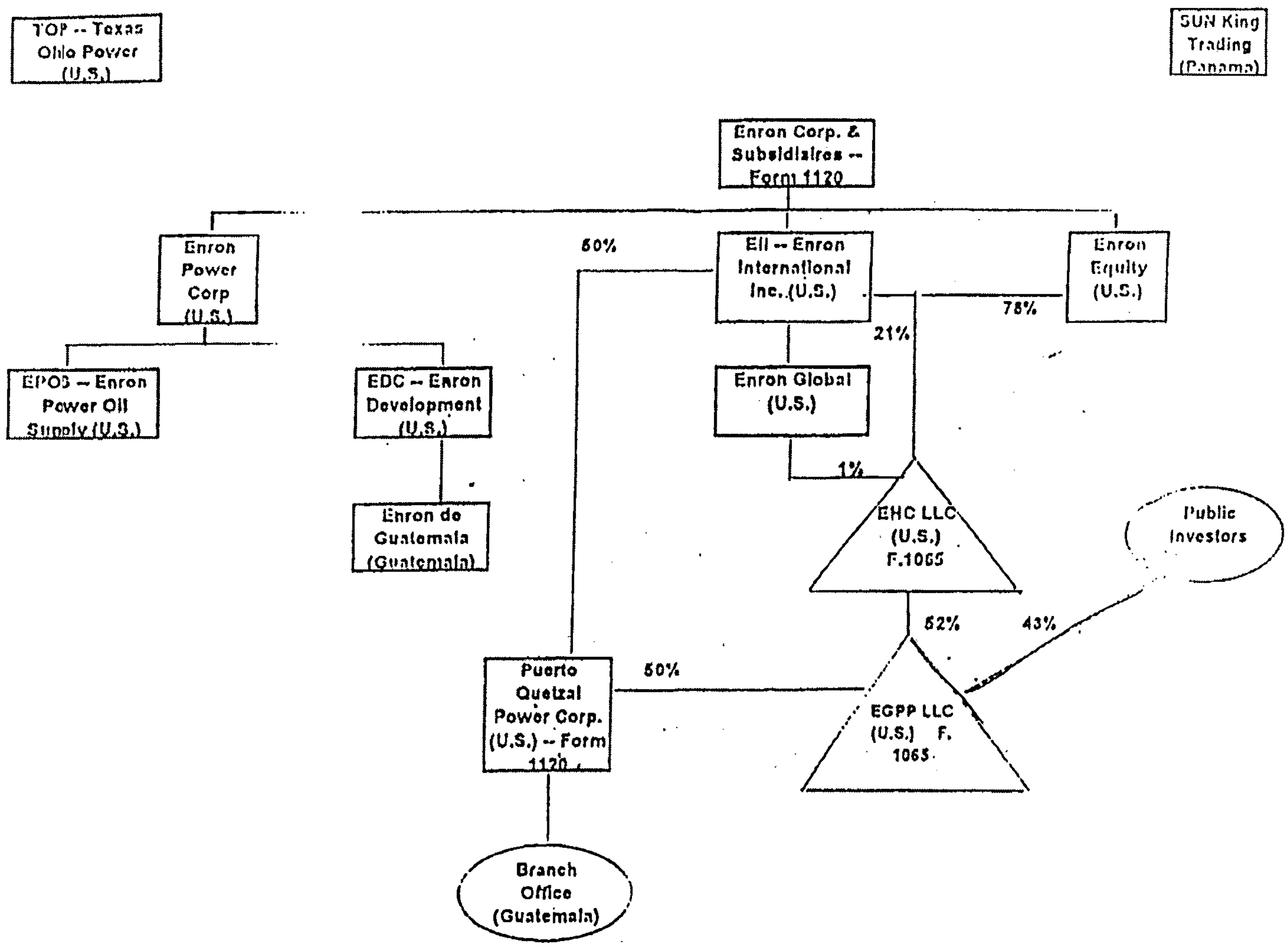
(b) the total $1,534,539 in monthly payments tendered SUN KING.

In Summary:

Under the authority of IRC sections 162, 263, and 197, the deductions claimed by PQPC, in tax years 1995 and 1996, are adjusted, and the disallowed amounts set out on page #1.

EXHIBIT A

EXHIBIT A"


TOP -- Texas Ohio Power (U.S.)
SUN King Trading (Panama)
Enron Corp. & Subsidiaires -- Form 1120
Enron Power Corp (U.S.)
EPOS -- Enron Power Oil Supply (U.S.)
EDC -- Enron Development (U.S.)
Enron de Guatemala (Guatemala)
EII -- Enron International Inc. (U.S.)
Enron Global (U.S.)
Enron Equity (U.S.)
50%
21%
78%
1%
EHC LLC (U.S.) F.1065
Public Investors
52%
43%
Puerto Quetzal Power Corp. (U.S.) -- Form 1120
50%
EGPP LLC (U.S.) F. 1065
Branch Office (Guatemala)