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Refreshing Capital Loss Carry Forwards: A Case Study Of Florida Power And Light

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Abstract

Estimates indicate that U.S. corporations illegally shelter $10 billion of taxable income each year. This case study describes how FPL Group, Inc., the parent company of Florida Power and Light, allegedly engaged in an elaborate trading strategy to generate a $337 million paper capital gain in order to refresh an expiring real capital loss carry forward. The trading strategy involved an offshore partnership, a large foreign bank, a major U.S. investment bank, obscure accounting regulations, and a series of fixed income transactions that collectively represented one of the more elaborate tax-motivated strategies of the 1990's. A recent United States Tax Court ruling held that while the strategy did not rise to the level of a tax sham and had sufficient economic substance to satisfy the business purpose doctrine, FPL Group Inc. did not comport with extant accounting regulations regarding its obligation on a short position in U.S. Treasury bills. The Court therefore disallowed the use of the paper gain to refresh the expiring capital loss carry forward. FPL Group Inc. will likely appeal the ruling. This case study may be of added interest in light of recent developments involving Enron Corporation.

I. Introduction

In December 1992, various participants of Salina Partnership, L.P. engaged in a series of transactions involving the purchase and sale of U.S. Treasury securities, repurchase and reverse repurchase agreements, and related activities. The Commissioner of Internal Revenue contended that the elaborate partnership and its subsequent transactions - which were "sponsored" by Goldman Sachs - were solely intended to manufacture a paper capital gain of approximately $337 million to FPL Group, Inc.[2] FPL Group Inc. is the parent company of Florida Power and Light (hereafter FPL) – currently the largest utility in the United States. Such a gain was allegedly sought by FPL in order to refresh an expiring real capital loss carry forward occasioned by FPL's sale of a number of its subsidiaries - most notably Colonial Penn Group. The Commissioner held that FPL apparently hoped to generate real gains thereafter, thus making use of the refreshed loss carry forward, and to engage in another series of subsequent sham transactions that would produce a paper capital loss to offset the manufactured gain.

[1] The author thanks Robert Bird, Seton Hall University, and an anonymous referee for helpful comments.

[2] See *Salina Partnership, LP v. Commissioner*, 80 T.C.M. (CCH) 686 (2000).

The purpose of this paper is to impart the details of this case, which represents one of the more elaborate tax-motivated strategies of the 1990's. [For case studies of other alleged tax-motivated strategies involving offshore partnerships, complex securities transactions, and obscure accounting regulations, see Tucker (2002).] This paper proceeds as follows: Sections II and III summarize the transactions of the various entities involved. Section IV analyzes the economic substance of the original partnership structure. Section V analyzes the economic substance of the transactions undertaken by the partnership, including FPL's prospects for profit. Section VI analyzes the economic substance of Salina's short sale obligation, which became the key issue to the Court. The November 14, 2000 ruling of the United States Tax Court is discussed in Section VII. Section VIII provides a brief conclusion. Before turning to these sections, however, it is useful to now provide the reader with a thumbnail of the key transactions and how they produced a *bona fide* (as claimed by FPL) capital gain. Said thumbnail serves as a type of roadmap for following the remainder of this complex case study.

II. Thumbnail Of Key Transactions

FPL allegedly wanted to refresh an expiring loss carry forward of about $337 million. Goldman Sachs devised a plan in which a newly created offshore partnership, Salina, engaged in a series of securities transactions. Originally, Salina consisted of two partners that were also newly created and, in a complex way, related to and managed by a large foreign bank - ABN AMRO Holdings NV. After its formation in mid-December 1992, Salina immediately engaged in a series of securities transactions, most notably the short sale of $344.4 million worth of 6-month Treasury bills and the purchase of $140.3 million worth of 2-year Treasury notes. Salina also engaged in a reverse repurchase agreement with ABN's New York office, that is, it loaned ABN NY $343.9 million. Salina borrowed, via a repurchase agreement, from Goldman Sachs $70.1 million, and the two original partners collectively posted $75.4 million in capital.

Following these transactions that became effective December 18, 1992, Salina's balance sheet was as follows:

ASSETS	$(millions)
Time Deposits	5.1
2-Year Treasury Note	140.3
Reverse Repo	343.9
LIABILITIES	
6-month Treasury Bills Sold Short	344.4
Repo	70.1
PARTNERS' CAPITAL	75.4

Just ten days later, on December 28, 1992, FPL purchased a 98% partnership interest in Salina. Under extant partnership accounting rules[3], this act occasioned a liquidation of the partnership whose assets and liabilities were then immediately re-contributed to an allegedly new partnership. This new partnership kept the same name and same tax identification number as the liquidated partnership.

The liquidation/re-contribution occasioned the desired gain of $337 million as follows: The short bill position was valued by FPL at zero, leaving approximately $145 million (the "outside basis") in liabilities and equity for the new partnership (approximately $70 million on the Goldman repo and $75 million of equity).[4,5] The approximately $5 million of time deposits (cash) was then subtracted from the outside basis to give an "inside basis" of $140 million. This amount was then proportionally allocated to the remaining assets of approximately $483 million: the approximately $343 million loan to ABN on the reverse repo plus the approximately $140 million worth of Treasury notes. The loan represented about 71% of the remaining assets while the notes the other 29%. Thus the inside basis of $140 million was allocated as follows: $99.4 million to the loan (71% of $140 million) and $40.6 million to the notes (29% of $140 million). Under existing partnership accounting rules previously cited, this allocation would therefore occasion a paper gain on the loan, to be triggered whenever the loan receivable is collected, of $243.6 million ($343MM - $99.MM). This allocation would also occasion a paper gain on the notes, to be triggered whenever the notes are sold, of $99.MM ($140MM - $40.6MM). Adding these two amounts results in a total paper gain of $343 million.

Now, by the end of December 1992, and therefore after FPL became a 98% partner in Salina, the loan receivable was indeed collected and the notes were indeed sold. Under existing partnership accounting rules, FPL thereby obtained 98% of the $343 million gain, which comports with its desired gain of $337 million.[6] December of 1992 also comported with the end of FPL's fiscal tax year as well as the expiration of its loss carry forward.

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[3] IRC section 708(b)(1)(B) states that a sale 50% or more of a partnership within a twelve-month period constitutes a termination of said partnership.

[4] Importantly, FPL contended that the Treasury bill short sale obligation was not a "liability" as governed by IRC section 752, but instead was governed by IRC section 1233 and regulation 1.1233-(1)(a), which states that a short sale is treated as an "open transaction" for income tax purposes. Here a short seller can defer recognition of income until replacing the borrowed shares closes the transactions. Therefore, any adjustments to FPL's basis must be deferred until the short sale transaction is complete. Remarkably, neither subchapter K partnership provisions of the IRC nor relevant regulations interpreting IRC section 752 clearly define "liability". At the end of the day, the real contribution of the Court's decision in the Salina/FPL case may lie in providing some clarity as to the meaning of "liability" for partnership tax accounting purposes.

[5] IRC section 732(b) discusses the pertinent basis allocations resulting from the termination of a partnership.

[6] If a corporation/parent (FPL) owns more than 50% of a partnership, the partnership's financial statements are integrated into those of the corporation/parent. In other words, the $337 million gain was reflected in FPL's financials for 1992.

III. Details Of Transactions

This section provides more detail regarding the formation of Salina and its security transactions. Table 1 provides a brief chronology of the key transactions and thus serves as a reference map for the reader.

TABLE 1: Summary of Salina's Transactions

Date	Event	Significance
12/17/92	Pallico and Caraville form Salina with $75MM in capital from ABN.	Goldman-sponsored strategy put into action.
	Transaction 1: Purchase $140MM face-value 2-year Treasury Notes; $70MM financed via repo with Goldman.	Transaction 1 serves as an interest rate hedge against the short Treasury bill position of transaction 2. FPL claims that transactions 1 and 2 collectively represent a yield-spread play.
	Transaction 2: Short $350MM face-value 6-month Treasury Bills.	Transactions 2 and 3 create a non-cash asset necessary to generate a gain of $344MM.
	Transaction 3: Reverse repo with ABN NY for $344MM on Treasury bills.	
12/28/92	Transaction 4: FPL buys a 98% interest in Salina and FPL pays $2.65MM to various parties including Goldman and ABN.	Salina is terminated under IRC section 708. A new partnership, also known as Salina, is formed. The bases of the new partners is determined under IRC section 732.
12/31/92	Transaction 5: Salina sells notes.	Transactions 5, 6, and 7 trigger a $337MM capital gain for FPL under FPL's tax accounting treatment, particularly its valuation of the short bill position, as of 12/28/92, at $0 under IRC section 1233. FPL's fiscal tax year ends. FPL refreshes an expiring capital loss carry forward.
	Transaction 6: Salina closes Goldman repo.	
	Transaction 7: Salina reverses short bill Position and closes ABN NY reverse repo.	
01/01/93	Salina trades mortgage-backed securities.	BEA begins active money management services.
01/15/01	Salina pays Caraville first of eight installments of Caraville's $750,000 capital investment.	Caraville's equity capital begins to be repaid.
10/15/01	Salina pays Caraville $93,750.	Caraville ceases to be a partner in Salina.
11/01/94	Salina is liquidated.	Partnership ceases to exist.
11/14/00	Court rules against FPL.	Court finds that FPL's treatment of Salina's short bill position is incorrect, siding with the Commissioner's position that the short sale is a liability under IRC section 752. Court's ruling helps to clarify the definition of liability under subchapter K partnership provisions such as section 752. Court does not find that FPL engaged in a tax sham. Ruling is a mixed victory for the Government.

A. Salina's Formation

Following a meeting on or about October 2, 1992, between FPL and Goldman Sachs, and subsequent meetings and discussions, the Salina Partnership, L.P. was formed on December 17, 1992**,** by two Netherlands Antilles entities, Caraville Corp. N.V., the general partner, and Pallico, N.V., the limited partner. The partners' equity contributions were as follows:

Caraville	$ 750,000	1%
Pallico	$74,250,000	99%
Total	$75,000,000	100%

Salina was registered in the state of Delaware as a domestic partnership, but had its principal place of business in Curacao, Netherlands Antilles. Caraville and Pallico were created for the purpose of participating in partnerships such as Salina by ABN Trust Company, a Netherlands Antilles-based affiliate of the Dutch banking firm, ABN AMRO Holdings NV (ABN NV). ABN NV controlled both Pallico and Caraville and funded their investments in Salina. (A discussion of the ownership and funding structure is provided in Section III.)

B. Salina's Transactions

Immediately following the formation of the partnership, Salina engaged in several transactions as follows:

December 17, 1992

1. Purchase, through ABN AMRO Bank, New York (ABN NY), of 4.625% coupon U.S. Treasury notes with a face value of $140,000,000, maturing on November 30, 1994. The purchase price was $140,212,145.03 ($139,891,953.03 principal plus $320,192 in accrued interest). Salina financed part of the purchase price through a repurchase agreement with Goldman Sachs for $70,087,500. That is, Salina borrowed $70,087,500 from Goldman Sachs, pledging the Treasury notes as collateral to secure the loan. Salina paid the balance of $70,224,645.03 in cash out of capital.
2. Short sale of $350 million face value U.S. Treasury bills maturing June 17, 1993, for $344,066,593.06. The Treasury bills were borrowed from ABN NV. Thus, Salina borrowed the Treasury bills from the entity that created both Pallico and Caraville, i.e., ABN NV, and then sold the bills (through Goldman Sachs and ABN NY) to unrelated third-party buyers for cash proceeds of $344,066,593.06. ABN NV obtained the Treasury bills by purchase at auction on December 14, 1992. The June 17, 1993 Treasury bills with CUSIP 912794D50 were first auctioned on December 14, 1992 with an issue date of December 17, 1992. It is these bills that Salina borrowed and then sold.
3. Reverse repurchase agreement with ABN NY for $343,875,000, on $350 million face value Treasury bills. The reverse repurchase transaction was a secured loan to ABN NY from Salina. That is, Salina loaned ABN NY $343,875,000, and in return ABN NY posted with Salina $350 million face value Treasury bills as collateral on the loan. The bills posted by ABN NY had the same maturity date -- June 17, 1993 -- as the Treasury bills that were sold short by Salina. If ABN and Salina are regarded as the same entity for

economic purposes, then transactions 2 and 3 together represent a straight sale of Treasury bills by ABN to unrelated third-party investors (see Section III). If ABN and Salina are regarded as distinct economic entities, then it is curious that a large, highly rated international bank such as ABN NV would need to borrow $344 million from a partnership such as Salina (see Section III).

In a 28 December 1992 letter from Salina to Andrews & Kurth, LLP (a well known Washington D.C. tax law firm), Salina officials described the combination of transactions 2 and 3 as follows:

> *"On December 17, 1992, the Partnership entered into short sales of six month Treasury bills (The "Treasury Bills") in order to protect against an increase in interest rates with respect to the Two Year Treasury Notes. Such short sale was carried out in accordance with standard securities industry practice pursuant to which the Partnership sells specific Treasury Bills at fair market value to unrelated third parties. To deliver the Treasury Bills, the Partnership entered into a Master Repurchase Agreement with ABN AMRO Bank N.V. ("ABN"), New York Branch. Pursuant thereto, the following events occurred: The Partnership sold the Treasury Bills to the buyers and loaned the proceeds from the short sale to ABN creating a receivable (a "Loan Receivable") to the Partnership. ABN collateralized its obligation to repay the Loan Receivable to the Partnership by delivering the Treasury Bills to the Partnership which, in effect, borrowed the Treasury Bills from ABN and delivered them to the buyers. The Partnership thereby became contractually obligated to return the identical Treasury Bills to ABN in the future, and collateralized its contract obligation to ABN to return the borrowed Treasury Bills with the Loan Receivable owed it by ABN."*

All of the above transactions, i.e., transactions 1 through 3, had an effective date of December 18, 1992.

December 28, 1992

4. FPL purchased a 98% limited partnership interest in the Salina Partnership from Pallico. The purchase was arranged by Goldman Sachs as part of the pre-planned transactions for which Salina was formed. On October 2, 1992, and subsequent occasions thereafter, Goldman Sachs had made presentations to FPL officers on the partnership strategy and transactions and their potential benefits to FPL. These are analyzed in the Section IV.

FPL now owned the vast majority of Salina, so under then current partnership accounting rules FPL claimed that its purchase effectively terminated the partnership for federal income tax purposes. This termination also occasioned a pro rata distribution of Salina's assets and liabilities to FPL, Caraville, and Pallico, which then became the contributions of each partner to a new partnership. As noted previously, the newly created partnership retained the name of the old partnership (Salina Partnership, L.P.) as well as the same tax identification number. The resultant equity participations were as follows:

FPL	$ 73,500,000	98%
Pallico	750,000	1%
Caraville	750,000	1%
Total	$ 75,000,000	100%

On entering the partnership, FPL made payments through Pallico, in addition to its $73,500,000 capital contribution, to the following entities:

Fees paid to Goldman Sachs	$1,250,000
Fees paid to ABN AMRO Bank	1,000,000
Legal fees to Andrews & Kurth, LLP	350,000
Additional payment to Pallico	50,000
Total	$2,650,000

In addition, FPL agreed to pay Caraville management fees in eight quarterly installments of $93,750 each. The total sum of these payments equaled Caraville's initial capital contribution of $750,000.

Recall that in the distribution and re-contribution of assets and liabilities, Salina treated its short sale obligation (on the $350 million face value June 1993 Treasury bills owed to ABN NV) as a contingent liability and "valued" the liability at zero. This reduced the basis in the non-cash assets distributed to the partners and re-contributed to the partnership. As a result of this and other factors discussed previously, FPL contended that the closing of the Treasury bill short sale and other security positions by December 31, 1992 generated a net gain for Salina of approximately $344 million, i.e., the value of the bills sold short. Under then current partnership accounting treatment, 98% of this gain or approximately $337 million was recorded on the income statement of FPL Group, Inc.

December 31, 1992

5. Sale of the 2-year Treasury notes for $140,408,750.
6. Repayment -- from proceeds of the sale of the notes -- of the approximately $70 million lent by Goldman Sachs under the repurchase agreement. Thus, the Goldman repurchase agreement was terminated. The remainder of the note proceeds was invested in various money market securities.
7. Salina terminated its short position in the $350 million face value U.S. Treasury bills. In other words, Salina purchased $350 million face value June 17, 1993 Treasury bills and returned them to ABN NV. Thus, the reverse repurchase agreement between ABN NY and Salina was terminated. As discussed in Section IV, a result of the reverse repurchase transaction was the conversion of cash to non-cash assets on Salina's balance sheet.

January 15, 1993

8. Salina paid back to Caraville, in the form of a management fee, the first of eight installments of Caraville's $750,000 initial investment.

October 15, 1994

9. The last $93,750 installment was paid to Caraville, which then ceased to be a Salina partner.

November 1994

10. Salina was liquidated.

IV. Analysis Of Partnership Structure

This section delves deeper into the structure of Salina as of its original formation in mid-December of 1992. It then discusses the legal consequences of said structure as argued by the Commissioner.

A. Salina's Original Partners And Their Relationship To ABN

As Figure 1 shows, the Salina Partnership, prior to December 28, 1992, appears to be have been controlled by ABN through a complicated hierarchy of other controlled entities. At the apex of the hierarchy was the Stichting Tot Behartiging Van Het Trustwezen (SBT), a stichting (a type of organization similar to a foundation recognized under Dutch law) controlled by the ABN AMRO Bank N.V. in Curacao. SBT owned ABN AMRO Trust Company, N.V. (ABN Trust), also located in Curacao. Through other stichtings and entities, ABN Trust controlled the Embrador Corporation, N.V and Sognare Corporation, N.V., which in turn owned Caraville Corporation, N.V. and Pallico, N.V. respectively.

Embrador, Sognare, Caraville, and Pallico each had a capital base of only $6,000. ABN provided the $75 million funding through the various foundations and corporations to Caraville and Pallico respectively for investment in Salina. As shown in Figure 1, ABN channeled funds in the form of a loan to Sognare, which then provided the funds to Pallico for the latter's 99% capital contribution ($74,250,000) in Salina.

As Figure 1 shows, Caraville and Pallico were essentially owned by the same entity that was in turn controlled by ABN. FPL officers believed -- as they were assured by Goldman Sachs -- that they were dealing with ABN as the other partner (represented by Caraville and Pallico). Clearly, as ABN controlled both Caraville and Pallico, these two were essentially the same entity, i.e., parts of the ABN Group.

B. Reexamination Of The Reverse Repo And Short Treasury Bill Trades

Figure 2 summarizes transactions 2 and 3 as described in Section II and Table 1. Here ABN NV and Salina are treated as separate entities. The arrows between ABN NV and Salina capture the effects of the ABN-Salina reverse repurchase and short sale transactions. These effects are exactly as described in the 28 December 1992 letter from Salina to Andrews & Kurth, LLP. The arrows between Salina and the unrelated third-party buyers capture the effects of Salina's sale of the borrowed Treasury bills.

Figure 3 now collapses ABN NV and Salina into the same economic entity, i.e., ABN Group. In other words, in Figure 3 the reverse repurchase and short sale transactions as described in the Andrews & Kurth letter are re-characterized, because they represent offsetting and economically meaningless transactions conducted by arms of the same economic body - ABN Group. As Figure 3 shows, when these offsetting transactions are collapsed ABN Group simply sold $350 million face value June 1993 Treasury bills to third-party buyers.

This simple sale was reversed under transaction 7 described in Section II and Table 1. That is, upon FPL buying 98% of Salina on December 28, 1992, Salina terminated the reverse repurchase agreement by buying $350 million face value June 1993 Treasury bills in the open market and selling them to ABN NV which paid fair value for the bills.

Thus, at the end of the day, here is what ABN Group did, economically speaking: On December 18, 1992 it sold $350 million face value Treasury bills (that it had just purchased at auction) for which it received fair market value of about $344 million. ABN Group then bought the Treasury bills back by the end of December 1992, for which it paid fair market value. Thus, ABN ended up with the same profit on the bills (change in fair market value due to changes in interest rates and maturity) as ABN would have earned had it simply sold short the bills and purchased them back in the same calendar period. ABN Group's profit from the transactions in the Treasury bills undertaken by Salina is the same profit it would have experienced had ABN Group simply entered into those transactions itself.

As will be demonstrated in Section IV, the reverse repurchase and short sale transactions 2 and 3 could have involved any asset (e.g., stock) and still reduced the basis in the non-cash assets distributed to the partners and re-contributed to the partnership on December 28, 1992. The choice of Treasury bills was made to protect ABN's economic interests. Treasury bills have no credit risk and little interest rate risk, and thus could be expected to exhibit little value change during the period between when Salina was formed on December 17, 1992 and the end of December 1992 - when FPL entered the partnership and instructed that the reverse repo agreement be closed. Using Treasury bills was preferable to using riskier securities such as common stock. In addition, I opine that, contrary to what is stated in Salina's letter to Andrews & Kurth, the Treasury bonds were purchased to hedge the small interest rate risk of the short Treasury bills position - not the other way around. In other words, the little interest rate risk that the bills occasioned was largely hedged by Salina's purchase of the Treasury notes. This point is discussed further in Section IV.

Given the funding structure of Salina as depicted in Figure 1, and thus the economic substance of transactions 2 and 3, it is clear that ABN and Salina were one economic entity. This entity simply sold Treasury bills on December 18, 1992 and repurchased them approximately two weeks later, i.e., by year-end 1992, purchasing Treasury notes to hedge its interest rate risk in the Treasury bills over the period. For establishing Salina and engaging in this simple exercise, ABN was paid directly $1 million in fees by FPL, $50,000 indirectly through Pallico, and $750,000 indirectly through Caraville.

C. Legal Consequences

Based largely upon the previous analysis, the Commissioner argued that the original Salina Partnership, L.P. was not a *bona fide* partnership and, therefore, FPL's capital gain should be denied. In other words, FPL's use of the various partnership accounting rules (e.g., IRC section 708(b)(1)(B)) was moot, because Salina was never a partnership.[7] Remarkably, the Court did not find for the Commissioner on this matter.

The Commissioner also unsuccessfully presented other arguments related to the analysis above. For instance, the Commissioner argued that ABN had very little Value-at-Risk (VaR).[8] ABN's VaR was *de minimus* before FPL entered Salina because, as discussed above, the transactions conducted by the partnership occasioned little interest rate and credit risk. Also, such transactions arguably presented ABN with even less risk when they are viewed in the context of ABN's overall balance sheet. Furthermore, the Commissioner argued that it was apparent that ABN's position in Salina would be reduced substantially in short order, which it was to 2% within ten days, and that ABN was only participating to accommodate Goldman's client and earn its $1 million fee noted previously. In addition, the Commissioner argued that ABN had little exposure in the post-FPL Salina partnership, because of ABN's 2% position and a particular risk-sharing provision in the new partnership agreement.[9] In sum, the Commissioner argued that ABN was more akin to a lender to or creditor of Goldman's client, and therefore ABN and FPL were not equity partners in the same economic boat.[10] Remarkably, the Court did not find for the Commissioner on this front.

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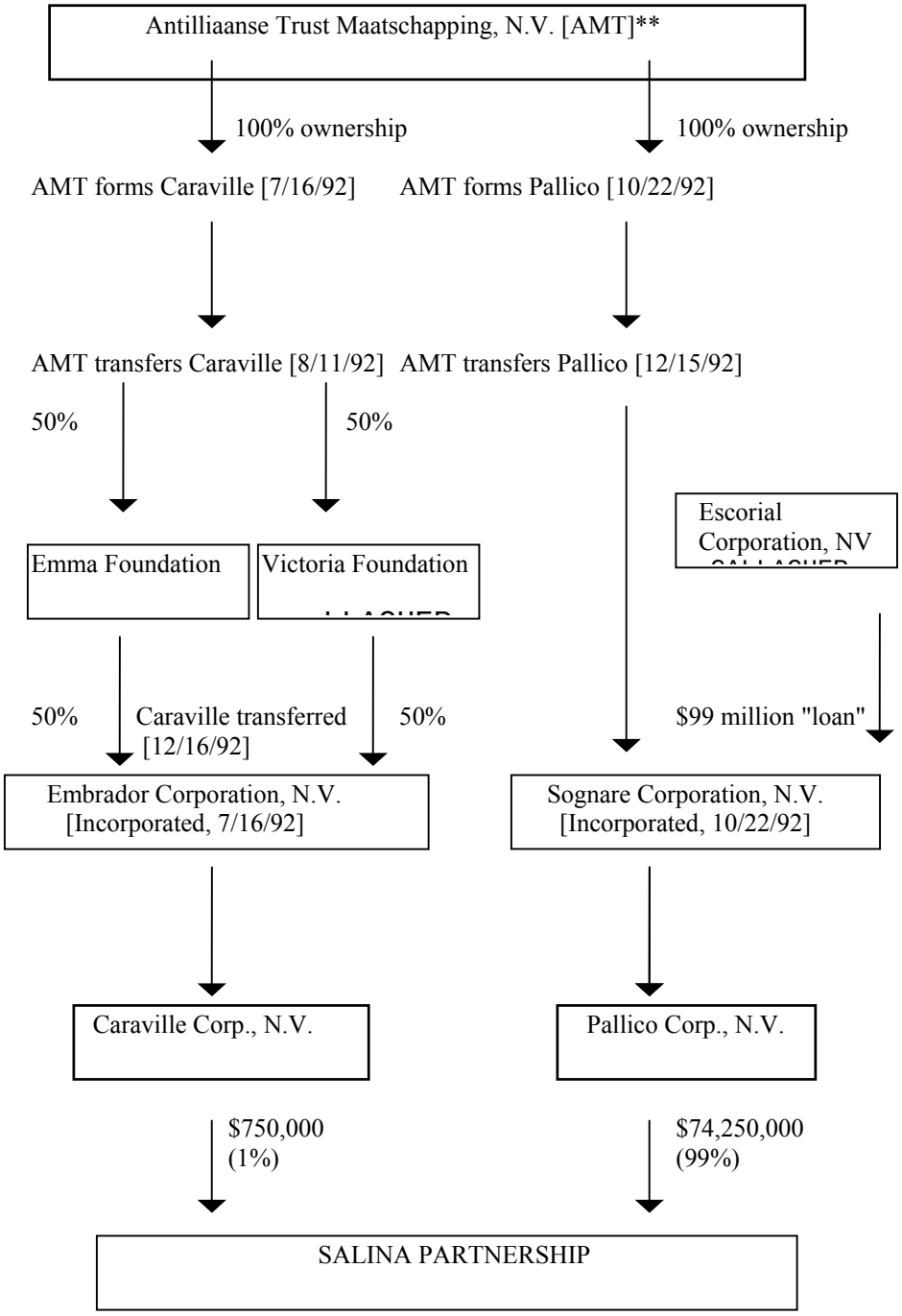
[7] In *ASA Investorings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998), the Commissioner successfully argued that ASA was not a true partnership. In that case, AlliedSignal Corporation had a reported capital loss denied for tax purposes.

[8] This may represent the first time that the concept of VaR was ever used in any legal case in the United States.

[9] When FPL entered Salina, the partnership agreement was revised. One paragraph of the revised agreement represented an asymmetric risk-sharing provision among FPL and the two ABN partners, Pallico and Caraville.

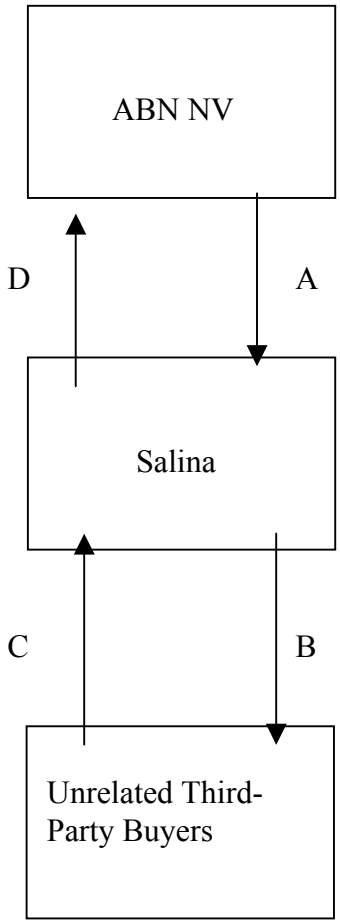
[10] Seminal legal opinions essentially hold that in order for two or more entities to be true economic/equity partners, they must exhibit some reasonable degree of common economic interest as measured by say, risk exposure. See ASA Investorings *supra* note 8. In the ASA/AlliedSignal case, there existed a "Bermuda Agreement" wherein the foreign partner, also ABN in that case, was assured a fixed rate of return from its participation in ASA Investorings. Also see *ACM Partnership v. Commissioner*, 157 F.3d 231, (3d Cir. 1998), *cert. denied*, 119 S. Ct. 1251 (1999).

FIGURE 1: Formation of Salina Partnership, L.P.



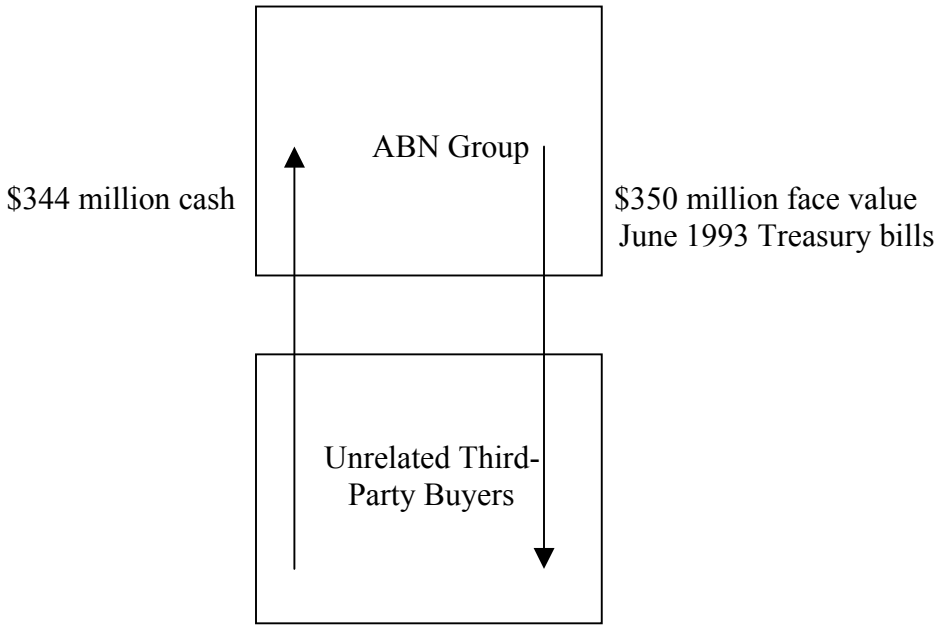
** AMT (and N.V. Fides) owned by ABN AMRO Trust, which is owned by Stichting Tot Behartiging Van Het Trustwezen (SBT), which is controlled by ABN AMRO Bank.

FIGURE 2: Transactions 2 and 3



Notes: In arrow A, ABN NV lent Salina $350MM face value June 1993 Treasury bills (the "bills"). ABN NV expresses that the bills represent collateral for the loan described in arrow D. In arrow B, Salina sells the bills to third-party buyers, for which it receives cash of approximately $344MM in arrow C. Arrows A, B and C collectively represent the short sale transaction 2 described in Section II of this paper. In arrow D, Salina loaned the approximately $344MM proceeds in arrow C to ABN NV. Salina expresses that the loan represented collateral to ABN NV for the bills borrowed in arrow A. Arrow A and D together represent the reverse repurchase transaction 3 described in Section II of this paper. All transactions had an effective date of December 18, 1992.

FIGURE 3: Transactions 2 and 3 Re-characterized



Notes: In this figure the ABN-Salina transactions 2 and 3 are re-characterized because they represent offsetting and economically meaningless transactions undertaken by arms of the same economic body. When these offsetting transactions are collapsed, it is apparent that ABN NV simply sold $350MM face value June 1993 Treasury bills to third-party buyers for proceeds of approximately $344MM.

V. Analysis Of Planned Transactions

This section delves deeper into the economic substance or lack thereof, of the various transactions undertaken by Salina.

A. Background

On or about October 2, 1992, Goldman Sachs made a presentation to FPL officials on a partnership strategy entitled "Special Treasury and Mortgage Partnership Units" ("STAMPS"). Essentially, the presentation described an investment opportunity wherein a foreign branch of an undisclosed international bank offered for sale a 98% limited interest in a partnership that would have already engaged in certain securities transactions involving highly credit-worthy assets. This 98% interest would be carved out of a limited partner holding a 99% interest at the time. The partnership would also have a professional money manager holding a continuing 1% general partnership interest. The profits to be earned by the partnership apparently stemmed from nebulous sources including "arbitrage opportunities" in the mortgage, treasury, and other fixed income markets, as well as narrowing yield spreads between assets of different maturity.

The actual transactions undertaken by the eventually disclosed foreign branch (Salina) of the international bank (ABN NV) represented a nominal variant of the STAMPS strategy presented by BEA Associates, an investment management firm that Goldman Sachs apparently engaged to collaborate with it on the strategy. Goldman Sachs introduced BEA to FPL as the prospective manager of FPL's investments. BEA and Goldman representatives met with FPL officials and made a presentation on BEA and a strategy designated "Mortgage Arbitrage Partners" ("MAPS"). The MAPS presentation, dated October 22, 1992, outlined a strategy similar to that of STAMPS. In particular, one MAPS variant consisted of short positions in six-month Treasury bills and long positions in two-year Treasury notes that Salina eventually held. This strategy was essentially duration-neutral, that is, interest rate risk free, and did not necessitate a partnership structure.

In a MAPS document entitled "Curve Trade" prepared sometime after December 1, 1992, BEA again presented the strategy involving the transactions that Salina eventually undertook. The stated objective of the strategy was to "benefit from a contraction of the large yield differential between 6-month T-bills to 2-year T-notes", which would be implemented through a trade in which the investor is long in two-year Treasury notes and short in six-month Treasury bills. The "Curve Trade" documentation also included a copy of a Bloomberg screen that graphically depicted the historical spread between the yields on the 2-year Treasury note and the 6-month Treasury bill from January 31, 1985 to November 30, 1992. This showed an average spread of 73 basis points (one basis point equals one one-hundredth of one percent), with the spread ranging between -32 and +148 basis points. The screen also showed data for securities similar to those in which Salina eventually transacted, i.e., the yields of the Treasury bill maturing June 17, 1993, and the 2-year Treasury note maturing November 30, 1994.

The example provided in the presentation, which used financial market data for December 1, 1992, was as follows:

	Yield	Duration	Quantity	Fin. Rate	Cash Flow
Long: 2-year T-Note	4.82%	1.89 Years	$10.00mill	3.25%	0.16
Short: 6-month T-Bill	3.60%	0.50 Years	$37.80mill	3.20%	-0.15
Yield Spread:	1.22				

In this example, the spread between the yields on the 2-year note and the 6-month bill is 122 basis points. The portfolio is duration-neutral as a result of the matching of the amounts invested in the long and short positions in proportion to their respective durations: (10.00mill x 1.89) - (37.80mill x 0.50) = 0 duration. Again, six-month bills and 2-year notes were eventually transacted by Salina.

The Commissioner argued that the alleged purpose of engaging in these transactions - to speculate on the narrowing of a historically wide yield spread - was a façade masking for the real purpose of the partnership's formation and subsequent transactions, namely the generation of a $337 million paper gain for FPL. As evidence of this, the Commissioner emphasized that FPL ordered the short bill and long note positions to be closed, thus also occasioning the

closing of the repo and reverse repo transactions, immediately upon entering the partnership. To counter this argument, agents of FPL, Goldman, and BEA all presented testimony that the curve trades were genuine and arms-length and that Salina in fact made money during the period from its original formation and until FPL entered the partnership. Furthermore, said agents testified that FPL's ordering of the closing of the preexisting positions was motivated by a desire to begin a new and different investment program. And, indeed, BEA (which specialized at the time in managing and trading mortgage-backed securities) did actively manage Salina's capital beginning in 1993. The Commissioner argued that Salina's investment activities in December 1992 and those beginning in January 1993 were wholly unrelated and should be bifurcated for the purpose of determining economic substance. Again, remarkably, the Court ruled against the Commissioner on this matter.

B. Generating FPL's Capital Gain

Following the transactions that became effective December 18, 1992 (see Section II and Table 1), Salina's main assets and liabilities were as follows:[11]

ASSETS	$ (million)
Time Deposit	5.1
2-Year Treasury Notes	140.3
Reverse Repurchase Agreement (Loan to ABN NY)	343.9
LIABILITIES	
6-month Treasury Bills Sold Short	344.4
Repurchase Agreement (Loan from Goldman Sachs)	70.1
PARTNERS' CAPITAL	75.4

Other than the 2-year Treasury notes, Salina's assets were essentially cash. The reverse repo with ABN NY simply had the effect of converting the cash proceeds from the Treasury bill short sale into a non-cash asset -- a loan to ABN that was secured by Treasury bills, which are cash equivalents. It is inconsistent with standard industry practice that ABN would borrow from Salina if the two were distinct economic entities. At this time ABN NV was one of the largest and most credit-worthy banks in the world. Its asset size was hundreds of times larger than that of Salina's, and as an international bank ABN NV would have had established lending-borrowing relationships with other large banks, particularly in the Eurodollar marketplace.

Here is how a paper capital gain was accomplished in this case, followed by two generic examples of how the Goldman-engineered partnership structure can produce any paper capital gain desired.

FPL wanted to generate a capital gain of about $337 million. As the plan pre-arranged by Goldman Sachs was that FPL would hold a 98% equity in Salina, the partnership needed to generate a total gain of about $344 million ($337/0.98) to provide FPL the desired amount of

[11] This is the same balance sheet that was introduced in Section I.

gain. To "create" a non-cash asset necessary to generate the gain, Salina sold short Treasury bills of approximately the amount of gain needed. Of course, Treasury bills were used because they were highly liquid, credit risk-free, and exhibited low duration or interest rate risk, hence their value was unlikely to change significantly from the desired value of non-cash assets. To effect the conversion of the cash proceeds from the short sale to non-cash assets, Salina executed the reverse repo transaction with ABN, thus creating a loan receivable asset on its balance sheet in place of cash. Salina simultaneously purchased $140 million worth of Treasury notes. The notes were bought to make the whole strategy more or less duration-neutral, thus serving to hedge the small amount of interest rate risk exhibited by the Treasury bills. Financing part of the on-balance sheet notes through a repurchase agreement (i.e., leveraging) was not necessary to create the gain. The Treasury notes are truly providing protection against the limited interest rate risk of the Treasury bills that were sold short. The overall duration of the long Treasury note position is more or less comparable (in absolute value) to that of the short bill position. Also, any "duration mismatch" for ABN would likely have little impact on its overall interest rate exposure. The exposure would remain relatively small because as a large firm ABN likely had a sizable marketable securities portfolio.

Put another way, Salina/ABN sold Treasury bills in mid-December 1992 and repurchased them by the end of December 1992. During this short time period, the price of the bills could rise somewhat, if Treasury yields fell, thus occasioning a loss to Salina/ABN. To hedge against this possibility, Salina/ABN purchased two-year Treasury notes in an amount to produce the same (but opposite) duration as the bills. So if yields fell, the loss on the bills would be off set by a comparable gain on the long notes. Also, if Salina were treated as a separate profit center for internal accounting purposes, then the purchase of the notes would hedge Salina's "obligation" to ABN NV. That is, Salina may have been operated as a separate profit center in order to determine its divisional profit and loss and compensation to employees. So the long Treasury note position provided Salina an interest rate hedge for its internal profit and loss accounting system, given its "obligation" to return Treasury bills to its parent, ABN NV. This is a "bottom up" approach to hedging - as opposed to hedging the potential effects of the Treasury bill transactions within ABN NV's global marketable securities portfolio.

Continuing, the liquidation/re-contribution occasioned the desired gain as follows:[12] The short bill position was valued at zero, leaving approximately $145 million (the "outside basis") in liabilities and equity for the partnership (approximately $70 million on the Goldman repo and $75 million of equity). The approximately $5 million time deposit (cash) was then subtracted from the outside basis to give an "inside basis" of $140 million. This amount was then proportionally allocated to the remaining assets of approximately $483 million: the approximately $343 million "loan" to ABN on the reverse repo plus the approximately $140 million worth of Treasury notes. The loan represented about 71% ($343MM/$483MM) of the remaining assets while the notes represented the other 29% ($140MM/$434MM). Thus the inside basis of $140 million was allocated as follows: $99.4MM to the loan (71% of $140MM) and $40.6MM to the notes (29% of $140MM). Under existing partnership

[12] The presentation here is similar to that in Section I.1.

accounting rules, this allocation would therefore occasion a paper gain on the loan, to be triggered whenever the loan receivable is collected, of $243.6MM ($343MM - $99.4MM), and a paper gain on the notes, to be triggered whenever the notes are sold, of $99.4MM ($140MM - $40.6MM). Adding these two amounts results in a total paper gain of $343 million. Recall that the loan receivable was collected and the notes were sold by the end of December 1992, which corresponded with the end of FPL's fiscal tax year and the expiration of its $337MM loss carry forward. Note that if the collateral on the reverse repo held by Salina, i.e., the $343MM worth of Treasury bills, was treated as cash (like the $5.1MM time deposit), then a zero capital gain would result as the inside basis would be fully allocated to the notes. This point is discussed more in Section VI.

C. Generating Any Desired Gain: Some Generic Illustrations

In a generic sense, with the Goldman-sponsored strategy, a taxpayer could create a $100 capital gain simply by having an investment bank form a partnership that sells short $100/0.98 = $102.04 worth of Treasury bills (or any other security for that matter). The partnership would then immediately enter into a reverse repurchase agreement with the entity that loaned the Treasury bills (an entity like ABN NY) for approximately this amount in order to create a non-cash asset of about $102. The partnership thereafter would buy highly correlated Treasury bonds in the right proportion to reduce overall duration, possibly financing part of this purchase using a repurchase agreement. As the bills were borrowed from the same entity that was party to the reverse repurchase agreement, the purchase of the bonds truly represents an interest rate hedge for said entity, which is merely accommodating the client of the investment bank in return for fees. The taxpayer would then buy its pre-arranged 98% equity stake and, following the liquidation/re-contribution and valuation of the securities sold short at zero, manufactures the capital gain amounting to 98% of $102, i.e., $100.

In another variation of the strategy, a taxpayer could generate a desired $200 million in capital gains by executing the following four steps:

- Investment banker approaches foreign bank which sets up a partnership (P) with $50 million in capital, for fees agreed upon up front
- P buys $90 million worth of common stocks, of which $40 million is financed through borrowing from the investment banker
- P sells short about $204 million worth of Treasury bills
- P lends the proceeds from the short sale to the foreign bank through a reverse repurchase agreement for approximately $204 million

These transactions would result in P's assets and liabilities as follows:

ASSETS	$(million)
Cash	5
Common Stock	90
Reverse Repo (Loan to Foreign Bank)	204
LIABILITIES	
Treasury Bills Sold Short	204
Loan for Stock Purchase	45
PARTNERS' CAPITAL	$50

Following the liquidation/re-contribution and valuation of $204 million Treasury securities sold short at zero, the capital gain amounting to 98% of $204 million, i.e., $200 million, is claimed as realized. Specifically, the short bill obligation is valued at zero, giving an outside basis of $95MM. The $5MM in cash is subtracted to give an inside basis of $90MM - which is the same as the value of the common stock. 30.61% of the $90MM is then allocated to the stock, while 69.39% is allocated to the loan/reverse repo. This produces a gain of $62.45MM on the stock and $141.55MM on the loan for a total paper gain of $204MM, of which 98% or $200MM goes to the taxpayer seeking the gain. Finally, notice that if the foreign bank loaned stocks (not Treasury bills), then the gain could still be produced. Here the partnership would likely invest capital in other, highly correlated stocks and/or in stock options in order to hedge the price risk of the stocks originally loaned by the foreign bank.

D. Legal Consequences

The Commissioner, through analysis like that just described, tried to persuade the Court that the Goldman-engineered strategy and, therefore, Salina's activities, were foremost designed to manufacture a targeted capital gain for the taxpayer, FPL. Thus the activities of the partnership during December 1992 lacked economic substance. Indeed, the Commissioner demonstrated that any number of short 6-month bill and long 2-year note combinations could have been used to speculate on the yield spread at the time while still achieving a more-or-less duration neutral position and equivalent VaR. However, said combinations would not hit the targeted capital gain required to refresh FPL's expiring loss carry forward.[13] Only the unique combination of bills and notes that Salina in fact traded hit the target. Ergo, the Commissioner argued that Salina was tailor-made for FPL and that Salina's trades were primarily and almost exclusively motivated by their tax consequences for FPL. Again, remarkably, the Court did not agree.

[13] Consider, for example, simply doubling the sizes of the short bill and long note positions. This would achieve the same duration and VaR but would not produce the targeted gain of $337 million.

E. FPL's Prospects for Recovering Costs

Arguably, another test of economic substance in the courts is whether or not a taxpayer can reasonably expect to recover its all-in transaction costs absent tax factors.[14] Absent tax factors, should FPL officials have reasonably *expected* to recover the $2.5+ million in costs occasioned from participating in Salina? The opinion of the author is "no". In general, securities markets are price-efficient, i.e., the prices of securities generally reflect all relevant information that is publicly available. Such information includes financial market participants' aggregate expectations about future interest rates, which are reflected in the yield curve. The notion that a trading strategy such as MAPS is some sort of money machine that results in guaranteed profits is fundamentally incorrect. The expected return on the strategy is commensurate with its risk. There was no reason to believe at the time of FPL's buy-in that FPL, or Goldman or BEA, could determine that the strategy would be profitable in the future.

On December 28, 1992, when FPL bought into the partnership, the six-month Treasury bill yield was about 3.4% and the 2-year Treasury note yield was about 4.6%. Given the spread of 122 basis points between the Treasury securities in Salina's portfolio, it is difficult at best to envision how FPL could have expected its strategy to provide enough return to recover its costs. For example, suppose that the yield on the bills unexpectedly and instantaneously increased by 122 basis points while at the same time the yield on the notes remained unchanged -- an almost unimaginably favorable outcome. Here the yield spread would be washed away, yet the profit on the strategy (all of which would be attributable to the short bill position) would still be under $2.5 million: 0.5 (duration) x .0122 x $350 million = $2.135 million. Based on monthly yield data provided in Salomon Brothers' *Analytic Record of Yields and Yield Spreads* (1995), for the five-year period immediately preceding December 1992 there was never a month in which the yields on six-month and two-year Treasury securities moved in opposite direction by more than 25 basis points - let alone 122. Of these sixty months, there were just six during which the yields on six-month bills and two-year notes moved in opposite directions. The correlation among the yield changes was 87.8 percent. Based on this historic information, FPL did not reasonably expect to recover its costs of $2.5+ million.

Moreover, immediately upon joining the partnership FPL instructed BEA to close out all the trades,[15] a clear indication that FPL was not counting on returns from Salina's Treasury securities to recover the costs it had already paid. That action strongly implies that FPL was never interested in participating in the MAPS strategy. This is consistent with the fact that utility treasury departments are typically conservative in their investing policies [see Euromoney Books (ed.), *Treasury Risk Management*, 2nd

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[14] Cf. ACM Partnership *supra* note 11.

[15] In a letter dated December 28, 1992, Salina Partnership instructed BEA to liquidate the repurchase and reverse repurchase contracts, and the long and short positions on December 30 and 31, and to invest proceeds in cash or cash equivalents until after January 1, 1993.

ed., 1998, Euromoney Publications]. ABN NV likely demanded up front that their Treasury bills be returned as soon as FPL entered Salina. Of course, ABN would then want to lift its hedge and thus the 2-year Treasury notes were sold off at the same time.

VI. Analysis Of Salina's Short Sale Obligation

As noted previously, an important aspect of this case concerns the accounting treatment of the short Treasury bill position, i.e., should it be treated as a "liability" under IRC section 752 or as an "open transaction" under IRC section 1233. This section delves into the economic substance of Salina's short sale obligation.

A. What Is A Short Sale?[16]

The financial liability resulting from a short sale can be illustrated by the requirements relating to short sales of stocks. While the potential loss that can result from the purchase of stock is limited to the purchase price, short-selling a stock creates potentially unlimited financial liability. For this reason short-selling stock is considered highly risky and most financial professionals recommend that only sophisticated investors engage in such transactions. Because of the risk involved, the New York Stock Exchange and other exchanges require maintenance of margin accounts for such transactions. A short seller's margin account is typically monitored constantly and the short sale transactions are marked-to-market on a daily basis to reflect changes in financial liability. [See Staley (1998) for a review of these procedures.]

A typical short-sale transaction is recorded by a broker-dealer as follows: Suppose that an investor opens a stock trading account with a broker-dealer and deposits $100,000 (interest-earning) on the penultimate trading day of the current month. The trader instructs the account executive to immediately short $20,000 worth of IBM stock, which is trading at $125 per share. For simplicity, assume that the price of IBM does not change for the rest of the month. What does the investor's account statement look like at the end of the month? The answer is <u>not</u> $120,000 (plus interest earned net of the commission on the short sale) of cash and zero liabilities. Rather, the answer is $120,000 (plus interest earned net of the commission on the short sale) of cash and $20,000 of liabilities on the short sale obligation, reflecting the current, marked-to-market closing price of IBM stock on the last trading day of the month.

B. The Absurdity Of Salina's Short Sale Valuation

From an economic viewpoint, assigning a value of zero to Salina's short sale obligation does not make sense. Salina had an obligation to return the $350 million face value Treasury bills to their owners. As of December 17, 1992, the value of the June 1993 Treasury bills could be readily obtained by marking-to-market, i.e., simply obtaining a real-time price quote from any one or more of numerous government securities broker-dealers. If the intent had been to

[16] Financially savvy readers can safely skip this subsection.

obtain a reasonable forecast of the obligation to be realized at a future date -- rather than at the moment through a real-time mark-to-market in the spot market -- then a forward price could have been used to estimate said future obligation. Numerous over-the-counter broker-dealers stood willing at this time to make markets in forward contracts on Treasury securities, and it is generally accepted in financial markets that forward prices are the best predictors of future asset values. [See Fama (1990), Fama and Bliss (1977) and Fama (1976).] In addition, it must be kept in mind that on December 17, 1992 and thereafter, one knew the value of the Treasury bills as of June 17, 1993 -- namely their face value of $350 million as the instruments lacked default risk and would sell for face value at maturity. Also, it is well known that the prices of discount securities such as Treasury bills tend to approach their face values as their maturity unwind and cost of carry therefore decreases. [See Hull (2001).] The upshot is that Salina's short position had a non-zero value on December 17, 1992, and that the obligation -- whether to be recognized immediately or on any date up to the June 17, 1993 maturity -- can be easily quantified via a marking-to-market process.

Take a moment to reflect on what is implied by the contention that the short Treasury bill obligation had a zero value either on December 17, 1992, or on any date thereafter up to their maturity: It would be cost-less to purchase Treasury bills, the U.S. Treasury would be bankrupt, and the U.S. dollar would have zero value in world currency markets. This scenario is economically unrealistic.

It is also inconsistent that the short Treasury bill position was considered a contingent liability whose value was zero, but the securitized loan (of the short sale proceeds by Salina to ABN) on Salina's balance sheet was not considered a contingent asset and also ascribed a zero value. This asymmetry in the treatment of the liability and the asset is puzzling. Per the basis-adjustment illustrations contained in Section IV, assigning a zero value to the loan asset would have the effect of eliminating the targeted capital gain. In the present case, the inside basis of $140 million would be fully allocated to the only remaining asset, namely the $140 million worth of two-year Treasury notes.

VII. United States Tax Court Ruling

The United States Tax Court ruled on the Salina case in November 2000. [See Tax Court Memo 2000-352, *Salina Partnership LP, FPL Group, Inc., a Partner Other than the Tax Matters Partner, Petitioner, v. Commissioner of Internal Revenue, Respondent*, No. 25084-96, 14 November 2000.] Remarkably, the Court held that "FPL's investment in Salina was not a sham in substance inasmuch as FPL invested in Salina in order to achieve legitimate business objectives and FLP's investment produced objective economic consequences." However, the Court further held that "Respondent's adjustments are sustained on the ground that Salina's short position in Treasury bills generated a partnership "liability", within the meaning of sec. 752, I.R.C., which liability Salina failed to account for in computing its substituted basis (from its partners) in its assets."

Thus, consistent with the arguments presented in Section V, Salina's short sale obligation on the U.S. Treasury bills was a genuine economic obligation under section 752 of the Internal Revenue Code, could have been readily valued, and therefore should not have been ascribed a value of zero by the partnership. Consistent with the analysis presented in Section IV, ascribing a true economic value to the short position resulted in the complete elimination of the paper capital gain of $344 million. Thus the Commissioner gained the tax adjustment sought, namely the elimination of a $337 gain claimed by FPL, thereby effectively preventing the firm from refreshing its expiring capital loss carry forward.

The victory for the Government in Salina was bittersweet as it spent tens of thousands of dollars to try a case only to win on a very narrow and technical ruling by the Court. Clearly such a ruling will not serve to discourage tax shelter promoters and their clientele. Also clear is the fact that the Court's decision adds little to the legal landscape of sham transactions beginning with *Gregory v. Helvering* and moving through *Goldstein v. Commissioner* and *Lyon v. United States* to *ACM Partnership v. Commissioner*.[17]

Still, the Court's decision does serve to clarify the meaning of "liability" under the tax code - at least how it pertains to partnerships. In addition, almost certainly Goldman and its competitors fashioned similar strategies for other corporate clients. The Court's ruling in Salina should serve to assist the Government in any forthcoming cases involving said clients.

VIII. Conclusion

This paper presented a case study focusing on a tax-motivated strategy undertaken by a major U.S. utility company. It described a series of 1992 transactions engineered by Goldman Sachs & Company and undertaken by Florida Power & Light whereby the latter expended over $2.5 million in fees in order to refresh an expiring $337 million capital loss carry forward. Accommodating the transactions was a major foreign bank, ABN AMRO. Remarkably, a November 2000 United States Tax Court ruling found that FPL's investment in Salina was not a sham and did not lack economic substance. The ruling did, however, find that FPL's accounting treatment of its short sale obligation on U.S. Treasury bills was not appropriate, the result of which was to make an adjustment to FPL's tax filings that negated the paper capital gain and thus prevented the expiring loss from being refreshed.

While the decision of the Court is likely to be appealed by FPL, said decision is one of several recent victories for the Government. For example, recently the Internal Revenue Service entered into an undisclosed monetary settlement with Merrill Lynch & Company relating to tax shelters promoted by Merrill during the early 1990's that the Court found to be shams. This action appears to signal further potential settlements by other tax sham promoters including investment banks and other

[17] *Gregory v. Helvering*, 293 U.S. 465 (1935); *Goldstein v. Commissioner*, 44 T.C. 284 (1965); *Lyon v. United States*, 435 U.S. 561 (1978); *ACM Partnership v. Commissioner*, 157 F.3d 231.

securities firms, accounting firms, and tax law firms. The settlement involves Merrill's failure to register tax shelters that were designed to save companies millions of dollars, as well as aiding and abetting the misstatement of tax liabilities and for failing to maintain lists of participants in the shelters.

On a forensic note, in response to the widespread marketing of tax shams, Congress, in 1997, passed legislation that beefed up tax shelter disclosure standards for promoters and clients. The Clinton administration, in February 2000, issued detailed rules implementing the new legislation, although many expect that such rules will be diluted somewhat under the current Bush administration. A notable and forthcoming test of the new disclosure standards may involve the Department of Justice's recent suit against the former partners of Long-Term Capital Management. [See Lowenstein (2000).]

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