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28UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIACANDYCE MARTIN 1999
IRREVOCABLE TRUST,

Petitioner,

No. C 08-5150 PJH

v.

THE UNITED STATES OF AMERICA,

**ORDER DENYING PETITION AND
ENTERING FINDINGS OF FACT AND
CONCLUSIONS OF LAW**Respondent.
_____ /

This matter came on for a court trial on August 22, 23, 25, 26, 29, and 30, 2011. The parties appeared through counsel at trial and filed post-trial proposed findings of fact and conclusions of law on September 9, 2011. Having carefully considered the papers, the evidence presented at trial, the argument of counsel and the relevant legal authority, and good cause appearing, the court hereby DENIES the petition for readjustment of partnership items pursuant to 26 U.S.C. § 6226, and makes the following findings of fact and conclusions of law.

I. FACTUAL BACKGROUND

This action was consolidated on May 22, 2009, with the case of Constance Goodyear 1997 Irrevocable Trust et al. v. United States of America, C-08-5151 (PJH), for all purposes. Petitioners contest the adjustment of certain partnership items proposed by the Internal Revenue Service ("IRS") in Notices of Final Partnership Administrative Adjustment ("FPAAs") dated June 19, 2008, issued to First Ship 2000-A, LLC ("2000-A") for the taxable year 2000, and to First Ship, LLC ("First Ship") for the taxable year 2001. The court has jurisdiction over this action pursuant to 28 U.S.C. § 1346(e) and 26 U.S.C.

1 § 6226(b)(1). See doc. no. 74, Stipulated Facts set forth in Joint Pretrial Statement,
2 (“Stip.”) ¶ 1.

3 **A. The Chronicle Publishing Company**

4 Michael deYoung (“M.H. deYoung”) and his brother, Charles deYoung, founded the
5 San Francisco Chronicle in 1865. Trial Transcript (“Tr.”) at 48:21-23; Stip. ¶ 23. Charles
6 deYoung was shot and killed in his office in the Chronicle in 1880 by a disgruntled politician
7 who shot him over an editorial Charles deYoung had written. Tr. 48:23-25; 307:13-15. At
8 the time of his death, Charles deYoung wasn’t married and had no children, and sole
9 ownership of the San Francisco Chronicle passed to M.H. deYoung. Tr. 48:25-49:1;
10 307:15-17. In 1906, M.H. deYoung incorporated the Chronicle Publishing Company
11 (“CPC”) as a Nevada corporation. Stip. ¶ 23. M.H. deYoung had five children, one boy,
12 Charles, who died with no children, and four girls, Helen Cameron, who had no children,
13 and Constance Tobin, Phyllis Tucker, and Kathleen Thieriot, each of whom had children.
14 Tr. 49:1-6; 307:15-17. M.H. deYoung placed the ownership of CPC into trust for the benefit
15 of his five children. Tr. 307:20-21. M.H. deYoung ran CPC until his death in 1925. Tr.
16 49:16.

17 Upon the death of M.H. deYoung, Helen Cameron’s husband, George Cameron
18 became the C.E.O. or President of CPC, and ran CPC until his death in 1955. Tr. 49:17-24.
19 During his tenure, CPC acquired one of the very first television stations, KRON, and then
20 other properties, including book publishing. Tr. 49:20-23. Upon George Cameron’s death
21 in 1955, Kathleen Thieriot’s son, Charles, took over control of CPC, and ran the company
22 until he died in 1977. Upon his death, his son, Richard, became the C.E.O. Tr. 49:24-50:4.
23 Michael deYoung’s trust for the benefit of his five children did not end until 1988, when his
24 last child, Phyllis Tucker, died. Tr. 307:21-24. Constance Tobin had three children,
25 Patricia, Michael and Consuelo. Tr. 49:6-9. Consuelo Tobin Martin (“CTM”) is the mother
26 of the “Martin siblings:” Candyce Martin, Francis A. Martin, III, Constance Martin Goodyear,
27 Priscilla Martin Tamkin, and Helen Spalding (collectively, the “Martin family”). Tr. 48:10-14.
28

1 During Richard Thieriot’s tenure as C.E.O. of CPC, Francis Martin was the head of
2 Chronicle Broadcasting Company. Richard Thieriot’s cousin, Peter Thieriot, was the head
3 of CPC’s Real Estate company. They retained these roles until 1993, when Phyllis
4 Tucker’s sole surviving child, Nan McEvoy, became Chairman of the CPC Board, and
5 brought in John Sias as C.E.O., and together they did some “housecleaning” by firing
6 Richard Thieriot, Francis Martin, Peter Thieriot, and others who had previously held
7 positions at CPC. Tr. 50:14-51:3. The other deYoung family members who were
8 shareholders of CPC, retaliated and, in 1995, Nan McEvoy was fired. She later sued the
9 company for age discrimination and lost. Tr. 51:4-5.

10 In 1995, CPC, which had before then elected to be treated as a Delaware S
11 Corporation, owned largely four businesses: (a) the newspaper business, including the San
12 Francisco Chronicle, the Worcester paper, and the Pantagraph paper in Illinois; (b) a
13 television business, including television station KRON and a couple of other stations; (c) a
14 cable business; and (d) Chronicle Books. Tr. 49:21-22; 309:24-310:3.

15 **B. The Martin Family Trusts**

16 As of the year 1999, the Martin siblings collectively owned through various trusts or
17 outright, 630,000 shares (or 16.67%) of the stock of CPC. Stip. ¶ 24; Ex. 25. Each of the
18 Martin siblings owned an equal amount of 126,000 CPC shares, either through various
19 trusts or outright. Tr. 54:25-55:10; 313:24-314:1; Ex. 25. Of the 630,000 shares of CPC
20 Stock held by the Martin siblings, 380,500 shares were held in fourteen (14) trusts related
21 to the Martin family (the “14 Martin Family Trusts”). Stip. ¶ 25; Ex. 25. The 14 Martin
22 Family Trusts included five non-grantor trusts that Consuelo Tobin Martin created in 1988
23 for the benefit of each of her five children as the income beneficiaries, with her
24 grandchildren as the remaindermen (the “1988 Trusts”). Tr. 52:17-21; Stip. ¶ 5.a; Ex. 25.
25 Consuelo Tobin Martin placed 23,100 shares of CPC stock into each of the five 1988
26 Trusts. Tr. 53:20-23; 259:17-19; 311:9-13; Ex. 25. The 1988 Trusts included:

- 27 a. The CTM Children’s Trust FBO Candyce Martin (1988 Trust);
- 28 b. The CTM Children’s Trust FBO Francis Martin, III (1988 Trust);

- 1 c. The CTM Children’s Trust FBO Constance Goodyear (1988 Trust);
2 d. The CTM Children’s Trust FBO Priscilla Tamkin (1988 Trust); and
3 e. The CTM Children’s Trust FBO Helen Spalding (1988 Trust).

4 Stip. ¶ 5.a.; Ex. 25.

5 The 14 Martin Family Trusts also included five grantor trusts that Consuelo Tobin
6 Martin created for the benefit of her five children in 1999 (the “1999 Trusts”). Tr. 54:18-24;
7 310:22-23; 311:14-16; Stip. ¶ 26. Consuelo Tobin Martin placed 26,000 shares of CPC
8 stock into each of the five 1999 Trusts. Tr. 54:25-55:2; 259:20-22; 311:15-23; Stip. ¶ 26;
9 Ex. 25. The 1999 Trusts included:

- 10 a. CTM 1999 Trust FBO Margaret Candyce Martin;
11 b. CTM 1999 Trust FBO Francis Augustus Martin, III;
12 c. CTM 1999 Trust FBO Constance Martin Goodyear;
13 d. CTM 1999 Trust FBO Priscilla Martin Tamkin; and
14 e. CTM 1999 Trust FBO Helen Martin Spalding.

15 Stip. ¶ 26; Ex. 25.

16 The 14 Martin Family Trusts also included four trusts created by three of Consuelo
17 Tobin Martin’s children for the benefit of their own children, into which they placed a varying
18 number of shares of CPC stock they had previously owned outright. These trusts included
19 the following into which the reflected amounts of shares were contributed:

- 20 a. The Francis A. Martin III 1997 Irrevocable Trust, 50,000 CPC shares;
21 b. The Francis A. Martin III 1998 Irrevocable Trust, 25,000 CPC shares;
22 c. The Constance M. Goodyear 1997 Irrevocable Trust, 40,000 shares; and
23 d. The Candyce Martin 1999 Irrevocable Trust, 20,000 shares.

24 Stip. ¶ 27; Ex. 25; Tr. 310:23-25. In addition to the CPC stock, certain of the 14 Martin
25 Family Trusts also owned, directly or indirectly, stock in Liberty Media Group (“Liberty
26 Media”), AT&T, and TCI Satellite. Stip. ¶ 34.

27 Peter M. Folger, a management labor lawyer who co-founded the San Francisco law
28 firm Folger, Levin & Kahn, LLP, was appointed to act as trustee of the 14 Martin Family

1 Trusts. Tr. 53:24-54:1; 258:10-20; 258:24-259:12; 318:9-10; 687:15-17; Ex. 25. Mr.
2 Folger had graduated from Stanford University and obtained his law degree from the
3 University of San Francisco law school. Tr. 258:4-8. Mr. Folger had been a long time close
4 family friend of the Martin family. Tr. 54:2-7; 258:22-23; 318:11-15. His parents had been
5 friends of Consuelo Tobin Martin and her husband. Id. Consuelo Tobin Martin wanted
6 someone of her children's generation with whom she felt comfortable. Tr. 54:15-17.
7 Members of the Martin family testified that Mr. Folger had "some really wonderful personal
8 characteristics that make him a great trustee for everybody. No one feels that he's closer
9 to and would represent one sibling's interest over another. He listens to everybody. He
10 takes everybody's views into account. And that's really a rare quality." Tr. 318:15-21. He
11 had a calming influence and relied on a consensus among the beneficiaries. Tr. 91:16-25.

12 Mr. Folger was also the Trustee of the trusts of Richard Thieriot, including the
13 Richard T. Thieriot 1997 Trust and the Thieriot Family 1999 Irrevocable Trusts. Richard
14 Thieriot was a cousin of the Martin siblings and also a shareholder of CPC. Ex. 25; Tr.
15 279:18-22.

16 From 1988 through 1998, Mr. Folger's position as Trustee required only that he
17 periodically attend CPC's annual meetings and give stock voting proxies to the Trusts'
18 beneficiaries. Tr. 259:23-260:7. Mr. Folger generally did not receive a fee for his services
19 as trustee, except for a period when he received compensation at an hourly rate for his
20 time spent dealing with reformation issues surrounding the five 1988 Trusts. Tr. 65:1-3;
21 259:14-16; 260:17-261:4.

22 On June 2, 1999, Consuelo Tobin Martin formed LMGA Holdings, Inc. ("LMGA
23 Holdings") as a Delaware S Corporation. Prior to November 1, 2000, Francis Martin was
24 the director of LMGA Holdings, and Peter Folger was a corporate officer. Tr. 287:23-
25 288:19; Ex. 1 at 110, 111. On November 1, 2000, Francis Martin resigned as President of
26 LMGA Holdings and on November 2, 2000, Peter Folger became President of LMGA
27 Holdings. Tr. 287:23-288:19; Ex. 1 at 110, 111. On June 15, 1999, each of the five 1999
28 Trusts purchased a 20% share of LMGA Holdings. Stip. ¶¶ 8, 29. On June 15 and June

1 16, 1999, 4,130,728 shares of Liberty Media stock and \$13.8 million in cash were
2 transferred to LMGA Holdings. Stip. ¶ 30.

3 First Ship was formed as a California limited liability company on March 6, 2000,
4 and remains in existence today. Stip. ¶¶ 3, 15; Stip. Ex. 1. First Ship's members (or
5 partners, for tax purposes) were the 14 Martin Family Trusts. Stip. ¶ 4; Stip. Ex. 2. On
6 October 10, 2000, 2000-A was formed as a California limited liability company. Stip. ¶ 6,
7 Stip. Ex. 3 (Articles of Organization of 2000-A). 2000-A had three partners with the
8 following percentage holdings: First Ship (77.03%); Fourth Ship, LLC ("Fourth Ship")
9 (22.22%); and LMGA Holdings (0.75%). Stip. ¶ 6; Stip. Ex. 4 (Operating Agreement of
10 2000-A).

11 LMGA Holdings was the managing member of 2000-A. Stip. Ex. 4. As President of
12 LMGA Holdings, Mr. Folger had the authority to act as the managing member of 2000-A.
13 Fourth Ship was formed as a California limited liability company on October 12, 2000.
14 Fourth Ship had nine partners: (1) the five 1988 Trusts; (2) the Francis Martin 1997 Trust;
15 (3) the Francis Martin 1998 Trust; (4) the Constance Goodyear 1997 Trust; and (5) the
16 Candyce Martin 1999 Trust. Stip. ¶ 7.

17 **C. Sale of the Chronicle Publishing Company**

18 After a great deal of turmoil among the CPC owners caused the deYoung family's
19 relations to deteriorate to such an extent that no one could get along, on June 16, 1999,
20 CPC's board of directors announced its decision to accept bids for the sale of all of CPC's
21 assets. Tr. 52:2-7; 308:19-21; Stip. ¶ 31. At this time, Helen Spalding was a member of
22 the CPC board of directors. She had been on the board since 1994, and remained a board
23 member until the final liquidation of CPC. Tr. 51:16-24; 694:14-23. CPC completed the
24 sale of substantially all of its business assets in 1999 and 2000. Stip. ¶ 31. The total final
25 sales price for all of the CPC assets was \$2,119,955,144, comprised of cash equal to \$479
26 per share of CPC stock, and shares of Young Broadcasting, Inc. stock. Id. CPC made
27 large distributions of cash and securities to its shareholders. Id. After the sale of CPC's
28

1 assets and distribution of the proceeds to its shareholders, the 14 Martin Family Trusts held
2 the following assets:

<u>Asset</u>	<u>Number of Shares</u>	<u>Value as of 11/8/00</u>
Cash	NA	\$121,452,146
Cash in Escrow	NA	\$ 3,019,841
Liberty Media	5,435,370	\$ 97,496,949
Young Broadcasting	391,444	\$ 11,376,341
AT&T	267,533	\$ 5,885,726
TCI Satellite	33,785	\$ 221,714
Total		\$239,452,518

7
8 Stip. ¶ 34.

9 In the midst of the efforts to sell CPC's assets, its board of directors realized that
10 there were certain types of liabilities that might arise after the proceeds from the sale of
11 CPC's assets had been distributed to its shareholders, and that the responsibility to cover
12 such liabilities could fall first and foremost to the board of directors as individuals to
13 personally cover the liabilities and that such liabilities might be unlimited. Tr. 57:8-58:22;
14 696:4-10. These potential future liabilities included but were not limited to contractual
15 matters, buyer's remorse, union or worker's contract issues, environmental issues, and
16 CPC's status as a Subchapter S corporation, and it was feared that these potential
17 liabilities could exist long into the future. Tr. 57:8-58:22; 309:10-19; 314:12-315:9;
18 597:20-598:9.

19 As a director, Ms. Spalding understood that her potential exposure for CPC liabilities
20 was unlimited and it was therefore very important that there be some mechanism whereby
21 all shareholders would share these possible responsibilities equitably. Tr. 696:4-10. In
22 order to more equitably share the responsibility for these potential future liabilities amongst
23 the CPC shareholders, the board of directors discussed with the shareholders and
24 ultimately caused to be prepared "The Chronicle Publishing Company Recontribution
25 Agreement" (the "Recontribution Agreement"), which governed shareholder responsibility
26 for potential future CPC debts or liabilities. Ex. 25; Tr. 54:24-55:2; 56:6-10, 12-17;
27 62:11-19. The Recontribution Agreement provided that CPC shareholders would contribute
28 on a pro rata basis funds to cover any excess liabilities incurred by CPC, and would

1 indemnify CPC and other shareholders at least to the extent of the distributions they had
2 received, and possibly beyond the extent of their distributions. Ex. 25; Tr. 136:4-5;
3 351:11-22.

4 On August 10, 2000, as a prerequisite to receiving a distribution of the CPC sales
5 proceeds and securities, each CPC shareholder, including the 14 Martin Family Trusts, was
6 required to sign the Recontribution Agreement. Ex. 25; Tr. 54:24-55:2; 56:6-10, 12-17;
7 350:1-4. The Recontribution Agreement gave rise to a concern among the Martin family
8 and the 14 Martin Family Trusts about ongoing potential exposure to excess CPC liabilities
9 faced by its shareholders pursuant to the Recontribution Agreement. The Martin family
10 was concerned that potential future CPC liabilities would extend many years into the future,
11 until various state and federal statutes of limitation had expired. Tr. 87:18-88:11.

12 One of the major issues that could have caused a recontribution of assets by the
13 CPC shareholders was a possible revocation of CPC's "Subchapter S" status. Tr.
14 79:15-19; 80:11-13. Subchapter S of the Internal Revenue Code, 26 U.S.C. §§ 1361 to
15 1379, allows a single tax on the shareholders of a corporation upon the distribution of
16 income, as opposed to the double taxation possible with a "C" corporation, first at the
17 corporate level and then again at the shareholder level. Tr. 79:15-19; 137:15-19;
18 137:25-138:6. There are certain eligibility requirements in order to elect and maintain
19 "Subchapter S" status, and problems as to eligibility might not surface for years. Tr.
20 79:19-80:7; 138:12-139:10; 271:8-17; 314:19-315:25. For example, CPC's Subchapter S
21 status could have been revoked: (a) if a non-US citizen acquired shares; (b) if the
22 maximum number of shareholders were exceeded through the death of one of the living
23 shareholders who had a large number of children; or (c) if the wrong kinds of trusts were
24 shareholders.¹ Tr. 314:12-315:6; 353:1-8. If CPC's Subchapter S status had been revoked

26 ¹ One of these possible scenarios nearly occurred but was avoided. One of the
27 Martin family cousins, Bob Thieriot, had established a number of unqualified trusts; he
28 discovered he had brain cancer about three months before he died. When his brother, Peter
Thieriot, who had worked for CPC, discovered the nature of these trusts, Bob Thieriot agreed
to make changes to the trusts so that they would qualify under the Subchapter S rules at his

1 for any of these reasons, the IRS could have gone back and taxed CPC as a C corporation
2 and then taxed the shareholders again as recipients of dividends and the sale proceeds.
3 Tr. 80:14-20; 137:15-19; 135:25-138:6; 315:6-14.

4 The Martin family and the 14 Martin Family Trusts had no way of knowing or
5 controlling what other CPC shareholders might have done to affect CPC's eligibility for
6 Subchapter S status, yet could become jointly and severally liable for a potentially colossal
7 tax owing at the corporate level at a time when CPC no longer had the assets. Tr.
8 138:12-139:10; 314:15-18. Given CPC's \$2 billion value at the time of sale, the extent of
9 this additional tax liability just on the sale alone could have been more than \$800 million.
10 Tr. 352:5-13. Concerned about possible revocation of CPC's Subchapter S status, the
11 Martin family and the 14 Martin Family Trusts determined to preserve a portion of their
12 distributions and hold them in a pooled fashion until after the statute of limitations on the
13 Subchapter S issue had expired. Ex. 25; Tr. 54:24-55:2; 56:6-10, 12-17; 62:11-19;
14 135:13-24; 139:12-21; 271:13-17; 352:20-22.

15 Besides the possible exposure to liability under the Recontribution Agreement, the
16 Martin family and the 14 Martin Family Trusts shared other concerns following the sale of
17 CPC. They were also concerned about dealing with and reforming the ambiguous
18 distribution provisions of the five 1988 trusts, which held a large percentage of the Martin
19 family's assets. There was an urgent need to clarify the terms of distribution to
20 beneficiaries upon the death of one of the Martin siblings. The remaindermen of the trusts
21 were comprised of the 10 grandchildren of Consuelo Tobin Martin and the five 1988 Trusts
22 provided that they receive equally on a pro rata instead of per stirpes basis. This was not a
23 problem while the Trusts simply held CPC shares. But, when those shares were converted
24 to cash upon the sale of CPC, distribution under the Trusts in their then current form
25 became extremely difficult. Tr. 75:12-16; 76:2-9; 136:12-137:10; 270:24-271:7; 312:3-8;
26 316:9-318:5.

27 _____
28 death. Tr. 315:14-25.

1 In 1998 or 1999, the five 1988 Trusts had previously been revised in order to
2 eliminate a provision that prohibited inheritance by an adopted child. Richard Sideman, a
3 Harvard Law School Graduate, a holder of a Masters in Tax from NYU, and a co-founder of
4 the San Francisco law firm Sideman & Bancroft, LLP, who had been hired by Consuelo
5 Tobin Martin in 1991 with respect to a gift tax issue, was hired again in 1998 or 1999 to
6 assist the Martin family in this first revision. Tr. 53:4-16; 80:25-81:71; 123:3-5;
7 123:24-124:1; 127:7-16; 128:13-18. Reformation of the trusts was a complicated and time
8 consuming process requiring extensive analysis as to potential beneficiary scenarios, and
9 obtaining a probate court order and an IRS private letter ruling, all of which finally
10 concluded in 2005. Tr. 142:24-143:1; 161:21-163:24; Exs. 322, 323, 324, 325.

11 The uncertain status of these trusts in the interim affected the Martin family's and the
12 14 Martin Family Trusts' investment decisions. In particular, given the complicated legal
13 tontine created by the Trusts' provisions, and to eliminate the possibility of a conflict of
14 interest between the trustee and unexpected beneficiaries, all of the 1988 Trusts had to be
15 managed as a unit. In addition, trust assets needed to be completely pooled in order to
16 assure there would be total equality for known and potentially unknown beneficiaries until
17 the 1988 trusts could be clarified. Tr. 53:4-10; 75:12-16; 76:2-9; 136:12-137:10; 142:9-11;
18 270:24-271:7; 275:13-21; 335:8-11.

19 The third concern shared by the Martin family and the 14 Martin Family Trusts was
20 the volatility of the Martin family's and the 14 Martin Family Trusts' investments. The
21 Martin family and the 14 Martin Family Trusts had received a large amount of cash and
22 stock from the sale of CPC's assets. These assets were held by the trusts and there were
23 interests of both income beneficiaries and remaindermen to be addressed. The Martin
24 family and Mr. Folger as trustee of the 14 Martin Family Trusts considered proposals for
25 investing the assets because keeping the funds in cash would not protect the interests of
26 the remaindermen in light of inflation or altered markets. Tr. 140:20-142:11.

27

28

1 **D. Development of the Joint Investment Transaction**

2 **1. Arthur Andersen Proposal**

3 In late 1998 or 1999, in anticipation of the CPC sale, Arthur Andersen, LLP (“AA”), at
4 that time the public accounting firm for both CPC and the Martin Family and their various
5 trusts, approached Francis Martin with a proposal that addressed the liabilities concerns
6 and also potentially had some tax benefits. Tr. 127:24-128:4; 129:24-130:11; 130:7-11;
7 130:19-22; 320:5-11; 598:11-16. The Arthur Andersen transaction was also proposed to
8 the cousins of the Martin family, the Theriots, who also faced large gains from the sale of
9 the Chronicle. Peter Folger was also the decision maker for the Theriot family trusts.
10 Ex.101 at RTS 176.

11 Because of their prior work for Consuelo Tobin Martin and their work on the first
12 reformation of the five 1988 Trusts, Richard Sideman and his firm, Sideman & Bancroft,
13 LLP, were well known to the Martin family. Tr. 53:4-16; 67:24-68:4; 80:25-81:71; 127:7-16;
14 128:13-18; 598:19-22. As such, at the request of his siblings, Francis Martin engaged
15 Sideman, briefed him about the family’s many concerns, and requested that he meet with
16 AA in order to learn about and independently review its proposal. Tr. 59:6-24; 63:11-15;
17 127:24-128:4; 129:24-130:11; 130:19-131:1; 262:18-22; 319:4-9; 589:11-16; 597:9-600:14.
18 Mr. Sideman’s job was to look at AA’s proposal and give independent advice to the Martin
19 family and Mr. Folger as trustee of the 14 Martin Family Trusts. Tr. 130:24-131:1;
20 270:20-23. He was also to address the family’s many concerns arising from the CPC sale
21 and to find a way to help them manage and potentially mitigate their potential exposure
22 under the Recontribution Agreement. Tr. 319:11-16; 598:11-16. Mr. Sideman had not
23 known Mr. Folger prior to this time, but came to learn that he was a contemporary of the
24 Martin siblings, and a childhood friend of Mr. Martin. Tr. 131:3-14.

25 In January and February 2000, Mr. Sideman and his partner, Kristina Harrigan, of
26 the Sideman firm had discussions with Arthur Andersen about the terms under which tax
27 attorney R.J. Ruble of the Brown and Wood law firm would issue an opinion letter
28 concerning an investment strategy for Francis Martin. Mr. Ruble had been asked by Arthur

1 Andersen to provide a tax opinion with respect to the proposed transaction for the Martin
2 Family. Tr. 132:19-25. On January 29, 2000, John Mullen from Arthur Andersen stated,
3 “R.J. [Ruble] does know all the facts. He knows that the trustee will contribute the
4 proceeds of CPC to the Corporation.” Ex. 218.

5 On February 24, 2000, the Sideman firm and AA discussed competitive pricing of
6 shelter strategies. John Mullen of AA said that the AA strategy was a proprietary strategy
7 that AA could only market jointly with AIG; thus AA could not carry it out with JP Morgan
8 (the Martin Family’s financial advisor and private bank) instead of AIG. John Mullen told
9 the Sideman firm that AA did not want to share any information on the AA strategy with JP
10 Morgan because JP Morgan was a competitor of AA in that type of product. Ex. 127.

11 On February 25, 2000, the Sideman firm sent a memo to trustee Peter Folger
12 describing the AA shelter strategy. Ex. 98. In that memo, Ms. Harrigan explained the
13 mechanics of the Son of BOSS transaction as follows:

14 Why does this work to help with Rani[’]s problem? When you
15 contribute assets to an entity, your basis in the entity reflects the
16 basis of the assets you put in, less any liabilities the entity takes off
17 your hands in the process. Here, you are contributing an asset—the
18 call that you BOUGHT—with basis of \$30, which is the price you paid
19 for the call exercisable at \$70. **While the entity will also assume**
20 **your obligations under the call that you SOLD, for which you**
21 **received \$50 premium, that liability is contingent in the eyes of**
22 **the Tax Code, and ignored for purposes of computing your**
23 **basis in the entity.** The net effect is to create \$30 of basis for the
24 call that you BOUGHT, and another \$20 basis for the net cash that
25 you kept in Step Two above. Although this \$20 basis (and the cash
26 that goes with it) is going to disappear if the market value of the
27 baskets is \$70 or more on the 180th day, **you have still created \$30**
of basis where there was none before. If the volume of these calls
is large enough, this basis will be large enough to equal the missing
basis of other valuable assets that you contribute to the entity, e.g.,
LMGA stock, AT&T stock.

28 Ex. 98 at RTS 000148-149 (emphasis added). After seeing this memo, Mr. Mullen

1 expressed concern to the Sideman firm because it had been Sideman’s counsel not to
2 have anything in the files that detailed the tax aspects of the transaction. Ex. 98 at
3 RTS000151. Mr. Mullen suggested that another memo, provided earlier to the Theriots, be
4 sent to Folger for his files. Id.

5 On March 2, 2000, Peter Folger faxed Richard Sideman an engagement letter
6 signed by R.J. Ruble, hiring Mr. Ruble to act as special tax counsel to the Martin Family
7 Trusts for the AA shelter strategy. Ex. 100. On March 2, 2000, Francis Martin called
8 Richard Sideman to say that he wanted to go forward with the AA shelter strategy without
9 waiting for the Ruble opinion letter, while his sisters preferred to wait until Mr. Sideman had
10 reviewed R.J. Ruble’s opinion letter. Ex.101 at RTS 176.

11 On March 8, 2000, John Mullen of AA faxed Peter Folger a representation letter
12 concerning the options portion of the AA proposed shelter transaction, which AIG
13 requested Mr. Folger complete and return. Ex. 102. On March 15, 2000, AA provided the
14 Sideman firm with a list of “competitors pricing” of tax shelter products sold by Ernst &
15 Young (COBRA), PWC, KPMG, UBS, and Presidio. Ex. 222. Mr. Sideman testified that he
16 was not aware that this was a list of tax shelters. Tr. 188:6-8.

17 On March 16, 2000, the Sideman firm faxed a list of the steps of the AA shelter
18 transaction to Owen Harper of JP Morgan. This document showed the various steps of the
19 contemplated tax shelter to be part of a single integrated transaction. Ex. 255. On April 5,
20 2000, Richard Sideman faxed to R.J. Ruble his comments on Ruble’s draft opinion letter for
21 the AA shelter transaction. Ex. 224. On April 19, 2000, AA sent Peter Folger and Richard
22 Sideman engagement letters dated March 17, 2000 and signed by R.J. Ruble, hiring Mr.
23 Ruble to act as special tax counsel to the Martin Family Trusts for the AA shelter strategy.
24 Mr. Ruble’s fee was \$700,000. Ex. 103. On or about April 24, 2000, Arthur Andersen sent
25 to the Sideman firm a draft Ruble opinion letter entitled “Investment in Foreign Currency,”
26 on which the Sideman firm made substantial editorial comments. Ex. 227.

27 On June 6, 2000, Richard Sideman sent AA and R.J. Ruble a memo prepared by the
28 Sideman firm comparing the pricing of competing shelter transaction proposals made by

1 AIG and Lehman Brothers. Ex. 230. The Martin family's fees for the AIG proposal were
2 \$17.5 million if the options contracts had a 90-day term or \$139.5 million if the options
3 contracts had a 12-month term. The Martin family's fees for the Lehman Brothers proposal
4 (taking into account the adjusted notional amount because the Lehman proposal was blind)
5 were \$4.7 million if the options contracts had a 90-day term or \$18.9 million if the options
6 contracts had a 12-month term. Ex. 230.

7 Sometime after meeting with AA and reviewing its proposal, Mr. Sideman and Ms.
8 Harrigan recommended against it. Tr. 132:2-13; 273:9-12. They had come to the
9 conclusion that there had been misleading statements by AA that were material and
10 important. Tr. 247:2-8. Mr. Sideman and Mr. Folger found the proposal inappropriate,
11 unworkable, and not economically viable. Tr. 320:15-23; 324:21-22; 462:17-19. The AA
12 proposal was never close to completion. Tr. 215:24-216:1. Ultimately, the family lost
13 confidence in AA and on June 28, 2000, Francis Martin terminated AA's services as the
14 Martin Family's accountant. Ex.105. By letter dated July 7, 2000, Mr. Folger as trustee for
15 the 14 Martin Family Trusts, terminated AA's services for the Trusts. Tr. 133:15-16;
16 285:12-23; 321:4-14; Ex. 105.

17 On June 9, 2000, AA informed AIG that the Martin Family would not be engaging in
18 any shelter transaction with AIG. In response, AIG requested that all proprietary
19 information concerning its shelter proposals be returned to AIG. By letter dated June 21,
20 2000, the Sideman firm declined to return any such information to AIG (explaining that the
21 information is not proprietary because the firm is required to maintain a client list of firms
22 that participate in tax motivated transactions under the "listed transaction regulations.") Exs.
23 45; 51.

24 **2. Dr. Rubinstein**

25 One component of the AA proposal had been a purported hedging transaction. A
26 hedge was of some interest to the Martin family and the 14 Martin Family Trusts, as they
27 already had a large portfolio of stock in the market and had been further advised by JP
28 Morgan, their long time investment bankers, to invest the large amount of the cash

1 distributions they had received or expected to receive from the CPC sale into the equity
2 market. Tr. 90:2-11; 326:4-8; 462:17-23; 464:4-8; 605:25-606:1; 607:19-22. They were
3 interested in maximizing the benefits from potential increases in the market while at the
4 same time insuring themselves against a possible decrease in the market. Tr. 144:4-19;
5 489:15-490:16; 606:9-607:14. Mr. Sideman sought an expert in economic modeling to
6 design or approve an economically viable options transaction that would both maximize the
7 potential upsides and mitigate the potential downsides in the market. Tr. 143:8-144:19;
8 189:8-10; 236:10-11; 248:17-249:24; 462:17-19.

9 Mr. Sideman was directed by Mukesh Bajaj, an economics and financial expert with
10 whom he'd previously worked, to Mark Rubinstein, an Economics Professor at the Haas
11 School of Business at the University of California, Berkeley, who has an economics degree
12 from Harvard University, an MBA from Stanford University, a PhD in Finance from UCLA.
13 Dr. Rubinstein, an expert on derivatives and portfolio structures, is considered by
14 investment banks to be the "godfather of derivatives," and with two other professors
15 developed the "binomial option pricing model," which is widely used to value options. Tr.
16 82:25-83:9; 143:15-144:1; 150:24; 385:23-386:5; 703:7-23; 704:15-705:22.

17 On April 11, 2000, Mr. Sideman engaged Dr. Rubinstein under a Kovel² agreement
18 to provide independent advice only with respect to the options portion of the transaction
19 that purportedly would enable the Martin family and the 14 Martin Family Trusts to
20 maximize the potential upsides in the market while mitigating their potential downside risk
21 and to otherwise address their business and financial objectives. Tr. 143:8-144:19;
22 189:8-10; 236:10-11; 248:17-249:24; 326:9-17; 462:17-19; Ex. 39. Dr. Rubinstein
23 understood his task was to analyze the options transaction to determine whether there
24 "could" be a business purpose to the transaction, that is, whether a rational risk-averse
25 investor would want to engage in the transaction to improve his position. This
26 determination was not based on any forward-looking view of the market, as to whether a

27 ² See U.S. v. Kovel, 296 F.2d 918 (2d Cir. 1961).
28

1 particular investor expected the market to go up or down. Tr. 707:18-709:2; 731:20-22;
2 791: 4-8. Dr. Rubenstein was not asked to consider tax implications of the transaction.

3 **3. Pricewaterhouse Coopers**

4 On June 14, 2000, Mr. Sideman formally engaged the global accounting and
5 consulting firm Pricewaterhouse Coopers (“PWC”) to design a joint investment structure to
6 meet the objectives of the Martin family and the 14 Martin Family Trusts of risk
7 management, asset conservation, flexible and prudent investment, maximization of returns,
8 and equitable allocation amongst the trusts of the attendant risks and rewards. Tr.
9 142:16-19; 145:10-16; 188:22-189:2; 322:21-25; Ex. 125. On June 19, 2000, Roger
10 Feusier of PWC sent Sideman a list of requests, including a request for “[a] more detailed
11 description of the specific mechanics of the hedging transaction and the commercial
12 reasons for undertaking it.” Ex. 129 at Priv Log 3888.

13 Having terminated AA as its accountant and tax return preparer, the Martin family
14 and the 14 Martin Family Trusts separately engaged PWC to handle the family’s and
15 Trusts’ accounting and tax return preparation needs. Tr. 170:10-171:8; Exs. 300, 301.
16 Over several months, PWC gathered information about the CPC sale, the Martin family and
17 the 14 Martin Family Trusts, and their objectives. Tr. 179:11-23; Ex. 129. Mr. Sideman
18 and his Sideman & Bancroft colleagues, Ms. Harrigan and C. Jean Ryan, worked closely
19 on the project with PWC and its partners and employees, principally Roger Feusier, a
20 Certified Public Accountant with a Masters in Tax Law, and Duane Pellervo, a lawyer with a
21 Masters in Tax Law from Georgetown University, speaking almost everyday and providing
22 PWC anything it requested in order to do its work. Tr. 180:2-6.

23 On June 19, 2000, Duane Pellervo and Roger Feusier, both PWC partners,
24 investigated and discussed the reputation of R.J. Ruble in the tax shelter area. This
25 investigation revealed Mr. Ruble’s reputation as very aggressive, and that he had gained
26 much financial success from writing tax opinions. Tr. 366:22-24. Because of his
27 aggressive reputation, PWC felt that his opinion letter should be fully evaluated for
28 accuracy. Tr. 367:11-17.

1 At Ruble's recommendation, Sideman decided to bring Lehman Brothers into the
2 transaction. Tr. 150:10-15. On July 11, 2000, Richard Sideman faxed to Roger Feusier a
3 draft engagement letter with regard to Lehman Brothers. Ex 132; Tr. 400:8-19. In
4 September 2000, the Sideman firm solicited proposals for the Martin family from both
5 Lehman Brothers and JP Morgan.

6 **4. Notice 2000-44**

7 On August 11, 2000, PWC sent the Sideman firm a copy of IRS Notice 2000-44, as
8 well as some news articles about the government's efforts to combat the Son of BOSS tax
9 shelter. At trial, Mr. Sideman testified about his understanding, at the time that Notice
10 2000-44 was issued, that the IRS took the position that transactions similar to the one
11 being proposed for the Martin family were abusive tax shelters, but that the Notice had no
12 binding effect at all.

13 On August 14, 2000, Mr. Pellervo of PWC informed the Sideman firm that R.J. Ruble
14 was still willing to provide an opinion letter for the Martin Family Trusts' shelter transaction,
15 proposed by Lehman Brothers, notwithstanding the issuance of Notice 2000-44. Mr.
16 Pellervo was interested in Mr. Ruble's rationale for "what seems to be a very optimistic
17 position in the face of the notice." Ex. 168.

18 **5. Presentation to the Martin Family**

19 PWC prepared and put on several iterative presentations of a proposed joint
20 investment structure it had designed to members of the Martin family, Mr. Folger as the
21 Trustee of the 14 Martin Family Trusts, Mr. Sideman, and Ms. Ryan. These presentations
22 described the various concerns and objectives that the joint investment structure was
23 intended to address and achieve and the components of a proposed joint investment
24 structure. Tr. 147:2-10; 153:1-24; 176:6-15; 323:1-22; Tr. 348:20-349:18; 372:6-373:4;
25 454:8-455:16; 533:17-536:18; Exs. 30, 120, 309. The tax ramifications of the transaction
26 were clearly described to the Martin Family, as well as the potential for IRS examination,
27 because of the issuance of IRS Notice 2000-44. Tr. 359:16-360:16.

28

1 At these meetings, Mr. Folger asked a lot of questions. He saw it as his role to
2 understand and vet the proposed joint investment structure. In the course of this process,
3 while he listened and might defer to the Martin family, it was ultimately his decision, based
4 on the advice of Mr. Sideman, Ms. Ryan, and PWC, as to whether to approve and finally
5 recommend the joint investment structure to the Martin family and to allow its
6 implementation by the 14 Martin Family Trusts. Tr. 233:12-20; 323:23-324:5; 324:14-15;
7 335:17-19. In addition to attending the PWC meetings, Mr. Folger also frequently met and
8 talked with Mr. Sideman separately about the proposed joint investment structure and met
9 with the Trusts' beneficiaries. Tr. 154:9-158:4; 266:8-18; 267:18-23; 268:7-12;
10 273:16-274:20; 325:21-25; 454:1-22.

11 At the same time that PWC was working to design a joint investment structure, Dr.
12 Rubinstein had been evaluating and rejecting various options transactions proposed by
13 Lehman Brothers and JP Morgan. Over the course of several months, he communicated
14 with Sideman & Bancroft his various concerns with respect to the rejected proposed
15 options transactions. Tr. 173:1-10; 733:18-25; Exs. 40, 47, 49, 50. After extensive
16 analysis and consultation with Dr. Rubinstein, JP Morgan finally designed an options
17 transaction that Dr. Rubinstein deemed could have economic purpose, to achieve the
18 business and financial objectives as understood by Dr. Rubinstein. Tr. 173:1-10;
19 733:18-25; 769:18-23; Exs. 51, 52. Once Dr. Rubinstein approved the last JP Morgan
20 proposed options transaction, Mr. Sideman also agreed to approve the options transaction
21 as a component of the joint investment transaction. Tr. 173:3-13. Mr. Sideman would not
22 have recommended or approved an options transaction that was not approved by Dr.
23 Rubinstein. Tr. 225:11-15.

24 On September 20, 2000, the Sideman firm and PWC made a presentation to the
25 Martin family in regards to the Lehman Brothers proposal. The family briefing document for
26 this presentation was titled "Martin Family Presentation, Joint Investment and Management
27 Proposal." Ex. 30. The presentation included an explanation of the tax ramifications and
28 tax risks of the proposal. Ex. 30 at Priv Log 3564; Tr. 444:20-445:10; Ex. 309. This

1 presentation was attended by the Martin family (either in person or by phone), Folger, and
2 representatives from PWC and the Sideman firm. Tr. 407:8-408:4; Tr. 543: 16-24.

3 At that presentation, the proposed transaction was described to the Martin family as
4 having “the same basic mechanics” as the transaction described by the IRS in Notice
5 2000-44. Ex 30 at Priv Log 3577. The proposed transaction was presented to the Martin
6 family as one that could completely eliminate their taxable gain on the sale of CPC. Ex 30
7 at Priv Log 3620. The written proposal states, “the joint investment management proposal
8 may yield through the hedging component of the overall proposal significant tax benefit in
9 the form of large capital loss.” Ex. 30 at Priv. Log. 3571. At that presentation, the Martin
10 family was informed of what rate of return they would need to achieve on the investment of
11 their tax savings in order to be indifferent to an IRS examination and ultimate repayment of
12 the tax, plus interest and penalties. Ex 30 at Priv Log 3622; Tr. 405:8-25. The tax aspects
13 of the transaction were explained to the Martin family at the presentation, with questions
14 asked by the Martin family and answered by Roger Feusier and Richard Sideman. Tr.
15 408:24 - 409:20.

16 The written proposal discusses the importance of the IRS Notice 2000-44:

17 Also it is important to note that on August 11, 2000 the IRS
18 announced in Notice 2000-44 that transactions involving the same
19 basic mechanics as the instant one did not give rise to the intended
20 capital loss. . . . As consequence, the Martin family should expect to
21 incur significant litigation expenses in defending any capital loss
22 resulting from the contemplated transaction.

22 Ex. 30 at Priv. Log. 3577. The written proposal also discusses the importance of the Ruble
23 opinion letter to avoid IRS penalties. Ex. 30 at Priv. Log. 3577. In the section titled “Non-
24 Tax Financial Considerations,” the written proposal states, “If the Parent LLCs were to be
25 eliminated shortly after the short term assets were disposed of or if it distributed
26 substantially all of its assets to its shareholders shortly thereafter the intended tax benefits
27 of the transaction would be seriously jeopardized.” Ex. 30 at Priv. Log. 3577.
28

1 As part of the presentation, PWC prepared a spreadsheet that showed the effect of
2 the proposed transaction on the Martin family income. This spreadsheet shows that
3 expected tax loss would completely eliminate all gains from the sale of CPC. Ex. 30 at
4 Priv. Log 3620. The mechanics and structure of the tax shelter portion of the transaction
5 presented in the Martin family briefing document were identical to the abandoned Arthur
6 Andersen proposal. Tr. 218:18-20.

7 On September 27, 2000, Lehman Brothers made a new proposal to the Sideman
8 firm. The Sideman firm solicited the views of Dr. Rubinstein, PWC, and JP Morgan, on the
9 proposal. Ex. 49. On September 29, 2000, R.J. Ruble provided to the Sideman firm a new
10 draft opinion letter for the Martin Family Trusts' shelter transaction. Ex. 179. PWC and
11 Jean Ryan of the Sideman firm provided comments on the opinion letters written by R.J.
12 Ruble for the Martin Family Trusts. Tr. 428:25-429:6; 522: 24-25; 458:7-15; Ex. 214 at Priv
13 Log 5341. On September 29, 2000, Dr. Rubinstein informed the Sideman firm that the
14 Lehman Brothers options strategy did not make sense, the pricing and payoff structure was
15 strange, and the options were still too expensive. Ex. 50. The Lehman Brothers proposals
16 were rejected as too expensive. Ex. 50.

17 In October 2000, the Sideman firm, PWC, and JP Morgan continued working
18 together on a proposed shelter transaction for the Martin family. Throughout the month of
19 October, JP Morgan made a variety of updated transaction proposals to the Sideman firm
20 with respect to the Martin family. On October 6, 2000, another draft Ruble opinion letter,
21 also entitled "Investment in Foreign Currency," was sent from Sideman to Folger with a
22 cover memo that states, "If the transaction occurs, we expect to close next week." Ex. 235.

23 On October 16, 2000, Dr. Rubinstein told Richard Sideman that he was even more
24 troubled by the JP Morgan options proposal than he was with the prior proposals from
25 Lehman Brothers. He characterized the only possible argument for business purpose for
26 this proposal as "a bit shakey [sic]." Ex. 51 at First Ship Summons 0736. On October 16,
27 2000, Mr. Sideman informed Francis Martin of Dr. Rubinstein's concerns about the JP
28 Morgan shelter proposal, and also informed Mr. Martin that the cost of the JP Morgan

1 transaction was \$10 million, rather than \$9 million. Ex. 123. On October 21, 2000, Francis
2 Martin called Mr. Sideman and told him that he disagreed with Dr. Rubinstein's concerns
3 and wanted to proceed with the proposed transaction anyway. Ex. 143. On October 24,
4 2000, Dr. Rubinstein told the Sideman firm that the options as proposed by JP Morgan
5 were overpriced by \$7 million, but later accepted JP Morgan's explanation for its fees to
6 account for the risk it was assuming for hedging this transaction. Ex. 51 at First Ship
7 Summons 0745; Tr. 751-753. On October 27, 2000, Mr. Sideman provided the Martin
8 family with a description of the transaction proposed by JP Morgan. Tr. 81:19-82:15.

9 PWC gave a final presentation to the Martin family, Mr. Folger, Mr. Sideman and Ms.
10 Ryan in late October or early November, 2000. Tr. 372:6-373:4; 454:8-455:5;
11 543:16-544:3; Ex. 309. Following this presentation, the Martin family and Mr. Folger on
12 behalf of the 14 Martin Family Trusts determined to go forward with a joint investment
13 structure and the hedging transaction. Mr. Folger, on behalf of 2000-A and the 14 Martin
14 Family Trusts, and the Martin family relied on Sideman & Bancroft and PWC to provide
15 them with advice as to whether to enter into the joint investment transaction and its
16 propriety. Tr. 151:18-22; 172:21-173:10; 264:3-10; 267:21-23; 268:7-23; 473:4-6;
17 477:9-16; 324:23-25; 325:1-10; 543:23-544:3. The Martin family understood that the
18 transaction had a tax component as well as the business objectives of risk management,
19 asset conservation, flexible and prudent investment, maximization of returns, and equitable
20 allocation amongst the trusts of the attendant risks and rewards. Tr. 62:5-10; 323:1-11;
21 450:13-15; 651:13-17.

22 **E. LLC Structure**

23 The Martin Family Trusts formed several limited liability companies to implement the
24 joint investment structure. See Ex. 30 (Joint Investment and Management Proposal); Ex. 6
25 (Ruble opinion letter). The implementation of the LLC structure, contemplated in November
26 2000, was completed in 2001. The Parent LLCs formed multiple lower tier LLCs (11 in all)
27 to hold specific pools of assets, with those pools further divided into "Discretionary
28 Investments" and "Common Investments." In general, assets held by the Parent LLCs at

1 the close of 2000 were not distributed to the ultimate owners but, rather, were invested
2 within the structure. Each owner of a Parent LLC indirectly owned interests in those two
3 categories of investments. Discretionary Investments were intended to provide a degree of
4 investment flexibility to individual Martin family members, whereas Common Investments
5 were intended to consist of conservative and uniform investments that were jointly agreed
6 to by the family members, in order to facilitate the objective of maintaining a relatively
7 stable pool of assets to cover the various exposures described above. Tr. 161:6-20;
8 374:10-375:14; 479:2-10; 482:3-16; 536:1-18; 575:21-24; Exs. 198, 266, 310. The joint
9 investment structure stayed in place until 2006, when the reasons for its implementation
10 were no longer of consequence. Tr. 87:13-88:15; 476:20-478:9.

11 The LLC structure and partnership at issue here involves the 2000-A partnership.

12 On June 2, 1999, LMGA Holdings was formed as a California C corporation. The
13 five 1999 Trusts were each 20 percent shareholders in LMGA. Stip. ¶ 8. On June 15,
14 1999, and June 16, 1999, the 1999 Trusts transferred 4,130,728 shares of Liberty Media
15 Group (LMGA) Stock and \$13.8 million in cash to LMGA Holdings. Stip. ¶ 30.

16 On March 6, 2000, First Ship, LLC was formed as a California limited liability
17 company. Stip. ¶ 3. The 14 Martin Family Trusts were the partners of First Ship, with
18 petitioners Constance M. Goodyear 1997 Irrevocable Trust and Candyce Martin 1999
19 Irrevocable Trust having partnership interests of 7.13% and 3.40%, respectively. Stip. ¶ 4
20 and Ex. 6 (First Ship's Form 1065 for tax year ended Dec. 31, 2000).

21 On October 10, 2000, First Ship 2000-A, LLC ("2000-A") was formed as a California
22 limited liability company with three partners: First Ship (77.03%); Fourth Ship LLC
23 (22.22%); and LMGA Holdings, Inc. (0.75%). Stip. ¶ 6.

24 On October 12, 2000, Fourth Ship LLC was formed as a California limited liability
25 corporation with nine partners: the five 1988 Trusts; the Francis Martin 1997 Trust; the
26 Francis Martin 1998 trust; the Constance Goodyear 1997 Irrevocable Trust; and the
27 Candyce Martin 1999 Irrevocable Trust. Stip. ¶ 7.

28

1 **F. Implementation of the Joint Investment Transaction**

2 The steps for implementing the joint investment transaction were outlined in the
3 “Joint Investment and Management Proposal” briefing document prepared by PWC, and
4 are described below. Ex. 30.

5 **1. Step One: Consolidation of Assets in Martin Family Trusts**

6 On November 9, 2000, LMGA Holdings distributed back to the five 1999 Trusts all of
7 its Liberty Media shares (4,130,728 shares) along with \$12.5 million of the \$13.8 million in
8 cash that LMGA then held. Stip. ¶ 30; Ex. 1 at MTCB 00116-00121. On that same date,
9 based on the advice of JP Morgan, \$121,452,146 in cash held by the 14 Martin Family
10 Trusts and \$1 million of cash retained by LMGA Holdings was invested in Standard &
11 Poor’s Depository Receipts (“SPDRs”), an investment unit that tracks the S&P 500. Stip.
12 ¶ 36. Investing in SPDRs purportedly permitted the Trusts to quickly and conveniently
13 convert the CPC proceeds into an investment that was intended to perform in a manner
14 similar to, and that promised a return measured by, S&P 500 equities to which the SPDRs
15 were later converted. Tr. 464:4-16; Exs. 30, 120, 309.

16 **2. Step Two: Purchase SPDRs**

17 Each of the 14 Martin Family Trusts then invested its cash proceeds into S&P
18 Depository Receipts (“SPDRs”). On November 9, 2000, the Martin Family Trusts invested
19 most of their cash, \$121,452,146, in SPDRs, an exchange-traded fund (“ETF”) that tracks
20 the performance of the S&P 500. Stip. ¶ 36.

21 **3. Step Three: Options**

22 Concurrently with Step Two, the Martin Family Trusts entered into a set of options
23 transactions with JP Morgan. The options were European-style options written against a
24 notional portfolio (the “option notional portfolio”) that was virtually identical to the assets
25 owned by the Trusts after the purchase of the SPDRs. Instead of SPDRs, the option
26 notional portfolio included units of the S&P 500 index (86,230 shares). The number of
27 shares of Liberty Media, Young Broadcasting, AT&T, and TCI Satellite included in the
28 portfolio were exactly the same as the Trusts owned (i.e., 267,533 shares of AT&T,

1 5,435,370 shares of Liberty Media Group, 33,785 shares of TCI Satellite, and 391,444
 2 shares of Young Broadcasting). Based on the initial stock prices and the initial level of the
 3 S&P 500 index used to value the portfolio, its initial value (the “notional value”) was \$226.3
 4 million. Ex. 3; Stip. ¶¶ 37, 40.

5 On November 10, 2000, the 14 Martin Family Trusts purchased six European-style
 6 option contracts (the long options) from JP Morgan for premiums paid totaling
 7 \$315,781,658.59. Ex. 332 at US011130. Also on November 10, 2000, the 14 Martin
 8 Family Trusts sold (or wrote) five European style option contracts (the short options) to JP
 9 Morgan for premiums received totaling \$314,885,515.96. Ex. 332 at US011150. The
 10 Martin Family Trusts paid JP Morgan a net up-front premium payment of \$896,142.64,
 11 which amount is the difference between the premiums paid on the long options and the
 12 premiums received on the short options. Stip. ¶ 37; Tr. 937:4-25; 938:1-939:5; Ex. 6 at 5-6;
 13 Ex. 3 at MTCB00578-MTCB00830.

14 The trusts entered into a total of eleven options contracts: six purchased options,
 15 consisting of five calls and one put, and five sold or written options, consisting of four calls
 16 and one put:

	<u>Purchased Options</u>			<u>Sold/Written Options</u>		
Option Type	Exercise Price*	Scale Parameter**	Option Type	Exercise Price	Scale Parameter**	
19 Call	80.50%	2.7	Call	83.5%	3.7	
20 Call	86.75%	1.0	Call	88.25%	1.0	
21 Call	91.50%	1.0	Call	93.00%	1.0	
22 Call	96.25%	1.0				
23 Put	119.00%	2.684	Call	119.00%	2.684	
24 Call	119.65%	2.684	Put	119.65%	2.684	

25 * Percentages are derived by dividing the call strike price by the Initial Notional Amount.

26 ** The scale parameter scales the notional portfolio on which the option is written.

27 Ex. 332 at US011129-31; US011149-51.

28

1 The put-call pairs with exercise prices of 119.00% and 119.65% (and an identical
 2 multiplicative factor of 2.684) collectively constituted a “box-spread,” which has a fixed
 3 dollar payoff at expiration. The combined effect of these four options was that the 14
 4 Martin Family Trusts would pay JP Morgan an incremental \$3.95 million embedded within
 5 the options at expiration, regardless of the value of the underlying portfolio in exchange for
 6 a smaller up-front premium. Tr. 995:1-16; 1075:23-1077:22.

7 The options expired on December 29, 2000. Stip. ¶ 37. The options were ordinary
 8 European-style options in all but one respect: the payoffs on the options did not depend on
 9 the value of the option notional portfolio at expiration. Rather, the payoffs depended on the
 10 average value of the options over three days leading up to and including expiration—that is,
 11 the option payoffs depended on the average value of the portfolio as of the market close on
 12 December 27, 28, and 29, 2000. Dr. Rubinstein testified that this feature of the options
 13 effectively prevented any attempt by JP Morgan to control the option payoffs. Tr.
 14 773:19-774:8; Ex. 332 at US011129.

15 **a. The Long Options**

16 The Martin family entered into a long call-spread with a lower exercise price of
 17 80.5% and an upper exercise price of 83.5%. Ex. 332 at US011129-31, US011149-51.
 18 The six long (purchased) options bought were as follows:

<u>Type</u>	<u>Premium</u>	<u>Strike Price</u>	<u>Multiplier</u>
Call Strike 1	\$123,805,727.02	\$182,170,411.18	2.7
Call Strike 2	\$ 33,729,813.40	\$196,314,076.64	1.0
Call Strike 3	\$ 24,935,847.96	\$207,063,262.40	1.0
Call Strike 4	\$ 17,520,041.28	\$217,812,448.15	1.0
Call Strike 5	\$ 2,998,457.08	\$270,766,331.65	2.684
Put Strike 1	<u>\$112,791,772.85</u>	\$269,295,390.44	2.684
Total	\$315,781,658.59		

26 Ex. 332 at US011130-31.

1 For the call options, if the final notional amount of the portfolio on December 29,
 2 2000, was greater than the call strike price, JP Morgan was required to pay the Martin
 3 Family Trusts the difference between such amount and the call strike price, multiplied by
 4 the 2.684 multiplier. If the final notional amount was below the call strike price, no
 5 payments or settlements were due from either party. The final notional amount of the
 6 portfolio could trigger payments on more than one of the call options. Ex. 332 at
 7 US011131.

8 For the put option, if the final notional amount of the portfolio on December 29, 2000,
 9 was below the put strike price, JP Morgan was required to pay the Martin Family Trusts the
 10 difference between such amount and the put strike price, multiplied by the above multiplier.
 11 If the final notional amount was greater than the put strike price, no payments or
 12 settlements were due from either party. Ex. 332 at US011131.

13 **b. The Short Options**

14 The Martin family entered into three short call-spreads with the following
 15 non-overlapping exercise prices:

<u>Lower Exercise Price (sold call)</u>	<u>Upper Exercised Price (purchased call)</u>
83.50%	86.75%
88.25%	91.50%
93.00%	96.25%

19 Ex. 332 at US011129-31; US011144-51.

20 The terms of the five sold options were as follows:

<u>Type</u>	<u>Premium</u>	<u>Strike Price</u>	<u>Multiplier</u>
Call Strike 1	\$145,235,838.80	\$188,959,370.60	3.7
Call Strike 2	\$ 29,160,843.71	\$199,708,556.35	1.0
Call Strike 3	\$ 20,760,637.91	\$210,457,742.11	1.0
Call Strike 4	\$ 3,297,171.29	\$269,295,340.44	2.684
Put Strike 1	\$116,408,024.24	\$270,766,331.65	2.684
Total	\$314,885,516.96		

27 Ex. 332 at US011150-51.

28

1 For the call options, if the final notional amount of the portfolio on December 29,
2 2000, was greater than the call strike price, the Martin Family Trusts were required to pay
3 JP Morgan the difference between such amount and the call strike price, multiplied by the
4 above multiplier. Ex. 332 at US011151. If the notional amount was below the call strike
5 price, no payments or settlements were due from either party. The final notional amount of
6 the portfolio could trigger payments on more than one of the call options. Id.

7 For the put option, if the final notional amount on December 29, 2000, was below the
8 put strike price, the Martin Trusts were required to pay JP Morgan the difference between
9 such amount and the put strike price multiplied by the above multiplier. Ex. 332 at
10 US011151. If the final notional amount was greater than the put strike price, no payments
11 or settlements were due from either party. Id.

12 **c. Underlying Basket of Stocks**

13 The payouts on the option contracts were based upon the average closing price of
14 the company stock owned by the Martin Family Trusts in an “underlying basket” or “notional
15 portfolio” of stocks for the three business days leading up to and including December 29,
16 2000. Ex. 3 at MTCB00578-MTCB00830. The option notional portfolio was virtually
17 identical to the asset portfolio owned by the Martin Family Trusts after the purchase of the
18 SPDRs. Instead of SPDRs, the option notional portfolio included units of the S&P 500
19 index. The number of shares of Liberty Media, Young Broadcasting, AT&T, and TCI
20 Satellite included in the portfolio were exactly the same as the trusts owned. These stock
21 positions remained unchanged throughout the entire transaction, and continued even after
22 it ended. Tr. 941:1-4. Based on the initial stock prices and the initial level of the S&P 500
23 index used to value the portfolio, its initial value (the “notional value”) was \$226.3 million.
24 Specifically, the underlying basket of stocks, as of November 8, 2000 (at or before the date
25 the options contracts were about to be entered into) was as follows:

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<u>Company</u>	<u>Number of Shares</u>	<u>Initial Share Price</u>	<u>Initial Notional Amount</u>
AT&T	267,533	\$ 21.1614	\$5,661,372.83
Liberty Media	5,435,370	\$ 16.4766	\$89,556,417.34
TCI Satellite	33,785	\$ 5.6250	\$190,040.63
Young Broadcasting	391,444	\$ 26.8003	\$10,490,816.63
S&P 500 Index	86,230	\$ 1,396.2620	<u>\$120,399,672.26</u>
Total			\$226,298,319.69

Ex. 6; Tr. 940:16-941:10.

4. Step Four: Contributions to Parent LLCs

The next step of the transaction was to have the Martin Family Trusts contribute their assets, including the long and short options, to their first-tier partnerships, First Ship and Fourth Ship, referred to as the “parent LLCs.” Ex. 6 at US006475-76. On or about November 17, 2000, the Martin Family Trusts purportedly contributed \$485 million to First Ship as follows:

<u>Description</u>	<u>Fair Market Value (\$)</u>
650,066 SPDRs	90,725,160
391,444 shares of Young Broadcasting	10,813,617
4,130,730 shares of Liberty Media Group	64,542,655
33,785 shares of TCI Satellite	162,575
KRON Holdback	3,019,838
Long Option Positions	<u>315,781,636</u>
Total	\$ 485,045,481

Stip. Ex. 2 at PWC02784-89; Ex. 37 at Priv Log 5434; Ex. 6 at 5-6; Ex. 3 at MTCB00839-MTCB00850, MTCB00870-MTCB00875.

As reflected in the table above, the amount of the purported contributions to First Ship included the premiums on the long options totaling \$315,781,658.59, unreduced by the premiums on the short options totaling \$314,885,515.96, although the Martin Family Trusts only paid \$896,142.64 net premium to enter into the option agreements. The

1 transfer of the purchased and sold options to the partnership caused a purported increase
2 in the Trusts' bases in First Ship, as the Martin Family Trusts did not treat the short position
3 on the sold options as a liability in computing the basis for the partnership.

4 Also on or about November 17, 2000, the five 1988 Martin Family Trusts and the
5 Francis Martin 1997 Irrevocable Trust, the Francis Martin 1998 Irrevocable Trust, the
6 Constance Goodyear 1997 Irrevocable Trust, and the Candyce Martin 1999 Irrevocable
7 Trust contributed 210,880 SPDRs with a fair market value of \$29.4 million to Fourth Ship.
8 Ex. 3 at MTCB 00859-00867; Ex. 37 at Priv Log 5437.

9 **5. Step Five: Contributions to 2000-A**

10 The next step of the transaction was to transfer the assets from the first-tier
11 partnerships, First Ship and Fourth Ship, to the second-tier partnership, 2000-A. On
12 November 27, 2000, First Ship purportedly contributed over \$415 million to 2000-A as
13 follows:

<u>Description</u>	<u>Fair Market Value (\$)</u>
650,066 SPDRs	\$ 88,368,347
391,444 shares of Young Broadcasting, Inc.	11,033,828
Long Option Positions Purchased from JP Morgan	315,781,636
Total	\$ 415,183,811

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17 Ex. 37 at Priv Log 5433; Ex. 3 at MTCB00879-87. 2000-A also took on First Ship's
18 obligations under the short options.

19 Also on November 27, 2000, Fourth Ship contributed its 210,880 SPDRs, with a fair
20 market value of \$28,666,500, to 2000-A. On the same date, LMGA Holdings contributed its
21 7,151 SPDRs, with a fair market value of \$972,089, to 2000-A. As of November 27, 2000,
22 2000-A held all of the 868,111 SPDRs that the 14 Martin Family Trusts and LMGA Holdings
23 had purchased. Ex. 3 at MTCB 00886-88. First Ship continued to hold its shares of Liberty
24 Media stock, its shares of TCI Satellite stock, and the KRON Holdback of \$3,019,838. Ex.
25 37 at Priv Log 5434.

26 **6. Step Six: Sale of 2000-A Assets**

27 Immediately after the transfer of the SPDRs to 2000-A, JP Morgan directed the
28 reinvestment of the SPDRs in stock of S&P companies. On November 29, 2000, 2000-A

1 sold the SPDRs for \$116 million, resulting in a lost of approximately \$5.4 million. On or
2 about December 1, 2000, 2000-A used the proceeds from that sale to purchase various
3 S&P 500 securities for \$112.2 million. These securities were sold on December 27, 2000
4 for \$106.9 million, resulting in an additional loss of \$5.3 million. The combined loss on the
5 Martin Family Trusts' S&P 500 investments (SPDRs and S&P securities) during November
6 and December 2000 was \$10,756,230. Stip. ¶ 38.

7 Although the options were European-style, an agreement was reached to terminate
8 them roughly a week prior to their expiration date, on December 21, 2000. Stip. ¶ 39. On
9 or about December 20, 2000, JP Morgan advised Mr. Sideman that the options had
10 achieved a positive return (net of transaction costs) of approximately \$3.9 million. Mr.
11 Sideman confirmed this information with Dr. Rubinstein, and, after informing Mr. Martin that
12 they were "in the money," Mr. Sideman advised that the options should be closed out. Tr.
13 235:2-12; 608:22-609:6. JP Morgan sought authorization to close out the options from Mr.
14 Folger, 2000-A's managing member, who authorized the termination of the options by
15 signing a Termination Agreement dated December 22, 2000. Ex. 4 at MTCB 01182-84. At
16 termination, JP Morgan paid the trusts approximately \$4.8 million, resulting in a net profit
17 (after subtracting the upfront premium) of \$3.9 million. Stip. ¶ 39. The purchased options
18 had a value of \$237,087,693, while the sold options cost the taxpayers \$232,270,067 to
19 close out. Ex. 37 at Priv Log 5423.

20 From December 26 to December 28, 2000, 2000-A sold all of its stock. Specifically,
21 on December 26, 2000, 2000-A sold all of its 391,444 shares of Young Broadcasting, Inc.
22 stock for \$11,596,138.68, resulting in a gain of \$562,300. On December 27, 2000 and
23 December 28, 2000, 2000-A sold its remaining stock, resulting in a loss of \$5,308,240. Ex.
24 4 at MTCB01182-1218; Ex. 37 at Priv Log 5416, 5421. 2000-A was cancelled on
25 December 28, 2000. Stip. ¶ 14 and Stip. Ex. 7.

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1 **7. Step Seven: Distributions by 2000-A**

2 The proceeds of the liquidation and closing of the hedge positions distributed by
3 2000-A to its partners, including the parent LLCs First Ship and Fourth Ship, consisted of
4 cash in the amount of \$127,168,869:

5 <u>Partner</u>	<u>Distribution</u>
6 First Ship	\$ 97,960,224
7 Fourth Ship	\$ 28,250,657
8 LMGA Holdings	<u>\$ 957,988</u>
9 Total:	\$127,168,869

10 Ex. 4 at MTCB01211-18; Ex. 37 at Priv Log 5433.

11 2000-A also paid a \$100,000 advisory fee to JP Morgan in 2000. Ex. 37 at Priv Log
12 5433. After December 29, 2000, 2000-A had no remaining assets, having distributed all of
13 its stock and cash in complete liquidation. Id.; Ex. 4 at MTCB01182-1218.

14 2000-A was designed at the outset of the transaction as a partnership, funded by the
15 parent LLCs (First Ship LLC and Fourth Ship LLC) and LMGA Holdings, to be a short-term
16 vehicle that would be sold or liquidated before the close of the taxable year. See Ex. 6 at
17 US006477 (“In essence, 2000-A LLC functions as the repository for all assets of the Family
18 Trusts that have been designated for prompt sale by the Martin Family.”). The Martin
19 family knew at the outset that if they wanted the capital loss to offset their gain from the
20 sale of CPC, then they would have to sell or liquidate 2000-A before the close of the
21 taxable year 2000. Tr. 424:23-425:22; Tr. 578:5-579:3.

22 **G. Allocation of Losses**

23 The Martin Family Trusts realized a loss of \$5,447,984 on the sale of the SPDRs, a
24 loss of \$5,308,240 on the sale of the S&P 500 securities, and a loss of \$320,031,270 on
25 the liquidation of 2000-A. The Trusts realized a gain of \$4,817,626 on the offsetting
26 options. Ex. 37 at Priv Log 5416, 5419, 5420, 5422, 5423. Each of the 14 Martin Family
27 Trusts that participated in the transaction was allocated a portion of the over \$320 million
28 loss generated on the liquidation of 2000-A. The losses were allocated as follows:

<u>Trust</u>	<u>Loss Allocated</u>
1 Consuelo T. Martin Trust fbo Francis A. Martin III (1988 Trust)	(\$19,352,930)
2 Consuelo T. Martin Trust fbo Priscilla Tamkin (1988 Trust)	(\$19,352,930)
3 Consuelo T. Martin Trust fbo Constance Goodyear (1988 Trust)	(\$19,352,930)
4 Consuelo T. Martin Trust fbo Candyce Martin (1988 Trust)	(\$19,352,930)
5 Consuelo T. Martin Trust fbo Helen Spalding (1988 Trust)	(\$19,352,930)
6 CTM 1999 Trust fbo Francis A. Martin III	(\$23,832,110)
7 CTM 1999 Trust fbo Priscilla Tamkin	(\$23,832,110)
8 CTM 1999 Trust fbo Constance Goodyear	(\$23,832,110)
9 CTM 1999 Trust fbo Candyce Martin	(\$23,832,110)
10 CTM 1999 Trust fbo Helen Spalding	(\$23,832,110)
11 Francis A. Martin III, 1997 Irrevocable Trust	(\$38,485,350)
12 Francis A. Martin III, 1998 Irrevocable Trust	(\$17,487,623)
13 Constance Goodyear 1997 Irrevocable Trust	(\$29,205,415)
14 Candyce Martin 1999 Irrevocable Trust	(\$18,927,653)
15 Ex. 37 at Priv Log 5418.	

13 **H. The Opinion Letters**

14 The viability of the recognized tax loss was the subject of favorable tax opinions
 15 written by Mr. Ruble of Brown & Wood, a nationally recognized law firm. Brown & Wood
 16 had been engaged by Mr. Sideman prior to the implementation of the joint investment
 17 transaction to provide a tax opinion with respect to its potential tax implications. Over the
 18 course of several months, Sideman & Bancroft and PWC worked closely with Brown &
 19 Wood, providing it with facts and information relevant to the Martin family and the Trusts,
 20 the then-developing joint investment transaction, and the issues to be addressed in the tax
 21 opinion, assuring the accuracy of the representations to be made therein. Tr. 368:15-20;
 22 369:15-18; 371:18-22; 372:3-5; 377:25-378:2; 475:10-17; 537:22-538:11.

23 By letters dated November 8, 2000, Mr. Ruble of Brown & Wood advised the Martin
 24 Family Trusts that his firm accepted their request to represent them as their federal income
 25 tax counsel “in connection with the restructuring and hedging of certain interests with
 26 respect to certain investments (the ‘Transaction’).” Brown & Wood agreed to provide
 27 advice as to the structuring of the transaction, and to provide an opinion as to the federal
 28

1 tax consequences which were “more likely than not to occur” as a result of the transaction.
2 Ex. 4 at MTCB 01236.

3 Brown & Wood provided the 14 Martin Family Trusts with identical favorable
4 opinions concerning the consequences of the transaction. The opinions, dated November
5 15, 2000, were provided at a non-contingent fee of \$700,000. Separate opinions were
6 issued to each of the five 1988 Trusts, the Francis Martin 1997 Trust, the Francis Martin
7 1988 Trust, the Constance Goodyear Trust, and the Candyce Martin Trust. One opinion
8 was also issued to the five 1999 Trusts. Ex. 109; Exs. 6, 8, 10, 12, 14, 16, 18, 20, 22, 24;
9 Tr. 458-459. Although the Brown & Wood opinion letter has a section entitled “Investor
10 Representations,” neither the Martin family nor Peter Folger provided the representations to
11 Brown & Wood. Rather, the “Investor Representations” in the opinion letters were authored
12 by Brown & Wood and reviewed by Sideman & Bancroft and PWC. Tr. 418:22-420:19;
13 474:22-475:2; Ex. 184. At trial, Dr. Rubinstein disagreed with certain statements in the
14 opinion letter and clarified that he did not review the complete transaction, and disagreed
15 with the statement in the opinion letter that attributed to him a declining market view. Tr.
16 834:24-835:21.

17 Brown & Wood also provided a six-page letter dated January 31, 2001 to each of the
18 Trusts, concerning the tax consequences of the distributions from First Ship 2000-A in
19 December 2000. Stip. ¶ 42; Exs. 5, 7, 9, 11, 13, 15, 17, 19, 21, 23. Years later, Mr. Ruble
20 would be indicted and then convicted of tax evasion, and sentenced to 78 months in prison.

21 **I. Tax Returns**

22 **1. 2000-A**

23 For the year ending December 31, 2000, 2000-A reported income, gain, loss and
24 deductions related to the transactions at issue on its 2000 partnership tax return, Form
25 1065. The 2000 partnership tax return of 2000-A was filed on or about March 22, 2001,
26 and was prepared and signed by PWC. Stip. ¶ 9; Stip. Ex. 5. The Schedule K, “Partner’s
27 Shares of Income, Credits, Deductions, etc.,” of 2000-A’s Form 1065 reported ordinary
28 dividends of \$159,264, net short-term capital losses of \$5,376,293, deductions related to

1 portfolio income of \$100,082, investment income of \$159,264, investment expenses of
2 \$100,082, and total cash distributions of \$127,168,869. Stip. ¶ 10 and Stip. Ex. 5.

3 Each member's distributive share of the reported items of income, gain, loss and
4 deductions from 2000-A was reported on Schedules K-1 issued to its members, including
5 First Ship, Fourth Ship and LMGA Holdings. Stip. ¶ 10; Stip. Ex. 5. The Schedules K-1,
6 "Partner's Share of Income, Credits, Deductions, etc.," of 2000-A's Form 1065 reported
7 First Ship's, Fourth Ship's, and LMGA Holding's distributive share of 2000-A's \$5,376,293
8 net short-term capital loss as follows:

<u>Partner</u>	<u>Short-Term Loss</u>
9 First Ship	(\$4,067,455)
10 Fourth Ship	(\$1,265,910)
11 LMGA Holdings	<u>(\$ 42,928)</u>
12 Total	(\$5,376, 293)

13 The Schedules K-1 of 2000-A's Form 1065 reported First Ship's, Fourth Ship's and LMGA
14 Holding's distributive share of 2000-A's \$127,168,869 distributions as follows:

<u>Partner</u>	<u>Distributions</u>
15 First Ship	\$ 97,960,224
16 Fourth Ship	\$ 28,250,657
17 LMGA Holdings	<u>\$ 957,988</u>
18 Total	\$127,168,869

19 **2. First Ship**

20 First Ship reported its distributive share of each item of income, gain, loss, and
21 deductions from 2000-A on its 2000 partnership tax return, Form 1065. Stip. Ex. 6. The
22 return was timely filed on or about March 22, 2001, and was prepared and signed by PWC.
23 On the attached Schedule D, First Ship reported a short term capital loss from the
24 liquidation of its interest in 2000-A of \$318,018,377. Stip. ¶ 11. First Ship reported a net
25 short-term capital loss of \$321,865,645, reported on the Schedule D as follows:
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<u>Description</u>	<u>Date Acquired</u>	<u>Date Sold</u>	<u>Sales Price</u>	<u>Cost Basis</u>	<u>Gain/(Loss)</u>
Contrib. of Young Stock to 2000-A	11/20/00	11/27/00	\$ 11,033,828	\$ 10,813,641	\$ 220,187
Liquidation of 2000-A	11/27/00	12/29/00	\$ 97,960,224	\$ 415,978,601	(\$318,018,377)
Net S-T Loss from 2000-A					<u>(\$ 4,067,455)</u>
Total					(\$321,865,645)

First Ship reported \$415,978,601 as its basis in its partnership interest in 2000-A, which included the premiums on the long options totaling \$315,781,636, unreduced by the premiums received on the short options totaling \$314,885,516. First Ship's purported \$415,978,601 basis in its partnership interest in 2000-A also included its \$3,319,128 pro rata share of the partners' purported total fees of \$4,308,787 paid for the transaction. First Ship distributed its reported \$321,865,645 net short-term capital losses to the 14 Martin Family Trusts, including petitioners. Stip. ¶ 47. Each member's distributive share of the items of income, gain, loss, and deductions from First Ship was reported on Schedules K-1 issued to its members, including the Martin Family Trusts. Stip. ¶ 12. Each of the 14 Martin Family Trusts reported its distributive share of the items of income, gain, loss and deductions from First Ship, including its share of the short term capital loss reported by First Ship from the liquidation of its interest in 2000-A, on its 2000 income tax returns. Stip. ¶ 13. On its Form 1065 for the period ending December 31, 2001, First Ship reported a deduction of \$1,353,736 for legal and professional fees relating to the transaction, which deduction was passed through to the Martin Family Trusts. Stip. ¶ 48.

3. Fourth Ship

On its Form 1065 for the period ending December 31, 2000, Fourth Ship reported a net short-term capital loss of \$1,910,955, including a net short-term capital loss of \$1,265,910 from the liquidation of 2000-A. Stip. ¶ 49.

1 **4. LMGA Holdings**

2 On its Form 1065 for the period ending December 31, 2000, LMGA Holdings
3 reported a net short-term capital loss of \$64,801, including a net short-term capital loss of
4 \$42,928 from the liquidation of 2000-A. Stip. ¶ 50.

5 **J. Audit**

6 In 2004, the IRS commenced an audit of 2000-A's taxable year 2000 partnership tax
7 return and of First Ship's taxable years 2000 and 2001 returns. Stip. ¶ 17. Both 2000-A
8 and First Ship are subject to the unified audit rules under the Tax Equity and Fiscal
9 Responsibility Act ("TEFRA") as codified in §§ 6221-6233. Stip. ¶ 18. On April 8, 2004,
10 and successively thereafter, the IRS, the 14 Martin Family Trusts that were members of
11 First Ship, and individual Martin family members ("Taxpayers") executed Forms 872-I,
12 Consent to Extend the Time to Assess Tax As Well As Tax Attributable To Items of a
13 Partnership, with respect to taxable year 2000 ("Consents"). Stip. ¶ 18. The Consent
14 forms contained the following language, as agreed to by the IRS and the Taxpayers:

15 The amount of any deficiency assessment is to be limited to that
16 resulting from any adjustment directly or indirectly (through one or
17 more intermediate entities) attributable to partnership flow-through
18 items of First Ship LLC, and/or to any adjustments attributable to
19 costs incurred with respect to any transaction engaged in by First
20 Ship LLC, any penalties and additions to tax attributable to any such
21 adjustments, any affected items, and any consequential changes to
22 other items based on any such adjustments.

23 The first Consent forms extended the statute of limitations to April 15, 2005. Several
24 successive consents were signed by the same parties extending the statute of limitations to
25 June 30, 2008. Each consent contained the same language reflected in the above
26 paragraph. Stip. ¶ 19.

27 By order dated December 11, 2009, the court denied petitioners' motion for partial
28 summary judgment on the issue whether the FPAA issued to 2000-A for the 2000 tax year
was time barred, holding that "the court finds that the extension agreements encompass
the adjustments made by the IRS in the FPAA issued to 2000-A. Since the extension
agreements extended the statutory period to June 30, 2008, and the FPAA was issued on

1 June 19, 2008, the FPAA is not time-barred.” Following the pretrial conference in this
2 matter, the court deemed this ruling as established for purposes of trial. See Final Pretrial
3 Order.

4 **1. FPAA Issued to 2000-A**

5 On June 19, 2008, the IRS issued an FPAA to 2000-A, determining that certain
6 items on 2000-A’s 2000 tax return should be adjusted and that an accuracy-related penalty
7 under 26 U.S.C. § 6662(a) was applicable to underpayments of tax attributable to
8 adjustments of partnership items of 2000-A. In the FPAA, the Service disallowed the items
9 reported on 2000-A’s Form 1065 for the period ending December 31, 2000, consisting of
10 ordinary dividends of \$159,264, net short-term capital loss of \$5,376,293, deductions
11 relating to portfolio income of \$100,082, investment income of \$159,264, investment
12 expenses of \$100,082, and distributions of money of \$127,168,869. Stip. Ex. 9.

13 First, the Service determined that 2000-A was formed solely for tax avoidance by
14 artificially overstating the basis in the partnership interests of its purported partners, First
15 Ship, Fourth Ship, and LMGA Holdings. The Service determined that the formation of
16 2000-A, the acquisition of any partnership interests by the purported partners, the purchase
17 and sale of options, the transfer of the options to a partnership in return for a partnership
18 interest, the purchase of assets by the partnership, and the subsequent sale of the assets
19 and distribution of the sale proceeds to the purported partners in complete liquidation of the
20 partnership interest, all within a period of three months, had no business purpose other
21 than tax avoidance, lacked economic substance, and constituted an economic sham for
22 federal tax purposes. Accordingly, the Service disregarded the transactions and disallowed
23 any purported losses resulting from the transactions as deductions for federal income tax
24 purposes.

25 Second, the Service determined that 2000-A was a sham, lacked economic
26 substance, and under Treas. Reg. § 1.701-2, was formed in connection with a transaction,
27 a principal purpose of which was to reduce the present value of its partners’ aggregate
28 federal tax liability in a manner inconsistent with the intent of the Internal Revenue Code’s

1 Subchapter K. The Service determined that: (a) 2000-A is disregarded and that all
2 transactions engaged in by the purported partnership are treated as engaged in directly by
3 its partners: First Ship, Fourth Ship; and LMGA Holdings; (b) the European-style options
4 purportedly contributed to 2000-A and any gains or losses purportedly realized by 2000-A
5 on the options should be treated as having been realized by its purported partners: First
6 Ship, Fourth Ship; and LMGA Holdings; (c) the purported partners of 2000-A should be
7 treated as not being partners in 2000-A; and (d) contributions to 2000-A will be adjusted to
8 clearly reflect the partnership's or the purported partners' income.

9 Third, the Service determined that the obligations under the short option positions
10 (written options) transferred to 2000-A constituted liabilities for purposes of Treas. Reg.
11 § 1.752-6, the assumption of which by 2000-A should reduce First Ship's basis in 2000-A in
12 the amount of \$314,885,516, but not below the fair market value of the purported
13 partnership interest.

14 Fourth, the Service determined that, even if the option positions were treated as
15 having been contributed to 2000-A, the amount treated as contributed by the partners
16 under IRC § 722 should be reduced by the amounts received by the contributing partners
17 from the contemporaneous sale of the short option positions to the same counter-party.
18 Thus, the Service determined, the basis of the contributed options should be reduced, both
19 in the hands of the contributing partners and 2000-A. Consequently, the Service
20 disallowed any corresponding claimed increases in the outside basis in 2000-A resulting
21 from the contributions.

22 Fifth, the Service determined that the adjusted bases of the purchased options
23 purportedly contributed by the purported partners to 2000-A had not been established
24 under IRC § 723 in an amount greater than zero.

25 Sixth, the Service determined that the legal, accounting, consulting and/or advisory
26 fees paid by 2000-A or its partners, or both, in connection with the option transactions were
27 not allowable as deductions because they related to transactions that lack economic
28 substance, were prearranged and predetermined, and were without legitimate business

1 purpose. In addition, the Service determined that it had not been established that such
2 expenditures were incurred, and if incurred, were deductible under any provision of the
3 Internal Revenue Code, including but not limited to IRC §§ 162, 212, and 1011. As a
4 result, the Service disallowed in full the deduction of \$100,082 shown on 2000-A's
5 partnership return, and determined that fees of \$4,308,787 were not includible in any
6 partner's basis in 2000-A.

7 Seventh, the Service determined that neither 2000-A nor its purported partners
8 entered into the option positions with a profit motive for purposes of IRC § 165(c)(2).

9 Eighth, the Service determined that the option positions constituted an arrangement
10 under IRC § 465(b)(4) to limit the exposure to risk of loss and that neither 2000-A nor its
11 purported partners established any other amounts considered to be at risk for purposes of
12 IRC § 465 that would allow the partners to deduct losses arising from or in connection with
13 2000-A.

14 Ninth, the Service determined that 2000-A and its purported partners lacked the
15 requisite profit intent and that their activities and any investment in the partnership lacked
16 the requisite economic substance in order to allow deductions arising from or related to
17 2000-A or its activities.

18 Tenth, the Service determined that the adjustments of partnership items of 2000-A
19 were attributable to a tax shelter for which no substantial authority has been established for
20 the position taken, and for which there was no showing of reasonable belief by the
21 partnership or its partners that the position taken was more likely than not the correct
22 treatment of the tax shelter and related transactions. The Service also determined that all
23 of the underpayments of tax resulting from the adjustments of partnership items were
24 attributable to, at a minimum, (1) substantial understatements of income tax, (2) gross
25 valuation misstatement(s), or (3) negligence or disregarded rules or regulations. The
26 Service determined that there had not been a showing by the partnership or its partners
27 that there was reasonable cause for any of the resulting underpayments, that the
28 partnership or its partners acted in good faith, or that any exceptions to the penalty apply.

1 As a result, the Service determined that, at a minimum, the accuracy-related penalty
2 under IRC § 6662(a) applied to all underpayments of tax attributable to adjustments of the
3 partnership items of 2000-A. The Service determined that the penalty should be imposed
4 on the components of underpayment as follows: (1) a 40% penalty on the portion of any
5 underpayment attributable to the gross valuation misstatement as provided by IRC
6 §§ 6662(a), 6662(b)(3), 6662(e), and 6662(h); (2) a 20% penalty on the portion of the
7 underpayment attributable to negligence or disregard of rules or regulations as provided by
8 IRC §§ 6662(a), 6662(b)(1), and 6662(c); (3) a 20% penalty on the underpayment
9 attributable to the substantial understatement of income tax as provided by IRC §§ 6662(a),
10 6662(b)(2), and 6662(d); and (4) a 20% penalty on the underpayment attributable to the
11 substantial valuation misstatement as provided by IRC §§ 6662(a), 6662(b)(3), and
12 6662(e).

13 **2. FPAA Issued to First Ship**

14 On June 19, 2008, the IRS issued an FPAA to First Ship, determining that
15 deductions for certain legal and professional fees claimed on First Ship's 2001 tax return
16 are disallowed and that an accuracy-related penalty applied to underpayments of tax
17 attributable to adjustments of partnership items of First Ship. Stip. Ex. 10. No FPAA was
18 issued to First Ship for taxable year 2000.

19 In the FPAA issued to First Ship, the Service disallowed legal and professional fees
20 of \$1,353,739. First, the Service determined that the deduction for legal and professional
21 fees was disallowed in full because they related to transactions that lack economic
22 substance, were prearranged and predetermined, and were without legitimate business
23 purpose. Additionally, the Service determined that it had not been established that the
24 expenditures were incurred, and if incurred, were deductible under any provision of the
25 Internal Revenue Code, including but not limited to IRC §§ 162 and 212.

26 Second, the Service determined that the adjustments of partnership items of First
27 Ship were attributable to a tax shelter for which no substantial authority had been
28 established for the position taken, and for which there was no showing of reasonable belief

1 by the partnership or its partners that the position taken was more likely than not the correct
2 treatment of the tax shelter and related transactions. Additionally, the Service determined
3 that all of the underpayments of tax resulting from the adjustments of partnership items
4 were attributable to, at a minimum, (1) substantial understatements of income tax, or (2)
5 negligence or disregarded rules or regulations. The Service determined that there has not
6 been a showing by the partnership or any of its partners that there was reasonable cause
7 for any of the resulting underpayments, that the partnership or any of its partners acted in
8 good faith, or that any exceptions to the penalty apply.

9 As a result, the Service determined that, at a minimum, the accuracy-related penalty
10 under IRC § 6662(a) applied to all underpayments of tax attributable to adjustments of the
11 partnership items of First Ship. The Service determined that the penalty should be imposed
12 on the components of underpayment as follows: (1) a 20% penalty on the portion of the
13 underpayment attributable to negligence or disregard of rules or regulations as provided by
14 IRC §§ 6662(a), 6662(b)(1), and 6662(c); and (2) a 20% penalty on the underpayment
15 attributable to the substantial understatement of income tax as provided by IRC §§ 6662(a),
16 6662(b)(2), and 6662(d).

17 **K. Expert Testimony**

18 On the issue of whether the transactions had economic substance, petitioners
19 presented expert testimony by Dr. Rubinstein, and the government presented expert
20 testimony by Dr. Steven Grenadier. The relevant portions of the expert testimony
21 presented at trial is discussed below.

22 On the issue whether penalties are applicable, petitioners offered the expert
23 testimony of Stuart Smith. Prior to trial, the government filed a motion to exclude Smith's
24 testimony pursuant to FRE 702 on the ground that Smith's expert opinions impermissibly
25 consist of legal conclusions, applying law to facts, thereby invading the province of the
26 court. By order dated July 8, 2011, the court denied the motion to exclude Smith's
27 testimony, and held that to the extent that Smith's testimony purports to apply the law or
28 offer legal conclusions, the court will disregard such testimony. See Final Pretrial Order.

1 II. DISCUSSION

2 A. Jurisdiction

3 This matter is governed by the partnership-level procedures under the Tax Equity
4 and Fiscal Responsibility Act of 1982 (“TEFRA”), see 26 U.S.C. §§ 6221–6234 (2000).
5 Under section 6226(f), the court has jurisdiction “to determine all partnership items of the
6 partnership for the partnership taxable year to which the notice of final partnership
7 administrative adjustment relates, . . . and the applicability of any penalty, addition to tax, or
8 additional amount which relates to an adjustment to a partnership item.” 26 U.S.C.
9 § 6226(f).

10 Petitioners seek redetermination of the adjustments in the FPAAs issued to 2000-A
11 and to First Ship, and seek readjustment of partnership items for 2000-A for the taxable
12 year 2000 and for First Ship for the taxable year 2001. Petitioners seek readjustment of the
13 tax, to allow petitioners to claim the losses and related deductions, on the following
14 grounds: that the transactions at issue complied with the Internal Revenue Code because
15 short options are not liabilities and do not decrease the partner’s basis in the partnership
16 under 26 U.S.C. § 752; that the transactions had economic substance; and that the tax
17 effects of the transactions are not invalidated under the step-transaction doctrine, anti-
18 abuse rules, or for lack of profit motive or bona fide loss under § 165. Further, petitioners
19 seek adjustment of the determination that penalties should apply on the ground that
20 penalties should not be imposed because there was substantial authority for the tax
21 positions taken and reasonable reliance on the advice of professionals.

22 The court has jurisdiction to determine de novo the partnership items of 2000-A and
23 First Ship that were adjusted by the FPAAs. See 26 U.S.C. § 6226(f). Petitioners bear the
24 burden of proving their entitlement to the claimed losses and deductions. U.S. v. General
25 Dynamics Corp., 481 U.S. 239, 245 (1987) (citing Helvering v. Taylor, 293 U.S. 507, 514
26 (1935)).

1 **B. 2000-A Adjustment**

2 **1. Partnership’s Assumption of Liability for Purposes of Section 752**

3 Under federal tax law, a partnership itself is not subject to federal income tax. 26
4 U.S.C. § 701. Rather, a partnership must file an annual information return (Form 1065) that
5 reports its partners' distributive shares of income, gains, deductions, and credits. Partners
6 are responsible individually for reporting their share of tax on their own income tax returns.
7 26 U.S.C. § 702.

8 Where a partnership acquires property, it has a basis in that property. Each partner
9 also has a basis in his or her own interest in the partnership. The partnership’s basis in its
10 assets is referred to as “inside basis,” whereas the partner’s basis in his or her own
11 partnership interest is referred to as “outside basis.” Kornman & Assoc. v. U.S., 527 F.3d
12 443, 456 n.12 (5th Cir. 2008). Under the Internal Revenue Code, no gain or loss is
13 recognized when a partner contributes property to a partnership in exchange for a
14 partnership interest. 26 U.S.C. § 721(a). The contributing partner’s basis in the
15 partnership interest, acquired by contribution of property, including money, to the
16 partnership, is defined as “the amount of such money and the adjusted basis of such
17 property to the contributing partner at the time of the contribution increased by the amount
18 (if any) of gain recognized under section 721(b) to the contributing partner at such time.”
19 26 U.S.C. § 722.

20 Section 752 of the I.R.C. governs the change in basis that occurs when a partner’s
21 liabilities are either increased or decreased.³ Under § 723, when a partner contributes

22 _____
23 ³ Section 752 provides in full as follows:

24 **§ 752. Treatment of certain liabilities**

- 25 **(a) Increase in partner's liabilities.** Any increase in a partner's share of the
26 liabilities of a partnership, or any increase in a partner's individual liabilities by
27 reason of the assumption by such partner of partnership liabilities, shall be
28 **(b) Decrease in partner's liabilities.** Any decrease in a partner's share of the
liabilities of a partnership, or any decrease in a partner's individual liabilities by
reason of the assumption by the partnership of such individual liabilities, shall be

1 property to a partnership, the partnership succeeds to the basis of the property in the
2 contributing partner's hands. When a partnership assumes a liability of a partner, the
3 partner's basis in his partnership interest is (1) decreased by the amount of the liability, and
4 (2) increased by the partner's share of the partnership liability resulting from such
5 assumption. 26 U.S.C. §§ 722, 733(1), and 752(a) and (b). See Kornman, 527 F.3d at
6 457. On the subsequent satisfaction of the liability, the partner's basis in his partnership
7 interest is decreased by the amount of the liability. 26 U.S.C. §§ 733(1), 752(b).

8 As demonstrated at trial, the Martin Family Trusts entered into a series of option
9 contracts which included purchasing long options and selling short options. The long
10 options and the obligation on the short options were contributed to First Ship and then to
11 2000-A. The parties dispute whether the obligation on the short options is treated as a
12 partnership liability under Section 752 for purposes of calculating partnership basis.

13 The government contends that the obligation on the short options sold by the Martin
14 Family Trusts should be treated as a liability for the purposes of Section 752, which would
15 yield the following effects on First Ship's outside basis:

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- (c) considered as a distribution of money to the partner by the partnership.
Liability to which property is subject. For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.
 - (d) **Sale or exchange of an interest.** In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

26 U.S.C. § 752.

<u>Date</u>	<u>Action</u>	<u>Description</u>	<u>Effect on First Ship's Basis</u>	<u>I.R.C. Provision</u>
11/27/2000	Contribution of long options to 2000-A	Generates First Ship's outside basis	+ 315.7 million	§ 722
11/27/2000	Assumption of liability for short options by 2000-A	Decreases First Ship's individual liabilities	- \$314.8 million	§ 752(b)
11/27/2000	Allocation of partnership liability among partners under § 752 regs.	Increases First Ship's share of partnership liabilities	+ \$314.8 million	§ 752(a)
12/21/2000	Satisfaction of liability for short options by 2000-A, by closing out option position	Decreases First Ship's share of partnership liabilities	- \$314.8 million	§ 752(b)

12 Petitioners agree that First Ship's basis in 2000-A was increased by the costs of its
 13 its long option position contributed to 2000-A, but contend that no adjustment to the basis
 14 for the short options position was required under 26 U.S.C. § 752, because the short
 15 option positions were contingent or speculative obligations and therefore not "liabilities."
 16 Petitioners rely on Helmer v. Comm'r, 34 T.C.M. 727 (1975), where the Tax Court held that
 17 a partnership's receipt of money pursuant to an option and the partnership's obligation to
 18 deliver property upon exercise of that option did not create a partnership liability under
 19 Section 752. Adopting the position advocated by the IRS, the court determined there that
 20 the holder's claim to the property under the option was not a liability for purposes of Section
 21 752, since the obligation of the partnership to credit the payments was contingent upon the
 22 option being exercised. Helmer, 34 T.C.M. 727. Petitioners also cite other decisions of the
 23 Tax Court and of the First and Fifth Circuits to support their position that the short options
 24 purchased by the 14 Martin Family Trusts and contributed to 2000-A did not create a
 25 partnership liability. Ps' Post-Trial Prop. Findings ¶ 188 (citing Brountas v. Comm'r, 692
 26 F.2d 152 (1st Cir. 1982); Gibson Prods. Co. v. U.S., 637 F.2d 1041 (5th Cir. 1981)
 27 (contingent obligations not "liabilities" under § 752); Long v. Comm'r, 71 T.C. 1 (1978)
 28

1 (contingent or contested obligations not “liabilities” for purposes of partnership basis); and
2 La Rue v. Comm’r, 90 T.C. 465, 479 (1988) (reserves for liabilities that cannot be
3 determined with reasonable accuracy were not “liabilities” included in basis pursuant to §
4 752)).

5 More recent appellate authority has rejected this application of Helmer to
6 transactions where the asset and liability were “inextricably intertwined,” such as the long
7 and short options at issue here, because allowing the partner to consider the asset to
8 increase its outside basis, but not the offsetting liability to decrease its basis, “flies in the
9 face of reality.” Kornman & Assoc. v. U.S., 527 F.3d 443, 461 (5th Cir. 2008). Kornman
10 distinguished Helmer on the ground that the partnership at issue there did not receive
11 assets giving rise to a partnership obligation. Id. See Marriott Int’l Resorts L.P. v. U.S.,
12 586 F.3d 962 (Fed. Cir. 2009) (per curiam) (affirming grant of summary judgment for the
13 government on ground that obligation to close a short sale qualified as liability under I.R.C.
14 § 752 where taxpayer treated contingent asset “asymmetrically” with respect to outside
15 basis); Cemco Investors LLC v. U.S., 515 F.3d 749, 751 (7th Cir. 2008) (declining to decide
16 whether Tax Court’s decision in Helmer applied to long and short options transaction “for it
17 is not controlling in this court - or anywhere else”).

18 The government characterizes the Martin Family Trusts’ transaction as a Son-of-
19 BOSS tax shelter.⁴ Petitioners argue that the obligations under the short options assumed

21 ⁴ A Son-of-BOSS transaction is described as follows:

22 a variation of a slightly older alleged tax shelter known as BOSS, an acronym for
23 “bond and options sales strategy.” There are a number of different types of
24 Son-of-BOSS transactions, but what they all have in common is the transfer of
25 assets encumbered by significant liabilities to a partnership, with the goal of
26 increasing basis in that partnership. The liabilities are usually obligations to buy
27 securities and typically are not completely fixed at the time of transfer. This may
28 let the partnership treat the liabilities as uncertain, which may let the partnership
ignore them in computing basis. If so, the result is that the partners will have a
basis in the partnership so great as to provide for large—but not
out-of-pocket—losses on their individual tax returns

Kligfeld Holdings v. Comm’r, 128 T.C. 192, 194 (2007).

1 by 2000-A were contingent because the options were exercisable on or before December
2 29, 2000, and would only be exercised if the aggregate value of the short term assets held
3 in the portfolio declined within the range of 81.2 to 90.5 percent. Ps' Post-Trial Prop.
4 Findings ¶ 191. The transaction was designed, however, as a putative "short term" hedging
5 strategy consisting of both the long and short options. Ex. 30 at Priv Log 3576. Here, the
6 long and short options were entered into on the same day, both sets of options were
7 contributed to the partnership, and simultaneously closed out. The transactions here, as in
8 Jade Trading v. U.S., "cannot be separated because they were totally dependent on one
9 another from an economic and pragmatic standpoint." Jade Trading v. U.S., 598 F.3d
10 1372, 1378 (Fed. Cir. 2010) (quoting Jade Trading v. U.S., 80 Fed.Cl. 11 at *51 (2007)).
11 By characterizing the short options position as a purely contingent obligation, and therefore
12 not a liability to offset First Ship's basis in 2000-A, petitioners created an artificially high
13 basis by claiming a basis in the long options contributed to 2000-A but disregarding the
14 obligation on the short options which was assumed by 2000-A. This inflated basis
15 generated a purported \$315.7 million tax loss. As other courts have determined with
16 respect to similarly structured transactions, the transaction at issue here is a Son-of-BOSS
17 tax shelter. See American Boat Company, LLC v. U.S., 583 F.3d 471, 474 (7th Cir. 2009)
18 (the key characteristic of a Son-of-BOSS shelter is "the transfer to a partnership of assets
19 laden with significant liabilities" to achieve the goal of creating "a large, but not out-of-
20 pocket, loss on a partner's individual tax return").

21 Following the reasoning of Kornman, the court finds that the obligation on the short
22 options, contributed to 2000-A by First Ship, was a liability of the partnership pursuant to
23 Section 752, where the long options were purchased and contributed to the partnership at
24 the same time as the "inextricably intertwined" short options but were treated as an asset
25 that increased the basis. 527 F.3d at 456-61. By application of Section 752, when the
26 liability for the short options was satisfied by 2000-A at the closing of the options positions
27 on December 21, 2000, First Ship's basis must be reduced by \$314.8 million. This results
28 in a net increase of \$0.9 million in First Ship's partner basis. By failing to treat the short

1 options as a partnership liability, First Ship's outside basis (and accordingly, the Martin
2 Family Trusts' bases in their partnership interests in First Ship) was artificially inflated by
3 \$314,885,515.96, equal to the amount of the premiums received on the short options,
4 which should have reduced the basis created by the premiums due on the long options.⁵

5 **2. Economic Substance Doctrine**

6 Petitioners further challenge the adjustments under the economic substance
7 doctrine on the ground that petitioners had a business purpose in the options transactions
8 and the transactions had economic substance beyond creation of tax benefits.

9 Taxpayers may structure transactions in a manner that takes advantage of benefits
10 under the Internal Revenue Code to generate the most tax-advantageous results. Avon
11 Prods., Inc. v. U.S., 97 F.3d 1435, 1443 (Fed. Cir. 1996) (that a transaction may have been
12 structured for tax purposes does not render it impermissible). However, "transactions that
13 comply with the literal terms of the tax code but lack economic reality" are disregarded for
14 tax purposes. Coltec Indus., Inc. v. U.S., 454 F.3d 1340, 1352 (Fed. Cir. 2006).

15 The economic substance doctrine requires "disregarding, for tax purposes,
16 transactions that comply with the literal terms of the tax code but lack economic reality."
17 Coltec, 454 F.3d at 1352. In Coltec, the Federal Circuit explained that the doctrine
18 "represents a judicial effort to enforce the statutory purpose of the tax code." Id. at 1353.
19 The doctrine, "[f]rom its inception, ... has been used to prevent taxpayers from subverting

21 ⁵ The parties further dispute whether Treasury Regulation § 1.752-6 may be
22 applied retroactively to petitioners here. Treas. Reg. § 1.752-6 was issued in temporary form
23 in 2003, and the final regulations, dated May 26, 2005, expanded the definition of "liability"
24 under Section 752 to include "any fixed or contingent obligation to make payment." See Treas.
25 Reg. § 1.752-1(a)(4)(ii), §1.752-6(a). The regulation was given retroactive effect to
26 transactions occurring between October 19, 1999 and June 24, 2003, requiring a partner to
27 reduce his basis in his partnership interest by the amount of any contingent obligation
28 assumed by the partnership during that time. As the Federal Circuit noted in Marriott, "[c]ourts
have struggled with the question whether the retroactivity provisions of Treasury Regulation
§ 1.752 are valid and enforceable." 586 F.3d at 977 n.21 (citations omitted). The government
contends that Treas. Reg. § 1.752.6 is applicable to the November 2000 options transactions
at issue here, citing evidence that petitioners were fully aware of IRS Notice 2000-44, whereas
petitioners challenge retroactive application of the regulations. Having determined that the
basis was properly adjusted under Section 752, the court need not reach the question whether
Treasury Regulation § 1.752-6 may be applied retroactively in this case.

1 the legislative purpose of the tax code by engaging in transactions that are fictitious or lack
2 economic reality simply to reap a tax benefit.” Id. at 1353-54.

3 Under Ninth Circuit authority, the court considers two related factors to determine
4 whether a transaction has economic substance: (1) the subjective factor – whether the
5 taxpayer had a business purpose in engaging in the transaction; and (2) the objective factor
6 – whether the transaction had economic substance “beyond the creation of tax benefits.”
7 Casebeer v. Comm’r, 909 F.2d 1360, 1363-65 (9th Cir. 1990) (citing Bail Bonds by Marvin
8 Nelson v. Comm’r, 820 F.2d 1543, 1549 (9th Cir. 1987)). The consideration of business
9 purpose and economic substance is not a rigid two-step analysis, but the inquiries are
10 “simply more precise factors to consider in the application of [the Ninth Circuit’s] traditional
11 sham analysis; that is, whether the transaction had any practical economic effects other
12 than the creation of income tax losses.” Casebeer, 909 F.2d at 1363 (quoting Sochin v.
13 Comm’r, 843 F.2d 351, 354 (9th Cir. 1988)).

14 **a. Subjective Business Purpose**

15 Under the subjective business purpose test, the court determines “whether the
16 taxpayers have shown that they had a business purpose for engaging in the transaction
17 other than tax avoidance.” Casebeer, 909 F.2d at 1363. “The business purpose factor
18 often involves an examination of the subjective factors which motivated a taxpayer to make
19 the transaction at issue.” Id. at 1364 (quoting Bail Bonds, 820 F.2d at 1549).

20 At trial, the Martin family members testified about the business purpose of the joint
21 investment transaction among the Martin Family Trusts, which was motivated by several
22 concerns. First, the Martin family and the Martin Family Trusts, as shareholders of CPC,
23 were concerned with managing the ongoing potential exposure to excess CPC liabilities
24 under the Recontribution Agreement. This Agreement increased the Martin Family Trusts’
25 need for asset conservation and a mechanism for bundling assets to ensure, to the
26 maximum extent possible, that each trust paid no more than its fair share of excess CPC
27 liabilities, including, in particular, potential liabilities from an attack on CPC’s S corporation
28 status.

1 The second concern was the need to reform the five 1988 trusts that held a large
2 percentage of the Martin family assets in order to clarify terms regarding distribution to
3 beneficiaries upon the death of one of them. The reformation process, which was a
4 complicated and time consuming process requiring extensive analysis regarding potential
5 beneficiary scenarios and the obtaining of a probate court order and an IRS private letter
6 ruling, was not finally completed until 2005. The uncertain status of the five 1988 trusts
7 required that the CPC distributions received by the trusts be prudently and conservatively
8 reinvested in keeping with the divergent investment views of the Martin family members in
9 the interim period while the five 1988 trusts were being reformed.

10 Third, the 14 Martin Family Trusts needed to reinvest their CPC proceeds and
11 protect those investments, along with their previously invested non-S&P equity holdings
12 including Liberty Media, Young Broadcasting, AT&T and TCI, from any downturn in the
13 market.

14 Petitioners contend that the joint investment transaction, and the various
15 partnerships within it, had a clear business purpose by giving the Martin family and the 14
16 Martin Family Trusts the ability to conserve and pool their assets in order to meet the
17 potential demand for contributions toward future excess CPC liabilities, and also provided a
18 flexible and asset-protective mechanism by which to prudently and conservatively invest
19 the CPC cash distributions pending the reformation of the 1988 trusts at a time when the
20 markets were extremely volatile. The stated business purpose of the overall joint
21 investment transaction is not at issue here, however. The joint investment partnerships, or
22 Parent LLCs, that were formed among the various Martin Family Trusts survived after the
23 dissolution of 2000-A, when the assets were redistributed to the Parent LLCs. With respect
24 to the 2000-A partnership at issue in the readjustment petition, petitioners contend that
25 2000-A had a legitimate business purpose, namely to hold assets that were expected to be
26 sold in the short term. However, the documentary and testimonial evidence demonstrates
27 that the series of transactions executed over a period of seven weeks was designed to
28 generate a loss for each partner entity on the liquidation of 2000-A.

1 The evidence at trial shows that the Martin family and Mr. Folger, trustee of the
2 Martin Family Trusts, are sophisticated people, each possessing a college-level or higher
3 education, and they have served on boards and/or worked in the professional fields of
4 journalism, television production, law, and business management. In particular, Ms.
5 Tamkin, Ms. Candyce Martin and Mr. Martin testified with a strong understanding of
6 tax-related issues involving trust formation (and reformation), gift and estate tax, and the
7 complex tax risks and benefits of CPC's status as an S-Corporation under the IRC.

8 As informed by a letter from CPC to all shareholders, the Martin family understood
9 that the sale of CPC would result in significant taxable gain due to the taxable distribution to
10 CPC shareholders and the relatively low tax basis in CPC stock owned by the Martin family
11 members and the Martin Family Trusts. See Ex. 155. As early as February 2000, Mr.
12 Martin and Mr. Folger considered a strategy proposed by Arthur Andersen to buy and sell
13 calls to create "basis where there was none before." Ex. 98. Although the Arthur Andersen
14 proposal was rejected, the Martin family and Mr. Folger engaged the Sideman firm and
15 PWC to advise the Martin Family Trusts on other proposals with a similar basis-creating
16 feature.

17 At the September 20, 2000 presentation to the Martin family, PWC and the Sideman
18 firm presented a briefing memo to the Martin family and Mr. Folger which outlines the
19 structure of the proposed transaction at that time, which was later modified and approved.
20 Ex. 30. The aspect of the proposal to use offsetting options and contribute the options to a
21 partnership to generate a high basis resulting in tax losses was explained in the family
22 briefing memo and remained part of the final transaction that was ultimately approved. In
23 particular, the Martin family and Mr. Folger were informed about the tax ramifications and
24 the need to dispose of the 2000-A partnership prior to the close of the tax year in order to
25 generate the losses to offset their gains. They were also informed of IRS Notice 2000-44,
26 which was released on August 13, 2000 and warned taxpayers that the IRS planned to
27 challenge transactions having the "same basis mechanics" as the one entered into by the
28 Martin Family Trusts. The Martin family was advised that "[p]articularly in light of Notice

2000-44,[] the Martin family should assume not only that the IRS will identify this issue but will vigorously litigate rather than settle it[, and] should expect to incur significant litigation expenses in defending any capital loss resulting from the contemplated transaction.” Ex. 30 at Priv Log 3577.

Roger Feusier testified that PWC prepared a spreadsheet projecting the rate of return required to generate cash in the event of a tax controversy:

Rate of Return							
		4 Year Projection			5 Year Projection		
		Taxpayer loses			Taxpayer loses		
	Taxpayer wins						
	No Penalties	0.0% No Penalties	20.00% Penalties	40.00% Penalties	0.00% No Penalties	20.00% Penalties	40.00% Penalties
Tax to be paid back	0	127,477,761					
Interest and penalties	0	55,095,889	90,261,904	125,427,919	72,241,647	110,709,337	149,177,026
Estimated future liability	0	182,573,650	217,739,665	252,905,681	199,719,409	238,187,098	276,654,787
Cash available for Investment	117,477,761	117,477,761	117,477,761	117,477,761	117,477,761	117,477,761	117,477,761
Pre Tax Rate of Return required to generate required cash	0.0000%	13.8327%	19.0010%	23.2826%	13.1881%	17.2620%	20.6454%
*** If the controversy period is shorter than 4 and 5 years, the rate of return required on investment would be significantly higher.							

Exs. 30 at Priv Log 3622; 174. This spreadsheet was attached to the family briefing memo and was presented to the Martin family. Thus, the Martin family and Mr. Folger knew the potential risks and tax benefits of the transaction that they were considering.

1 Though petitioners contend that the joint investment transaction had several non-tax
2 business purposes, neither the Martin family nor Mr. Folger could explain how the offsetting
3 options portion of the transaction through contributions to the 2000-A partnership could
4 mitigate the concerns about exposure to potential liability under the CPC Recontribution
5 Agreement or the unsettled reformation of the 1988 trusts. The transaction at issue began
6 on November 9, 2000, when the Martin Family Trusts converted their cash holdings into
7 SPDRs, then purchased and sold long and short options. The Martin Family Trusts then
8 contributed their assets, including the long and short options at issue, to the parent LLC
9 First Ship on November 17, 2000. First Ship held those assets and liabilities until
10 November 27, 2000, when it contributed to 2000-A all of its SPDRs (\$88,368,347 FMV), its
11 Young Broadcasting stock (FMV \$11,033,828), and its long and short options
12 (\$315,781,658.59 - \$314,885,515.96 = \$896,142.64 net premium paid to JP Morgan), but
13 retained its other stocks and holdings. By December 29, 2000, 2000-A liquidated all its
14 assets and distributed all its stock and cash back to its three partners, including First Ship.

15 In the five weeks that the 2000-A partnership held the assets of First Ship and its
16 other partners, Fourth Ship and LMGA Holdings, it conducted the following transactions:

- 17 11/29/2000: 2000-A sells the SPDRs at total \$5.4 million loss.
- 18 12/1/2000: Using proceeds from the sale of SPDRs, 2000-A purchases
 S&P 500 securities
- 19 12/21/2000: 2000-A exercises all the options, resulting in a net profit of \$3.9
20 million.
- 21 12/26/2000: 2000-A sells all its shares of Young Broadcasting at \$562,300
22 gain.
- 22 12/27/2000: 2000-A sells the S&P 500 securities at \$5.3 million loss.
- 23 12/28/2000: 2000-A is cancelled; distributes assets to its partners, including
24 \$97,960,224 to First Ship.

25 Looking to the economic realities of the transaction, First Ship contributed assets,
26 including the offsetting options, worth about \$100,298,295 to the 2000-A partnership, and
27 five weeks later, recovered \$97,960,224 in the partner distribution upon 2000-A's
28

1 dissolution. Yet, First Ship claimed a short term capital loss of about \$321 million, primarily
2 by claiming a partner basis of \$315.7 million in the long options without deducting the
3 premiums for the short options.

4 The \$315.7 million tax loss reported on the options transaction was not the result of
5 an actual economic loss, as petitioners were fully aware. This artificial \$315.7 million tax
6 loss was then used to offset the taxable gains from the sale of CPC. By contributing First
7 Ship's assets to 2000-A, the Martin Family Trusts enabled 2000-A to sell the assets by the
8 end of the taxable period ending December 31, 2000, so that the non-economic loss
9 resulting from the partners' artificially inflated bases in their partnership interest of 2000-A
10 could be recognized for that period. Thus, the loss-generating transaction, including the
11 Martin Family Trusts' purchase of SPDRs and the options positions, contribution to 2000-A
12 through First Ship, and liquidation of the 2000-A partnership,⁶ did not further the joint
13 investment goal other than to generate an artificial tax basis and preserve capital through
14 non-payment of federal taxes. The business explanations for engaging in the co-
15 investment strategy that continued after 2000-A's dissolution do not legitimize the tax
16 avoidance scheme achieved by conducting the series of steps involving purchase and sale
17 of SPDRs and S&P securities, offsetting options, contribution to the 2000-A partnership
18 through First Ship, and dissolution of the 2000-A partnership. "Any anticipated benefit from
19 participating in [the 2000-A partnership] for a few weeks, and then quickly liquidating the
20 partnership before year's end is negligible in comparison to the [] tax benefit which would
21 not have been achieved but for this pre-determined course of action." Sala v. U.S., 613
22 F.3d 1249, 1254 (10th Cir. 2010). As a matter of "common-sense examination of the
23 evidence as a whole," the options transaction involving the 2000-A partnership generated

24
25 ⁶ As petitioners' advisor, Mr. Pellervo, testified at trial, it was always assumed and
26 understood that 2000-A would be sold or liquidated before the end of the year. See Ex. 189
27 ("Assuming that . . . an exercise/termination of the options will not give us the loss we need,
28 . . . [if 2000A is not sold this year,] the question is whether we liquidate 2000A this year or
defer a trigger until next year. . . . [I]f we conclude that IRS scrutiny of a loss carryback is
unacceptable, then I think we need to liquidate 2000A this year, notwithstanding how awful that
looks.") (12/19/2000 email from E Ulhaq to D Pellervo and R Feusier).

1 \$3.9 million in net profit, which is an insignificant amount (about 1.2%) in relation to the tax
2 benefits of the transaction. Id.

3 The court finds that petitioners have failed to show that they had a business purpose
4 for engaging in the options transaction other than tax avoidance.

5 **b. Objective Economic Substance**

6 Under the objective economic substance inquiry, the court determines whether the
7 transaction had economic substance beyond the creation of tax benefits. Casebeer, 909
8 F.2d at 1365 (citing Bail Bonds, 820 F.2d at 1549). “The economic substance factor
9 involves a broader examination of whether the substance of a transaction reflects its form,
10 and whether from an objective standpoint the transaction was likely to produce economic
11 benefits aside from a tax deduction.” Id. (quotation marks omitted).

12 In the transaction at issue, on November 9, 2000, \$121,452,146 in cash held by the
13 Martin Family Trusts and \$1 million of cash retained by LMGA Holdings were invested in
14 SPDRs, an investment unit that tracks the performance of the S&P 500. At the same time,
15 each of the Trusts executed a series of long and short options purportedly designed to
16 hedge the investment risk of the Trusts’ assets, including the various non-S&P stocks held
17 by the Trusts: Liberty Media, Young Broadcasting, AT&T and TCI. Much of the stock and
18 SPDRs and all of the options were contributed to First Ship, then to 2000-A, except for the
19 Liberty Media stock, TCI Satellite stock and KRON holdback retained by First Ship. On
20 November 28, 2000-A sold the SPDRs and purchased S&P 500 securities. On December
21 21, 2000-A terminated the options contracts, yielding a positive payout to 2000-A of
22 \$3,921,483, net of transaction costs. In the last week of December 2000, the stock
23 holdings were sold and 2000-A was liquidated. Thus, within a seven week period, the
24 Martin Family Trusts ended up in almost the same position where they started: starting in
25 cash and a portfolio of four individual stocks, and ending with cash (subject to loss on the
26 sale of the SPDRs and the S&P 500 securities) and a stock portfolio of the same individual
27 stocks except Young Broadcasting.

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1 The parties offered competing expert testimony about the potential for profit from the
2 transaction. On behalf of petitioners, Dr. Rubinstein, whose background and expertise is
3 discussed above, testified that the options transactions were the proper transactions to
4 evaluate from an economic perspective, and that the options transactions had a reasonable
5 expectation of making a profit. The government's expert, Dr. Grenadier, is currently the
6 chair of the Finance Department at Stanford University and received his undergraduate
7 degree in finance and economics at U.C. Berkeley and his PhD in financial economics at
8 Harvard University. Dr. Grenadier opined that the series of transactions at issue lacked
9 objective economic substance because any gain in the options transactions would be offset
10 by a larger drop in the value of the underlying portfolio caused by downturn in the market.

11 At the core of the experts' dispute is the starting point of the analysis. Dr.
12 Grenadier's analysis begins at the Martin Family Trusts' position of holding cash and
13 individual stocks before purchasing the SPDRs on November 9, 2000 (referred to by the
14 experts as "Portfolio A"), whereas Dr. Rubinstein begins his analysis with the assumption
15 that the Martin Family Trusts had already purchased the SPDRs ("Portfolio B"), to
16 determine whether the options transaction, which changed the Martin Family Trusts'
17 holdings to stocks and options ("Portfolio C"), had a business purpose. In other words, the
18 experts disputed whether to assess the business purpose of the transaction beginning from
19 Step One or Step Two, as defined above.

20 The facts developed at trial demonstrate that the series of transactions at issue
21 began with the Martin Family Trusts' use of their cash holdings from the proceeds of the
22 CPC sale to purchase SPDRs on November 9, 2000.⁷ Dr. Grenadier offered several
23 reasons why the analysis of the Martin family's transaction should include the investment in
24 the SPDRs as well as the purchase and sale of options on the SPDRs and stock holdings
25 of the Martin family. First, the purchase of SPDRs and the execution of the option

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27 ⁷ Dr. Rubinstein testified that when he was hired by the Sideman firm in 2000 to
28 analyze the business purpose of the proposed options transactions, he was not aware of the
investment of cash in SPDRs and had assumed that there was an underlying equity portfolio
without any cash in it.

1 contracts commenced at basically the same time and then terminated at basically the same
2 time. Second, case documents show that these investments were intended to be entered
3 into simultaneously, such as the Ruble opinion letter which states that the purchase shall
4 be done concurrently. Ex. 6. Thus, Dr. Grenadier's economic substance analysis is the
5 analysis that the court finds more persuasive because it accounts for the movement from
6 Portfolio A to Portfolio B, whereas Dr. Rubinstein's analysis omits this important step of
7 moving from an all cash and stocks position to the position of holding stocks and SPDRs.

8 **i. No Reasonable Expectation of Profit**

9 The Martin Family Trusts' advisors described the transaction as a hedging strategy
10 which provided for the execution of a series of call and put options based on a notional
11 investment portfolio that mirrored the Trusts' actual aggregate investment portfolio. The
12 putative purpose of this hedging strategy was for the Trusts to recover a portion of their
13 investment losses in the event the investments' value fell to certain specified levels in the
14 near term, and also to potentially profit if the investments' value rose.

15 Dr. Grenadier examined the potential profit from the entire transaction and
16 concluded that there was no reasonable expectation of earning a profit on the transaction
17 unless one assumed that the stock market would increase very sharply in the near term,
18 i.e., more than 14% in seven weeks, a highly unlikely possibility. Dr. Grenadier considered
19 the combined payoff of the options portfolio and the S&P 500 portfolio, and concluded that
20 the entire transaction would lose money unless the market went up by 14% or more.

21 Dr. Rubinstein challenged Dr. Grenadier's conclusion that a 14% rise in the value of
22 the portfolio was required in order to earn an overall profit, on the ground that Dr. Grenadier
23 excluded the Liberty Media and other non-S&P equities held prior to November 2000. If
24 these non-S&P stocks had been included in the analysis, Dr. Rubinstein calculated that
25 only a 4% rise in the value of the entire portfolio was required to achieve a profit overall,
26 even taking into consideration the cost of the options, and that this had a 41% chance of
27 happening, which he characterized as a significant chance of making a profit. Tr.

28 1030:17-1031:18. The court determines that the performance of the non-S&P stocks is not

1 relevant to the analysis of the business purpose of the transaction at issue because the
2 pre-existing stock holdings in Liberty Media, AT&T and TCI were not contributed to 2000-A
3 and remained constant during the course of the transaction. The court therefore finds Dr.
4 Grenadier's opinion to be highly persuasive.

5 **ii. Increased Exposure to Financial Risk**

6 Dr. Grenadier calculated the actual results during this time frame, based on the
7 actual facts of this case, as follows:

- 8 a. Stock prices fell between November 10 and December 29, 2000;
- 9 b. Options terminated prior to expiration on December 21, 2000;
- 10 c. S&P 500 investment liquidated on December 27, 2000;
- 11 d. The Martin Family Trusts lost \$10.8 million on the S&P investment;
- 12 e. The Martin Family Trusts gained \$3.9 million on the options;
- 13 f. Overall, the Martin Family Trusts lost \$6.9 million on the transaction.

14 As a result, Dr. Grenadier concluded that the transaction did not meet the Martin Family's
15 stated objectives of reducing risk of the overall stock market and profiting from falling stock
16 prices.

17 Having defined the transaction by the Martin Family Trusts as moving from a
18 position of holding cash and four individual stocks, to the conversion of the cash into the
19 S&P investment on November 9, the purchase and sale of options on November 10, and
20 the ultimate termination of the options contracts on December 21 and sale of the S&P
21 investment on December 27, Dr. Grenadier determined that this transaction actually
22 increased risk from 22.9 percent to 24.40 percent. Moreover, the options portfolio did not
23 provide a form of insurance because it would not be reasonable to invest all the cash in the
24 market, then purchase options against the market. Dr. Grenadier compared the options
25 purchase concurrent with the S&P investment to "buying fire insurance and a house that
26 was on fire." Dr. Grenadier demonstrated that no rational investor would have undertaken
27 this transaction on the basis of risk-aversion because the transaction added risk, compared
28

1 to the starting position of cash and stocks, and the transaction was expected to lose
2 money.

3 **iii. Transaction Was Expected to Lose Money**

4 Dr. Grenadier showed that the transaction as a whole was expected to lose money if
5 stock prices fell in the short term, as the Martin family and/or their advisors expected.
6 Petitioners' maximum potential for economic gain on the offsetting options (before
7 consideration of fees and expenses related to the entire transaction) was around \$13.5
8 million, or about 4% of the non-economic tax losses they claimed. However, the high-end
9 of this profit potential for the options portfolio would occur only if the value of the underlying
10 portfolio had decreased by around 15%. Even in the unlikely event that the market
11 dropped at the optimal rate of about 15%, the gain of \$13.5 million on the options would be
12 completely offset by a corresponding drop of over \$30 million in the market value of the
13 portfolio owned by petitioners. If the market dropped at a rate of 4%, on the other hand, the
14 options portfolio stood to lose about \$8 million. If the fees and expenses related to the
15 transaction are factored in, the possibility of a gain becomes even more remote. As the
16 actual investment results demonstrate, even a modest gain in the options portfolio would be
17 outweighed by the loss in the underlying portfolio: the options gained \$3.9 million (after
18 deducting fees), but the S&P 500 investment lost \$10.8 million, for a net loss of \$6.9
19 million. Accordingly, this series of transactions was expected to lose money if stock prices
20 fell.

21 Dr. Rubinstein testified that he does not dispute Dr. Grenadier's method or
22 conclusion with respect to whether there was any business purpose in moving from an all
23 cash and stock position to purchasing SPDRs and the offsetting options:

24 And as I said in my report, I agree with Steven Grenadier that a careful
25 analysis --which he did of A [cash and stock] to C [stock and options]
26 suggests that to a reasonably -- if someone had done a good analysis, they
27 would have seen there was no good business purpose in going from A to C in
terms of risk aversion. And if I had done that analysis, I would have concluded
that there was no business purpose in going from A to C.

28 Tr. 825-28 (quoting deposition testimony). Assuming that the starting point of the

1 transaction was the Martin Family Trusts' position of cash and stocks, the experts agree
2 that there was no business purpose to the transaction. Dr. Rubinstein added that no
3 rational risk-averse investor would prefer portfolio C (the family's holdings of stock plus
4 options) to portfolio A (the family's initial holdings of cash and stock).

5 Petitioners further contend that at the time of the transactions, the market was
6 extremely volatile, and that no one could have predicted whether the market would have
7 gone up or down on any given day. Petitioners point out that while the options were
8 obtained precisely for the purpose of insuring against a dramatic drop in the market, both
9 Professors Rubinstein and Grenadier testified that the Martin Family Trusts could have
10 yielded sizeable gains if the market had gone up. Petitioners argue that the options would
11 only have been exercised if the aggregate value of the short term assets held in the
12 portfolio declined to between 81.2 and 90.5 percent, and that there was no way to
13 determine prior to the exercise date whether the aggregate value of the short term assets
14 would have declined to that range. The record demonstrates, however, that petitioners and
15 their advisors expected the market to drop before the transaction was completed. In
16 particular, Mr. Martin testified at deposition that JP Morgan expected the market to decline.

17 Further, the Ruble opinion letter states that the taxpayers entered into the options
18 transaction to offset market risks with respect to the underlying portfolio, reflecting "the view
19 that, in light of current market volatility, the aggregate value of trust assets most likely will
20 decline to between 81.2 and 90.5 percent." Ex. 6 at US6475. Dr. Rubinstein disagreed
21 with that statement because he could not have predicted how the market would act, but he
22 acknowledged an analysis conducted by JP Morgan in October 2000 comparing gain or
23 loss on the proposed options transaction to the gain or loss on the underlying portfolio.
24 See Ex. 319 at Priv Log 4691. Dr. Rubinstein testified that the options portfolio would gain
25 when the market went down to 80% of its original level, up to the point where the market
26 reached 90%. In the event of such a market downturn of 10 to 20 percent, only the options
27 portfolio would realize a gain whereas the underlying portfolio would lose significantly more.
28 Thus, the transaction would not result in a profit from falling stock prices, because the

1 losses on the S&P investment wiped out any potential profit from the options. Based on the
2 expectations of a market downturn at the time of engaging in the transaction, the
3 transaction was expected to lose money and did not provide petitioners with a reasonable
4 expectation of economic profit.

5 **iv. Option Portfolio Was Overpriced**

6 Dr. Grenadier concluded that the options were overpriced and that the Martin Family
7 Trusts overpaid JP Morgan by at least \$5 million. Specifically, Dr. Grenadier noted that the
8 Martin Family Trusts paid \$0.9 million for the options, but opined that JP Morgan should
9 have paid the Martin family at least \$4.5 million for the options transaction. Dr. Rubinstein
10 challenged Dr. Grenadier's analysis on the ground that it was solely based on the Black-
11 Scholes method of pricing and failed to consider (1) jump risk associated with a sudden
12 change in the price or value of the option, (2) JP Morgan's fees, (3) the customized nature
13 of the options, and (4) a customary profit margin for JP Morgan, each of which would cause
14 the prices of options to be higher. Dr. Grenadier acknowledged that jump risk would make
15 hedging more risky and would cause deviation from the Black-Scholes model, but noted
16 that to the extent that JP Morgan's potential exposure was increased by the jump risk, JP
17 Morgan overcharged the same amount, \$5 million, for its various options proposals, even
18 for a proposal based on a \$1 billion notional that was significantly larger in size than the
19 transaction that was approved. Dr. Grenadier reasoned that if JP Morgan's fees were
20 adjusted to reflect the degree of exposure, the fees for the \$1 billion proposal should have
21 been much larger than the \$5 million amount that was charged for the proposals with
22 significantly less exposure. This flat fee charged by JP Morgan did not reflect the economic
23 reality of the options transaction, suggesting that the fee was charged to create a
24 transaction, without a business purpose, in order to generate a tax benefit.

25 When reviewing the JP Morgan proposals in 2000, Dr. Rubinstein himself expressed
26 concern that the fees were too high, but testified that he was later satisfied that the fees
27 could be reasonable. See Ex. 52 ("I was worried that \$7M seemed a lot to pay. They said
28 that the primary risk that JP Morgan faced in hedging themselves was the large Liberty

1 Media stock component of the underlying portfolio, particularly around levels of 82 in the
2 portfolio.”) Dr. Rubinstein testified that he later accepted JP Morgan's explanation of the
3 fees, as taking on the risk for hedging this transaction, but did not verify JP Morgan’s
4 statements about the reasonableness of the fees, noting that JP Morgan’s hedging strategy
5 is their proprietary information.

6 The government has demonstrated that petitioners paid above-market, excessive
7 fees for the options, tending to suggest that the fees were not negotiated at arms-length but
8 were charged as a service fee, which tends to show that the transaction at issue lacks
9 economic substance. The court finds that the transaction at issue did not have objective
10 economic substance based on the combination of factors discussed above: the absence of
11 a non-tax business purpose, lack of a reasonable expectation of profit, increased exposure
12 to financial risk by investing cash in the S&P 500 and buying/selling options, the expected
13 loss based on petitioners’ downward market view, and the above-market fees charged for
14 the options transaction.

15 **3. Section 165**

16 Title 26 U.S.C. Section 165 allows taxpayers to deduct losses incurred in any
17 transaction entered into for profit though not connected with a trade or business. 26 U.S.C.
18 § 165(a). The accompanying regulation provides that “[o]nly a bona fide loss is deductible.”
19 Treas. Reg. § 1.165-1(b).

20 Under Ninth Circuit authority, in order to deduct any loss resulting from the
21 transaction, petitioners must show that their primary motivation for entering into the
22 transaction was economic profit. Landreth v. Comm’r, 859 F.2d 643, 645 (9th Cir. 1988)
23 (“‘entered into for profit’ under section 165(c)(2), [] has long been construed as imposing a
24 subjective standard requiring that the taxpayer’s motive in entering the transaction be
25 ‘primarily for profit’”) (quoting Helvering v. Nat’l Grocery Co., 304 U.S. 282, 289 n.5 (1938)).
26 As explained by the Tax Court in Fox v. Comm’r, 82 T.C. 1001, 1022 (1984):
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By “primary”, we mean “of first importance” or “principally.” [Citations omitted.] Profit motive refers to the desire for economic profit, independent of tax savings. [Citations omitted.] Evaluating [a taxpayer’s] motives is, of course, a factual inquiry. The language of section 165(c)(2) speaks of the taxpayer’s motive in “entering” a particular transaction and thus our main focus must be on the time petitioner initiated his transactions. Nevertheless, all the circumstances surrounding petitioner’s transactions, including the disposition of the [assets], are material to the question of petitioner’s intent.

The Section 165(c)(2) issue is independent of the question of economic substance. Keeler v. Comm’r, 243 F.3d 1212, 1220 (10th Cir. 2001).

Here, numerous factors evidence a lack of primary profit motive for the series of transactions in question. First, as in Keeler, the losses were designed to offset petitioners’ gain from the sale of the CPC stock. Even if the transaction at issue was part of an overall profit-motivated investment strategy, the transactions themselves would have to be profit-motivated in order to be deductible under § 165(c). See id. With respect to the specific series of steps involved in the transaction at issue, put in the context of the entire investment program, the Martin Family Trusts started and ended with basically the same portfolio in a seven-week period during which time the Trusts used the cash from the sale of CPC to purchase SPDRs, engaged in offsetting options transactions, and contributed assets to, then dissolved, the 2000-A partnership. As discussed above with respect to the economic substance doctrine, there was no reasonable expectation of profit and the series of S&P investments and options transactions netted a loss of \$6.9 million. Second, the tax savings from that series of transactions, over \$321 million, was over 20 times the maximum economic profit (\$13.5 million) that could have been made from the transactions. Third, the sum that petitioners paid for the options (\$896,142.64) represented only about .2% of the losses they sought from the transaction. Fourth, petitioners shopped around for a tax shelter proposal for almost a year before settling on the transaction they ultimately implemented, and they completed the transaction in December before the end of the taxable year.

1 The evidence does not support petitioners' contention that the primary motives for
2 entering into the transaction were profit and other non-tax concerns and that tax saving was
3 not the primary motive for entering into the transaction. Rather, the record demonstrates
4 that the \$321 million loss from the set of transactions at issue was designed to offset the
5 large capital gain from the CPC sale. Accordingly, any deduction for that loss would be
6 barred by the terms of § 165(a) and Treas. Reg. § 1.165-1(b).

7 Because the court determines that the adjustment under the FPAA issued to 2000-A
8 was proper under Section 752, the economic substance doctrine, and Section 165, the
9 court declines to review petitioners' other challenges to the alternative bases on which the
10 IRS issued the FPAA: substance over form doctrine, step transaction doctrine, and anti-
11 abuse rules.

12 **C. Out of Pocket Expenses**

13 Petitioners challenge the FPAAs issued to 2000-A and First Ship disallowing the
14 deduction for expenses attributable to petitioners' participation in the transaction at issue in
15 this case. The court determines that the out-of-pocket expenses were properly disallowed.

16 Section 212 allows a deduction for all ordinary and necessary expenses paid or
17 incurred during the tax year (1) for the production or collection of income; (2) for the
18 management, conservation, or maintenance of property held for the production of income;
19 or (3) in connection with the determination, collection, or refund of any tax. 26 U.S.C.
20 § 212. Further, Section 165 allows as a deduction for any loss in a transaction entered into
21 for profit, though not connected with a trade or business.

22 Generally, when a transaction is disregarded for lack of economic substance,
23 deductions for costs expended in furtherance of the transaction are prohibited. Klamath
24 Strategic Investment Fund v. U.S., 568 F.3d 537, 549 (5th Cir. 2009). See also Enrici v.
25 Comm'r, 813 F.2d 293, 296 (9th Cir. 1987). Expenses are deductible under Section 212
26 only "if the facts and circumstances indicate that the taxpayer made them primarily in
27 furtherance of a bona fide profit objective independent of tax consequences." Agro Science
28 Co. v. Comm'r, 934 F.2d 573, 576 (5th Cir. 1991) (citing 26 C.F.R. § 1.183-2(a)).

1 Petitioners contend that the deduction by 2000-A on its year 2000 Form 1065 for
2 expenses of \$4,308,787 and the deduction by First Ship on its year 2001 Form 1065 for
3 expenses of \$1,353,736 representing fees related to the transactions are allowable under
4 26 U.S.C. §§ 165(c)(2) and 212 as the amounts in question were paid or incurred and
5 satisfy the requirements of these sections. Because these fees reflect legal and
6 professional fees related to the transaction that the court has determined to lack economic
7 substance or primary profit motive, these expenses were properly disallowed. “Section 212
8 was not designed to allow tax deductions based on mere preservation of net worth.”
9 Zmuda v. Comm’r, 731 F.2d 1417, 1422 (9th Cir. 1984).

10 **D. Penalties**

11 Section 6662 of the Internal Revenue Code imposes a variety of accuracy-related
12 penalties for tax underpayment. As a general rule, when Section 6662 is applicable, the
13 taxpayer is penalized “an amount equal to 20 percent of the portion of the underpayment.”
14 26 U.S.C. § 6662(a). Examples of when the 20 percent penalty applies include taxpayer
15 negligence, § 6662(b)(1), and substantial valuation misstatements, § 6662(b)(3). The 20
16 percent penalty is enhanced to 40 percent, however, in the case of gross valuation
17 misstatements. § 6662(h)(1). See Keller v. Comm’r, 556 F.3d 1056, 1059 (9th Cir. 2009).
18 There is no stacking of penalties, so the maximum penalty is either 20% or 40% of the
19 underpayment of tax, even if an underpayment is attributable to more than one type of
20 misconduct. See Treas. Reg. § 1.6662-2(c).

21 During the audit of 2000-A, the IRS determined that four penalties apply to
22 petitioners’ transaction: (1) a 40% penalty for a gross valuation misstatement (§ 6662(b)(3)
23 and (h)); (2) a 20% penalty for substantial valuation misstatement (§ 6662(b)(3)); (3) a 20%
24 penalty for substantial understatement of income tax (§ 6662(b)(2)); (4) a 20% penalty for
25 negligence or disregard of rules and regulations (§ 6662(b)(1)). Petitioners contend that
26 imposition of penalties is inappropriate here.

27 The Ninth Circuit has adopted a restrictive view of the substantial and gross
28 valuation misstatement penalties under Sections 6662(b)(3) and (h) on the grounds that

1 neither a substantial valuation nor gross valuation misstatement can occur when the
2 underlying transaction lacks economic substance because the tax underpayment that is
3 attributable to a valuation overstatement must be determined after making other proper
4 adjustments to tax liability. Keller, 556 F.3d at 1060) (quoting Gainer v. Comm'r, 893 F.2d
5 225 (9th Cir.1990)). Thus, under Gainer, when a deduction is disallowed in total, an
6 associated penalty for overvaluing an asset is precluded.

7 The parties do not dispute that the court has jurisdiction to consider the partnership's
8 defense against the imposition of penalties where the defense relates to the activity of the
9 manager or of a controlling partner rather than a partner-level defense that depends on
10 facts specific to a particular partner. See American Boat, 583 F.3d at 480. Because the
11 court has determined that the transaction at issue lacks economic substance, the penalties
12 are limited to 20 percent here under the substantial understatement or negligence penalty
13 provisions. Keller, 556 F.3d at 1061 ("in this circuit we are constrained by Gainer"). The
14 court proceeds on the question whether application of the negligence penalty was
15 appropriate here.

16 **1. Negligence**

17 Section 6662(a) and (b)(1) imposes an accuracy-related penalty of 20 percent on
18 any portion of an underpayment of tax attributable to negligence or disregard of rules or
19 regulations. For purposes of Section 6662(b), the Code defines negligence as "any failure
20 to make a reasonable attempt to comply with the provisions of [the Code]," § 6662(c), and
21 requires the taxpayer to prove he acted with due care. Hansen v. Comm'r, 471 F.3d 1021,
22 1028 (9th Cir. 2006) (citing Collins v. Comm'r, 857 F.2d 1383, 1386 (9th Cir.1988)). Due
23 care is an objective standard by which the taxpayer must show that he acted as a
24 reasonable and prudent person would act under similar circumstances. Treas. Reg.
25 § 1.6662-3(b)(1). Negligence is "strongly indicated" when "[a] taxpayer fails to make a
26 reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a
27 return which would seem to a reasonable and prudent person to be 'too good to be true'
28 under the circumstances." Hansen, 471 F.3d at 1029 (citing Treas. Reg. § 1.6662-3(b)(1),

1 (b)(1)(ii)). The court considers both the underlying investment and the taxpayer's position
2 taken on the tax return in evaluating whether a taxpayer was negligent. Id.

3 **a. Reasonable Basis**

4 A taxpayer is not liable for a negligence penalty where there is a reasonable basis
5 for the position taken. Treas. Reg. § 1.6662–3(b)(1). “Reasonable basis is a relatively high
6 standard of tax reporting, that is, significantly higher than not frivolous or not patently
7 improper. The reasonable basis standard is not satisfied by a return position that is merely
8 arguable or that is merely a colorable claim.” Treas. Reg. § 1.6662–3(b)(3). Reasonable
9 basis requires reliance on legal authorities and not on opinions rendered by tax
10 professionals. Id.; Treas. Reg. § 1.6662–4(d)(3)(iii). The court may, however, examine the
11 authorities relied upon in a tax opinion to determine if a reasonable basis exists. See
12 Treas. Reg. § 1.6662–4(d)(3)(iii). “If a return position is reasonably based on one or more
13 of the authorities set forth in [the substantial authority standard for substantial
14 underpayment penalty] . . . the return position will generally satisfy the reasonable basis
15 standard even though it may not satisfy the substantial authority standard as defined in
16 § 1.6662–4(d)(2).” Treas. Reg. § 1.6662–3(b)(3).

17 The evidence developed at trial supports the assessment of the negligence penalty
18 against the 2000-A partnership. Mr. Folger, as the trustee of the 14 Martin Family Trusts
19 and as president of LMGA Holdings, which was the managing partner of 2000-A, acted as
20 the decisionmaker on behalf of the 2000-A partnership after consulting with the members of
21 the Martin family.⁸ Petitioners contend that the negligence penalty does not apply because
22 there was a reasonable basis for their tax position and Mr. Folger made a reasonable
23 attempt to ascertain the correctness of the position. Treas. Reg. § 1.6662-3(b)(1)(ii). Mr.
24 Folger, a well-educated attorney with considerable business knowledge and experience,
25 should have known that the transaction was designed to generate an artificial capital loss to

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27 ⁸ On January 22, 2001, Mr. Folger obtained an indemnification letter from the
28 members of the Martin family concerning the purchase and sale of the securities market
derivative contracts and related transactions. Ex. 26.

1 offset the capital gains from the CPC sale. As demonstrated by the evidence in the record,
2 PWC prepared spreadsheets for Mr. Folger and the Martin family showing that the losses
3 generated by the transaction could wipe out the entire capital gain from the sale of CPC.
4 Ex. 30 at Priv Log 3620. However, the tax loss reported by 2000-A did not reflect the
5 economic reality of the actual transaction, which involved offsetting options costing a net
6 premium of \$0.9 million, not a loss of \$315.7 million as reported on the partnership return.
7 The fact that the actual cost of the options was only 0.29% of the reported increase in the
8 tax basis should have alerted Mr. Folger and the Martin family that the options transaction
9 was substantially overvalued and that the income taxes were therefore substantially
10 understated. Mr. Folger and the Martin family, particularly Mr. Martin, a
11 highly-sophisticated and very successful businessman who had wide-ranging experience in
12 analyzing business and investment transactions, should have known that the transaction
13 was “too good to be true.” Acting with the consent and at the direction of the Martin family,
14 Mr. Folger failed to act as a reasonable and prudent person in filing the partnership return
15 reporting a total \$321 million tax loss when the partnership did not suffer an economic loss
16 of that magnitude.

17 Petitioners argue that they acted reasonably by relying on the advice of experienced
18 tax professionals at PWC and the Sideman firm, both of which were compensated at their
19 normal hourly rates. However, the mere act of seeking legal advice does not in and of itself
20 shield taxpayers from a negligence penalty. See Treas. Reg. § 1.6664-4(b)(1). The
21 discussions in the briefing memo and during the Martin family presentation by PWC and the
22 Sideman firm about the likelihood of an audit and litigation by the IRS, particularly in light of
23 the issuance of Notice 2000-44, should have alerted Mr. Folger and the Martin family
24 members that the “significant tax benefit in the form of a large capital loss” from the options
25 transaction was questionable. These red flags were clear warnings that the proposed
26 transaction was likely improper, but Mr. Folger and the Martin family did not act as
27 reasonable, prudent taxpayers. See Collins, 857 F.2d at 1386. Here, the evidence tends
28 to show that Mr. Folger and the Martin family members not only stuck their heads in the

1 sand in the face of these warnings about reporting the inflated capital loss, but took a
2 calculated risk of being challenged in court by the IRS after considering cost projections of
3 a tax controversy. Ex. 30 at Priv Log 3622. See Mortensen v. Comm’r, 440 F.3d 375, 385
4 (6th Cir. 2006). Where the losses reported by the taxpayers did not reflect the economic
5 reality of the transaction and the resulting tax benefit was too good to be true, the
6 negligence penalty was appropriate here.

7 **b. Disregard of Rules or Regulations**

8 The penalty for “disregard” of rules or regulations includes any careless, reckless or
9 intentional disregard. 26 U.S.C. § 6662(c); Treas. Reg. § 1.6662-3(b). The term “rules or
10 regulations” includes the provisions of the Internal Revenue Code, temporary or final
11 Treasury regulations issued under the Code, and revenue rulings or notices (other than
12 notices of proposed rulemaking) issued by the Internal Revenue Service and published in
13 the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). A disregard of rules or
14 regulations is “careless” if the taxpayer does not exercise reasonable diligence to determine
15 the correctness of a return position that is contrary to the rule or regulation. A disregard is
16 “reckless” if the taxpayer makes little or no effort to determine whether a rule or regulation
17 exists, under circumstances which demonstrate a substantial deviation from the standard of
18 conduct that a reasonable person would observe. A disregard is “intentional” if the
19 taxpayer knows of the rule or regulation that is disregarded. Nevertheless, a taxpayer who
20 takes a position contrary to a revenue ruling or notice has not disregarded the ruling or
21 notice if the contrary position “has a realistic possibility of being sustained on the merits.”
22 Id. In determining whether a realistic possibility of being sustained on its merits exists for
23 return positions, the regulations defining the realistic possibility standard refer to the same
24 list of authorities on which taxpayers may rely for substantial authority under the provisions
25 for substantial understatement penalty. Treas. Reg. § 1.6694-2(b)(2) (citing Treas. Reg.
26 § 1.6662-4(d)(3)(iii)). The “realistic possibility” standard is a lesser standard than
27 substantial authority. See Joint Committee on Taxation, 106th Cong., Comparison of Joint
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1 Committee Staff and Treasury Recommendations Relating to Penalty and Interest
2 Provisions of the Internal Revenue Code (JCX-79-99) 13 (Nov. 5, 1999).

3 Petitioners contend that to the extent that Notice 2000-44 applied, the taxpayers’
4 position had a realistic possibility of being sustained on the merits because court opinions
5 such as Helmer, 34 T.C.M. 727 (holding that contingent obligations are not liabilities under
6 section 752) are entitled to greater deference than notices issued by the IRS. Petitioners
7 argue that the taxpayers have not disregarded a rule or regulation under section 6662 and
8 that the penalty is therefore inapplicable. Petitioners fail to acknowledge, however, the line
9 of authorities recognizing the long-standing economic substance doctrine which requires
10 disregarding, for tax purposes, transactions that comply with the literal terms of the tax
11 code but lack economic reality. See Cemco, 515 F.3d at 752 (Treas. Reg. § 1.752–6
12 merely serves to “instantiate the pre-existing norm that transactions with no economic
13 substance don’t reduce people’s taxes”) (citing Coltec, 454 F.3d 1340).

14 At a minimum, the record demonstrates that Mr. Folger and the Martin family
15 carelessly disregarded Notice-44, which was issued in August 2000 before the Martin
16 Family Trusts engaged in the transaction at issue, despite being warned by PWC and the
17 Sideman firm that “the IRS announced in Notice 2000-44 that transactions involving the
18 same basic mechanics as the instant one did not give rise to the intended capital loss.” Ex.
19 30 at Priv Log 3577. Mr. Folger and the Martin family were advised that “Notice 2000-44
20 represents only the opinion of the IRS on this issue, and that opinion is not binding on the
21 courts.” Id. Yet, Mr. Folger and the taxpayers were also advised of the high likelihood that
22 the IRS would “vigorously litigate rather than settle” the issue, giving rise to the inference
23 that Mr. Folger and the taxpayers were aware that it was not a realistic possibility that their
24 tax position would be sustained on the merits. The “disregard” penalty was therefore
25 appropriately applied.

26 Petitioners also challenge the penalty assessed under the provision for substantial
27 understatement of income tax on the ground that there was “substantial authority”
28 supporting the understatement. 26 U.S.C. § 6662(d)(2)(B). At trial, the government did

1 not fully address the grounds for applying the substantial understatement penalty to
2 petitioners, and the court does not make any determination with respect to the substantial
3 understatement penalty here. Having determined that petitioners failed to meet the
4 reasonable basis standard under the negligence penalty and the “realistic possibility”
5 standard under the penalty for disregard of rules or regulations, however, the court notes
6 that petitioners’ challenge to the substantial understatement penalty would fail under the
7 more stringent standard for substantial authority. See Treas. Reg. §§ 1.6662–3(b)(3),
8 1.6662-4(d)(2) (“[t]he substantial authority standard is less stringent than the more likely
9 than not standard (the standard that is met when there is a greater than 50–percent
10 likelihood of the position being upheld), but more stringent than the reasonable basis
11 standard”).

12 **2. Reasonable Cause and Good Faith Defense**

13 In challenging the negligence and substantial authority penalties, petitioners contend
14 that they demonstrated reasonable cause and good faith as an absolute defense to those
15 accuracy-related penalties. Section 6664(c) provides that “[n]o penalty shall be imposed
16 under section 6662 . . . if it is shown [1] that there was a reasonable cause for [the
17 underpayment] and [2] that the taxpayer acted in good faith.” 26 U.S.C. § 6664(c)(1). The
18 reasonable-cause-and-good-faith defense acknowledges that penalties are inappropriate
19 when a taxpayer underpays as a result of “an honest misunderstanding of fact or law that is
20 reasonable in light of all of the facts and circumstances.” Treas. Reg. § 1.6664-4(b)(1). The
21 taxpayer carries the burden of establishing the reasonable cause and good faith exception.
22 See 26 U.S.C. § 6662, 6664(c). Generally, the most important factor is the extent of the
23 taxpayer's effort to assess the taxpayer's proper tax liability. Treas. Reg. § 1.6664-4(b)(1).

24 Petitioners contend that they had reasonable cause and acted in good faith because
25 they reasonably relied on the advice of competent and independent professional advisors.
26 Reliance on professional advice constitutes reasonable cause and good faith if, under all
27 the circumstances, such reliance was reasonable and the taxpayer acted in good faith.
28 Treas. Reg. § 1.6664-4(b)(1). However, mere reliance on the advice of a professional tax

1 advisor “does not necessarily demonstrate reasonable cause and good faith.” *Id.* A
2 taxpayer’s claim of reliance upon professional advice as support for this defense is to be
3 evaluated under an objective standard. “The reasonableness of any reliance turns on the
4 quality and objectivity of the advice.” *Stobie Creek Investments LLC v. U.S.*, 608 F.3d
5 1366, 1381 (Fed. Cir. 2010). Reasonable cause requires the taxpayer to show that the
6 advice was based on “all pertinent facts and circumstances and the law as it relates to
7 those facts and circumstances.” Treas. Reg. § 1.6664-4(c)(1)(i).

8 At trial, Mr. Folger and the Martin family members testified that they did not have the
9 expertise to fully understand how the transaction was structured and the tax ramifications
10 and that they relied on the advice of the Sideman firm and PWC, primarily on Mr. Sideman.
11 The evidence presented at trial tends to show that they relied on their tax attorney, Mr.
12 Sideman, to review all the advisory opinions and analyses and to make a recommendation
13 as to whether they should engage in the transaction. The evidence also demonstrates that
14 Mr. Folger and the Martin family had negligible contact with either Dr. Rubinstein or Mr.
15 Ruble, on whom Mr. Sideman relied for an analysis of the business purpose and legality of
16 the transaction. Mr. Folger testified that he did not understand the Ruble opinion letter and
17 relied on Mr. Sideman “to say this was an authentic, valid transaction, and I satisfied myself
18 that he was answering that question.” Tr. 267:3-23. While the record is clear that Mr.
19 Folger and the Martin family relied heavily on Mr. Sideman, the record is not clear as to the
20 extent that they relied directly on the advice of Dr. Rubinstein and Mr. Ruble, if at all. It was
21 Mr. Sideman who appears to have relied on the advice of Dr. Rubinstein and Mr. Ruble in
22 advising Mr. Folger and the Martin family.

23 With regard to Dr. Rubinstein’s economic advice, the record establishes that he was
24 given a very limited set of facts on which to conduct his analysis of whether the transaction
25 could have a business purpose. As he testified at trial, Dr. Rubinstein limited his analysis
26 to whether the offsetting options portfolios could make a profit but did not take into account
27 the preexisting holdings of cash which were converted to SPDRs. Dr. Rubinstein did not
28 know that petitioners started in a position of cash and was also instructed not to consider

1 any tax consequences of the transaction. Thus, any reliance on Dr. Rubinstein’s advice
2 would not be reasonable because his conclusions were not based on all pertinent facts and
3 circumstances as required for reasonable cause.

4 With respect to the opinion letters issued by Mr. Ruble and the Brown & Wood firm,
5 the evidence presented at trial demonstrates that the advice was similarly not based on “all
6 pertinent facts and circumstances” and included unreasonable factual and legal
7 assumptions. The Brown & Wood opinion letters contained misstatements of fact and
8 reached conclusions about the transaction that the Sideman firm and PWC, as well as the
9 taxpayers, should have known could not be correct. For instance, in the section of each
10 opinion letter entitled “Investor Representations,” Mr. Ruble states that the investor, being
11 each of the Martin Family Trusts, dealt with First Ship and the other members at arms
12 length, and that the investor reviewed the description of the transactions contained in the
13 letter and verified that the description is accurate. However, Mr. Folger testified that he had
14 never communicated with or spoken to Mr. Ruble and that he did not remember reviewing
15 the opinion letter or providing the investor representations, which would have been
16 provided by the Sideman firm or PWC. For his part, Mr. Martin testified that he never read
17 the entire Ruble opinion letter and the record reflects that at one point he was willing to
18 proceed with the earlier Arthur Andersen shelter transaction before receiving the Ruble
19 opinion letter. Ex. 101.

20 With respect to Ruble’s statement that the transactions were motivated by non-tax
21 reasons, Mr. Sideman, as well as the taxpayers, should have known that this statement
22 was contrary to the purpose of the options transaction which was specifically to generate a
23 large capital loss to offset the capital gains from the CPC sale. Furthermore, they should
24 have known that Ruble’s factual assumption that the series of options transactions was a
25 viable means of reducing market risks was unfounded because the transaction actually
26 increased the Martin Family Trusts’ risk of exposure to market fluctuations and offered no
27 reasonable expectation of profit in the face of an expected market decline, as opined by Dr.
28 Grenadier.

1 There are other reasons why the Ruble opinion letter lacked “quality and objectivity,”
2 rendering reliance on his advice unreasonable. See Klamath, 568 F.3d at 548 (citing
3 Swayze v. U.S., 785 F.2d 715, 719 (9th Cir. 1986)). After being introduced by Arthur
4 Andersen, the Sideman firm hired Ruble in early 2000 to write an opinion letter for the
5 shelter transaction proposed by Arthur Andersen which counsel from the Sideman firm
6 described as one that “creates basis where there was none before.” Exs. 98, 100. The
7 evidence shows that the Ruble opinion letter that was issued to the Martin Family Trusts
8 was based on a template opinion letter concerning foreign currency investments that had
9 been circulated earlier in the year with respect to the Arthur Andersen proposal. In addition
10 to the boilerplate nature of the Ruble opinion letter provided to the Martin Family Trusts, the
11 opinion letter was rendered further unreliable after the IRS published Notice 2000-44, which
12 put Mr. Sideman and taxpayers on notice that transactions such as the one they
13 contemplated would be challenged as a sham transaction, particularly after PWC explained
14 that Notice 2000-44 covered “transactions involving the same basic mechanics as the
15 instant one.” Ex. 30.

16 For his part, Mr. Sideman understood that Mr. Folger and the Martin family relied on
17 him to “greenlight” or approve the transaction, but denied that he designed the transaction
18 with PWC and JP Morgan. Tr. 149:10-20; 250:17-25. Mr. Sideman communicated
19 primarily with Mr. Martin as the principal voice on behalf of the Martin family. Tr. 134:16-25.
20 Mr. Sideman testified that he saw his role as that of overseeing the transaction “in a broad
21 way [and] hiring or engaging at my recommendation the most qualified people that I knew
22 who could provide the actual expertise about the transaction and about its financial
23 implications.” Tr. 152:19-25. Mr. Sideman characterized himself as a tax controversy
24 lawyer, unfamiliar with economic judgments involving financial matters to advise the Martin
25 family directly on the issue whether the tax proposal by Arthur Andersen, and the
26 subsequent proposal by PWC, would have an economic reality or economic benefit. Mr.
27 Sideman testified that he relied on the advice of PWC, Dr. Rubinstein and Mr. Ruble to
28 examine the business purpose of the proposed transaction. Tr. 143:4-145:16.

1 While the evidence at trial establishes that Mr. Folger and the Martin family relied on
2 Mr. Sideman’s advice, the trial evidence lacks clarity as to exactly what advice Mr. Sideman
3 gave them, other than approving or “greenlighting” the transaction based on the advice he
4 received from the other professionals. The weaknesses noted above in the Ruble and
5 Rubinstein opinions, as well as other aspects of the transaction, should have put at least
6 Mr. Sideman, if not the taxpayers, on notice that the transaction was a questionable tax
7 avoidance scheme lacking economic substance. However, the question before the court is
8 not whether Mr. Sideman’s reliance on professional advice was reasonable, but whether
9 Mr. Folger and the Martin family’s reliance on Mr. Sideman’s and the other professionals’
10 advice was reasonable. As previously noted, it is not clear to what extent the taxpayers
11 themselves relied on any advice other than Mr. Sideman’s. Nor was it established that Mr.
12 Sideman ever specifically advised them that the transaction was bona fide or legal. All the
13 evidence clearly establishes is that Mr. Sideman approved the transaction.

14 The government contends that Mr. Folger’s and the Martin family’s reliance on the
15 Sideman firm and PWC was unreasonable on the ground that those firms had an inherent
16 conflict of interest arising from their roles in promoting and implementing the transaction
17 and receiving fees. The court is satisfied, however, that the Sideman firm and PWC did not
18 have a profit motive or other monetary interest in the outcome of the transaction because
19 those advisors were paid at an hourly rate to advise Mr. Folger and the Martin family,
20 regardless of whether they ultimately engaged in the transaction. There was not, in the
21 court’s view, a conflict of interest.

22 The government has not provided a clear argument or any authority for whether Mr.
23 Sideman’s unreasonable reliance on the professionals he hired should be imputed to the
24 taxpayers. This was a highly sophisticated transaction, one for which a taxpayer would
25 reasonably be expected to hire a tax lawyer. The court is not prepared to find that having
26 retained a tax lawyer who “greenlights” a complicated transaction as having a business
27 purpose, a taxpayer necessarily acts unreasonably by relying on that advice. See United
28 States v. Boyle, 469 U.S. 241, 250–51 (1985) (when an accountant or attorney advises a

1 taxpayer on a matter of tax law, it is reasonable for the taxpayer to rely on that advice,
2 “even when such advice turned out to have been mistaken”). Even assuming, however,
3 that the taxpayers acted reasonably in relying on their tax lawyer’s advice to proceed with
4 the transaction, to be entitled to the reasonable cause and good faith defense, the
5 taxpayers must also prove that they acted in good faith. Good faith is not synonymous with
6 objective reasonableness. Even if the concept of business purpose was too complicated
7 for the taxpayers to assess and apprehend, the court finds that Mr. Folger and the Martin
8 family have not demonstrated good faith under the circumstances and in light of the
9 underlying purposes of entering into the transaction.

10 First, Mr. Folger and the Martin family should have known that the transaction
11 resulting in a \$315.7 million tax basis for a \$0.9 million offsetting options transaction was
12 “too good to be true.” Stobie Creek, 608 F.3d at 1383. Furthermore, they knew that the
13 purpose of the transaction was to boost the basis to generate a large capital loss to offset
14 the capital gains from the CPC sale. Finally, they proceeded with the transaction even after
15 the issuance of Notice 2000-44, entitled “Tax Avoidance Using Artificially High Basis,”
16 which alerted them that the basis created by the options transaction would likely be
17 disallowed. Although they were advised by Mr. Sideman that the transaction had a
18 legitimate business purpose, Mr. Folger and the Martin family entered into this transaction
19 with the knowledge that it would generate an artificially high capital loss. Given the level of
20 education and business experience shared by Mr. Folger and the Martin family, they should
21 have known that the absence of a tax liability on a sizeable capital gain did not reflect the
22 economic reality of the transaction. The underpayment of tax was not, therefore, the result
23 of “an honest misunderstanding of fact or law.” Treas. Reg. § 1.6664-4(b)(1). Because Mr.
24 Folger, with the consent of the Martin family, did not act in good faith, the court finds that
25 the accuracy-related penalty was appropriately applied here.

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CONCLUSION

Based on the findings and conclusions set forth above, the court finds that the final partnership administrative adjustments setting forth adjustments to the 2000-A partnership tax return for the taxable year ending December 31, 2000, and the First Ship partnership tax return for the taxable year ending December 31, 2001, were proper. The petitions in this consolidated action are hereby DENIED.

IT IS SO ORDERED.

Dated: October 6, 2011



PHYLLIS J. HAMILTON
United States District Judge