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UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

MAGUIRE PARTNERS - MASTER)	Case No. CV 06-07371-JFW(RZx)
INVESTMENTS, LLC, MAGUIRE)	
PARTNERS, INC., TAX MATTERS)	Related Case Nos.:
PARTNERS, et al.,)	
)	CV 06-0774-JFW (Rzx)
Plaintiffs,)	CV 06-7376-JFW (Rzx)
)	CV 06-7377-JFW (Rzx)
v.)	CV 06-7380-JFW (RZx)
)	
UNITED STATES OF AMERICA,)	FINDINGS OF FACT AND
)	CONCLUSIONS OF LAW
Defendant.)	
_____)	

This action came on for a court trial on August 12, 13, and 14, 2008. Steven R. Mather and Lydia Turanchik of Kajan Mather and Barish appeared for Plaintiffs Maguire Partners - Master Investments LLC, Maguire Partners Inc., Thomas Master Investments LP, Thomas Partners Inc., Tax Matters Partner, Huntington/Fox Investments LP, Edward D. Fox, Jr., Thomas Division Partnership LP, Thomas Investment Partners Ltd., (collectively "Plaintiffs"). Andrew Pribe, Rick Watson, and Jonathan Sloat of the Office of the United States Attorney

1 appeared for Defendant United States of America
2 ("Defendant"). On September 22, 2008, the parties filed
3 their proposed Post-Trial Findings of Fact and Conclusions of
4 Law. On October 6, 2008, the parties each filed their Post-
5 Trial Briefs and their marked copies of the opposing parties'
6 proposed Post-Trial Findings of Fact and Conclusions of Law.
7 After considering the evidence, briefs and argument of
8 counsel, the Court makes the following findings of fact and
9 conclusions of law:¹

10

11 ¹ The Court deferred ruling on the admissibility of
12 deposition testimony of Messrs. Mandel, Varellas and Nelson
13 offered by the government as well as certain trial exhibits
14 objected to by the parties in the Final Pre-Trial Exhibit
15 Stipulation filed August 5, 2008, pending further post-trial
16 submissions/briefing by the parties. On October 6, 2008, the
17 parties filed Notices of Designated Deposition Testimony of
18 Kenneth Mandel, Lawrence Varellas, and Kurt Nelson, along
19 with Plaintiffs' Objections and Defendant's Response to
20 Objections.

16

17 The Court has reviewed the objections to the proffered
18 deposition testimony and the objections to certain trial
19 exhibits in the Final Pre-Trial Stipulation filed August 5,
20 2008, and rules as follows: The Court overrules the
21 objections to Exhibits 45, 52, 53, 54, 74, 81, 82, 85, 86,
22 88, 89, 90, 94, 95, 97, 100, 101, 102, 103, 105, 130, 131,
23 140, 141, 142, 143, 144, 145, 146, 151, 260 (a) - (v) and
24 those exhibits will be received into evidence as of the last
25 day of trial, which was August 14, 2008. As to the
26 objections to the deposition testimony of Mr. Mandel, all of
27 the Plaintiffs' objections are overruled except for the
28 following objections which are sustained: (1) p. 35, lines
2 - 4. As to the objections to the deposition testimony of
Mr. Varellas, all of Plaintiffs' objections are overruled
except the following which are sustained: (1) p. 47, lines
1 - 10 and 15 - 25; (2) p. 48, lines 1 - 25; (3) p. 54,
lines 1 - 25; (4) p. 55, lines 1 - 8; and (5) p. 87, lines
15 - 25. As to the objections to the deposition testimony of
Mr. Nelson, all of Plaintiffs' objections are overruled.
Plaintiffs' objections to Defendant's attempt to introduce
documents through deposition excerpts which were not marked
by Defendant as trial exhibits are sustained. Those
documents are inadmissible and will not be received into

28

(continued...)

1 Findings of Fact²

2 I. Factual and Procedural Background

3 A. The Principals and Their Entities

4 1. James Thomas

5 James Thomas, a real-estate investor and developer, is
6 the trustee of the Lumbee Clan Trust, which is a partner in
7 Thomas Investment Partners Ltd. ("TIP"), which, in turn, is a
8 partner in Thomas Division Partnership LP ("TDP"). In 2001
9 through 2002, these various partnerships owned an interest
10 in: the Library Tower in Los Angeles; the Gas Company Tower
11 in Los Angeles; the Wells Fargo Center in Los Angeles; the
12 MGM Plaza in Santa Monica; the Solana project in Dallas; and
13 Commerce Square in Philadelphia. These investments were
14 highly leveraged with debt in the range of eighty to ninety
15 percent of the value of the property. Thomas's net worth in
16 2001 was approximately \$200 million, with approximately
17 twenty to thirty percent in cash or marketable
18 securities/cash equivalents and the remainder in real estate
19 holdings, including those identified above.

20 2. Edward Fox

21 Edward Fox, a real-estate investor and developer, is the
22 trustee of The Edward D. Fox, Jr. Family Trust dated February

23 _____
24 ¹(...continued)
evidence and have not been considered by the Court.

25
26 ² The Court has elected to issue its findings in
narrative form. Any finding of fact that constitutes a
27 conclusion of law is also hereby adopted as a conclusion of
law, and any conclusion of law that constitutes a finding of
28 fact is also hereby adopted as a finding of fact.

1 14, 1990 (the "Fox Trust"), which is a partner in
2 Huntington/Fox Investments LP ("HFI"), which, in turn, is a
3 partner in both Maguire Partners - Master Investments LLC
4 ("MP-MI") and Thomas Master Investments LP ("TMI"). In 2001
5 through 2002, these various partnerships owned an interest
6 in: the Library Tower in Los Angeles; the Gas Company Tower
7 in Los Angeles; the Wells Fargo Center in Los Angeles; the
8 MGM Plaza in Santa Monica; the Solana project in Dallas; and
9 Commerce Square in Philadelphia. These investments were
10 highly leveraged with the debt in the range of eighty to
11 ninety percent of the value of the property.

12 In 2001, Fox also was a major investor in the
13 publicly-held Center Trust REIT where he served as chairman
14 of the board and chief executive officer. The Media Center
15 Shopping Mall in Burbank, California was one of the key
16 assets owned by the Center Trust REIT. In 2001, Fox also was
17 a founder and owner of Commonwealth Partners, which was
18 assembling a portfolio of commercial real estate projects in
19 partnership with various California state pension funds.
20 Fox's net worth in 2001 was approximately \$50 million.

21

22 **B. The Transactions At Issue**

23 **1. The Lumbee Clan Trust Transaction**

24 On December 20, 2001, the Lumbee Clan Trust and AIG
25 entered into a transaction in which the Lumbee Clan Trust
26 paid \$1.5 million to AIG. The source of the funds used to
27 pay AIG was a distribution from TIP. Thomas contends that
28 the purpose of the transaction was to serve as a hedge

1 against potential loss in the value of his real-estate
2 interests arising from the risk of terrorism after September
3 11, 2001. Thomas also contends that the Lumbee Clan Trust
4 paid \$1.5 million for an opportunity to receive a net maximum
5 of \$38.4 million. The potential payout from the transaction
6 was tied to the value of a portfolio of twenty REIT stocks
7 (the "REIT basket").

8 **a. The Structure of the Transaction**

9 In general, the transaction between the Lumbee Clan Trust
10 and AIG consisted of a short option, a long option, and a
11 promissory note. On December 20, 2001, the Lumbee Clan Trust
12 and AIG in order to implement the transaction did the
13 following: (1) the Lumbee Clan Trust sold a short option to
14 AIG for \$100 million; (2) the Lumbee Clan Trust purchased a
15 long option from AIG for \$61,683,169; (3) the Lumbee Clan
16 Trust purchased a promissory note from AIG for \$39,816,831;
17 and (4) the Lumbee Clan Trust pledged the proceeds from the
18 long option and the promissory note to secure the short
19 option. The Lumbee Clan Trust's transaction costs amounted
20 to \$1.5 million. The long and short options were Asian-style
21 European options.³ The promissory note eliminated AIG's
22 obligation to transfer funds to the Lumbee Clan Trust in the
23 amount representing the difference between the price of the

24
25 ³ An Asian-style option is an option whose payoff
26 depends on the average value of the underlying security or
27 commodity over a specified period of time. In this case, the
28 Asian-style feature meant that the payout was dependent on
the average value of the REIT basket from December 20, 2001,
to March 19, 2002, as compared to the value of the REIT
basket on December 19, 2001. A European option is one that
can only be exercised on a particular date. In this case,
the date was March 19, 2002.

1 short option and the price of the long option. The strike
2 price of the short option was fifty percent of the value of
3 the REIT basket, or \$100,021,176. The strike price of the
4 long option was seventy percent of the value of the REIT
5 basket, or \$140,029,647.

6 **b. The Terms of the Transaction**

7 The terms of the transaction provided that any payoff
8 depended on the average value of the REIT basket between
9 December 20, 2001, and March 19, 2002, as compared to the
10 value as of December 19, 2001. If the average value of the
11 REIT basket between December 20, 2001, and March 19, 2002,
12 did not fall by greater than thirty percent as compared to
13 the value of the REIT basket on December 19, 2001, then the
14 Lumbee Clan Trust would receive no payout. If the average
15 value of the REIT basket between December 20, 2001, and March
16 19,2002, fell more than thirty percent as compared to the
17 value of the REIT basket on December 19, 2001, then the
18 Lumbee Clan Trust would receive a cash payment that would
19 increase dollar-for-dollar with the reduction in the average
20 value of the REIT basket below seventy percent of the value
21 of the REIT basket on December 19, 2001, until a maximum
22 payout of \$40,008,471 was reached. This maximum payout would
23 be reached if the average value of the REIT portfolio fell by
24 fifty percent or more from its value of December 19, 2001.
25 However, the Lumbee Clan Trust would never be obligated to
26 pay out-of-pocket anything other than the \$1.5 million
27 transaction costs paid to AIG on December 20, 2001, for the
28 transaction.

1 **c. The Contributions to the Partnerships**

2 On December 27, 2001, the Lumbee Clan Trust contributed
3 the transaction to TIP. Specifically, the Lumbee Clan Trust
4 contributed the long option and the promissory note, and TIP
5 assumed the short option. On December 27, 2001, TIP
6 contributed the transaction to TDP. Specifically, TIP
7 contributed the long option and the promissory note, and TDP
8 assumed the short option. These contributions of the assets
9 and assumptions of the short option were with the approval of
10 AIG. After the contributions to the partnerships, AIG's
11 position in the short option remained secured by the pledge
12 of the long option and the promissory note.

13 **d. The Performance of the REIT Basket and the**
14 **Transaction**

15 The value of the REIT basket did not decline by an
16 average of thirty percent for the period between December 20,
17 2001, and March 19, 2002, as compared to its value on
18 December 19, 2001. Therefore, the transaction did not yield
19 a net payment to TDP.

20 **e. The Tax Reporting by the Partnerships and**
21 **the IRS Adjustments Related to the**
22 **Transaction**

23 **i. Thomas Investment Partners**

24 TIP reported on its 2001 Form 1065 that \$101,500,000 had
25 been contributed in capital during the year and that this
26 amount constituted an asset of TIP. TIP also reported on its
27 2001 Form 1065 that the Lumbee Clan Trust had increased its
28 capital in TIP by \$101,500,000. TIP also issued a K-1

1 (partner's share of income, credits, deductions, etc.) to the
2 Lumbee Clan Trust for 2001 that reflected an increase in the
3 Lumbee Clan Trust's capital account of \$101,500,000 due to
4 the contribution of the transaction. TIP reported on its
5 2002 Form 1065 that it had interest income of \$191,640 and it
6 claimed deductions of \$1,691,640. TIP did not account for
7 the short option on either the Form 1065 or the K-1s for 2001
8 and 2002. For 2001, the IRS issued a notice of Final
9 Partnership Adjustment ("FPAA") which adjusted downward the
10 capital contributed to and assets of TIP by \$101,500,000 and
11 sought to adjust the outside basis of LCT by \$101,500,000.
12 For 2002, the FPAA adjusted downward income by \$191,640 and
13 disallowed the deduction of \$1,691,640.

14 **ii. Thomas Division Partnership**

15 TDP reported on its 2001 Form 1065 that \$101,500,000 had
16 been contributed in capital during the year and that this
17 amount constituted an asset of TDP. TDP also reported on its
18 2001 Form 1065 that TIP had increased its capital in TDP by
19 \$101,500,000. TDP also issued a K-1 to TIP for 2001 that
20 reflected an increase in TIP's capital account of
21 \$101,500,000 due to the contribution of the transaction. TDP
22 reported on its 2002 Form 1065 that it had interest income of
23 \$191,640, and it claimed deductions of \$1,691,640. TDP did
24 not account for the short option on either the Form 1065 or
25 the K-1s for 2001 and 2002. For 2001, the IRS issued an FPAA
26 that adjusted downward the capital contributed to and assets
27 of TDP by \$101,500,000, and sought to adjust the outside
28 basis of TIP by \$101,500,000. For 2002, the FPAA adjusted

1 downward income by \$191,640, and disallowed the deduction of
2 \$1,691,640.

3 **2. The Fox Trust Transaction**

4 On December 20, 2001, the Fox Trust and AIG entered into
5 a transaction in which the Fox Trust paid \$675,000 to AIG.
6 Fox contends that the purpose of the transaction was to serve
7 as a hedge against potential loss in the value of his
8 real-estate interests arising from the risk of terrorism
9 after September 11, 2001. Fox also contends that the Fox
10 Trust paid \$675,000 for an opportunity to receive up to a net
11 maximum of \$17,242,574. The potential payout from the
12 transaction was tied to the value of a portfolio of twenty
13 REIT stocks (the "REIT basket"). This was the identical
14 basket that the Lumbee Clan Trust transaction used.

15 **a. The Structure of the Transaction**

16 In general, the transaction between the Fox Trust and AIG
17 consisted of a short option, a long option, and a promissory
18 note. On December 20, 2001, the Fox Trust and AIG in order
19 to implement the transaction did the following: (1) the Fox
20 Trust sold a short option to AIG for \$45 million; (2) the Fox
21 Trust purchased a long option from AIG for \$27,757,426; (3)
22 the Fox Trust purchased a promissory note from AIG for
23 \$17,917,574; and (4) the Fox Trust pledged the proceeds from
24 the long option and the promissory note to secure the short
25 option. The Fox Trust's transaction costs amounted to
26 \$675,000. The options were Asian-style European options.
27 The promissory note eliminated AIG's obligation to transfer
28 funds to the Fox trust in an amount representing the

1 difference between the price of the short option and the
2 price of the long option. The strike price of the short
3 option was fifty percent of the value of the REIT basket, or
4 \$45,009,529. The strike price of the long option was seventy
5 percent of the value of the REIT basket, or \$63,013,341.

6 **b. The Terms of the Transaction**

7 The terms of the transaction provided that any payoff
8 depended on the average value of the REIT basket between
9 December 20, 2001, and March 19, 2002, as compared to the
10 value as of December 19, 2001. If the average value of the
11 REIT basket between December 20, 2001, and March 19, 2002,
12 did not fall by greater than thirty percent as compared to
13 the value of the REIT basket on December 19, 2001, then the
14 Fox Trust would receive no payout. If the average value of
15 the REIT basket between December 20, 2001, and March 19,
16 2002, fell by more than thirty percent as compared to the
17 value of the REIT basket on December 19, 2001, then the Fox
18 Trust would receive a cash payment that would increase
19 dollar-for-dollar with the reduction in the average value of
20 the REIT basket below seventy percent of the value of the
21 REIT basket on December 19, 2001, until a maximum payout of
22 \$18,003,812 was reached. This maximum payout would be
23 reached if the average value of the REIT portfolio fell by
24 fifty percent or more from its value on December 19, 2001.
25 However, the Fox Trust would never be obligated to pay
26 out-of-pocket anything other than the \$675,000 transaction
27 costs paid to AIG on December 20, 2001.

28

1 **c. The Contributions to the Partnerships**

2 On December 27, 2001, the Fox Trust contributed the
3 transaction to HFI. Specifically, the Fox Trust contributed
4 the long option and the promissory note, and HFI assumed the
5 short option. On December 27, 2001, HFI contributed
6 \$34,749,083 of the transaction to MP-MI. Specifically, HFI
7 contributed seventy-six percent of the long option and the
8 promissory note, and MP-MI assumed seventy-six percent of the
9 short option. HFI had no prior investment in MP-MI. On
10 December 27, 2001, HFI contributed \$7,682,535 of the
11 transaction to TMI. Specifically, HFI contributed seventeen
12 percent of the long option and the promissory note, and TMI
13 assumed seventeen percent of the short option. HFI had no
14 prior investment in TMI. On December 27, 2001, HFI
15 contributed the remaining seven percent of the transaction to
16 Manhattan Properties, LP⁴, which assumed the remaining seven
17 percent of the short option. These contributions of the
18 assets and assumptions of the short option were with the
19 approval of AIG. After the contributions to the
20 partnerships, AIG's position in the short option remained
21 secured by the pledge of the long option and the note.

22 **d. The Performance of the REIT Basket and the**
23 **Transaction**

24 The value of the REIT basket did not decline by an
25 average of thirty percent for the period between December 20,
26 2001, and March 19, 2002, as compared to its value on

27 ⁴ The Manhattan Properties, L.P., transaction is not a
28 part of this litigation.

1 December 19, 2001. Therefore, the transaction did not yield
2 a net payment to Fox.

3 **e. The Tax Reporting by the Partnerships and**
4 **the IRS Adjustments Related to the**
5 **Transaction**

6 **i. Huntington/Fox Investments**

7 HFI reported its investment in MP-MI on its 2001
8 Form 1065 in the amount of \$513,515. HFI reported its
9 investment in TMI on its 2001 Form 1065 in the amount of
10 \$113,519. HFI reported on its 2002 Form 1065 deductions of
11 \$707,183 and income of \$80,114 pertaining to the transaction.
12 HFI did not account for the short option on either the Form
13 1065 or the K-1s for 2001 and 2002. For 2001, the IRS issued
14 an FPAA that adjusted downward the capital contributed to and
15 assets of HFI by \$42,431,618, and sought to adjust outside
16 basis of the Fox Trust by \$42,431,618. For 2002, the FPAA
17 adjusted income downward by \$80,114, and disallowed the
18 deduction of \$707,183.

19 **ii. Maguire Partners-Master Investments**

20 MP-MI reported on its 2001 Form 1065 that it had made a
21 capital contribution of \$34,749,083 during the year and that
22 this amount constituted an asset of the partnership. MP-MI
23 also reported on its 2001 Form 1065 that HFI had increased
24 its capital in MP-MI by \$34,749,083. MP-MI also issued a K-1
25 to HFI for 2001 that reflected an increase in the HFI's
26 capital account of \$34,749,083 due to the contribution of the
27 transaction. MP-MI reported on its 2002 Form 1065 that it
28 had interest income of \$65,609 and it claimed deductions of

1 \$579,143 pertaining to the transaction. It also reported
2 other investments of \$34,235,549. MP-MI did not account for
3 the short option on either the Form 1065 or the K-1s for 2001
4 and 2002. For 2001, the IRS issued an FPAA that adjusted
5 downward the capital contributed to and assets of MP-MI by
6 \$34,749,083 , and sought to adjust the outside basis of HFI
7 by \$34,749,083. For 2002, the FPAA adjusted downward income
8 by \$65,609, and disallowed the deduction of \$579,143. The
9 IRS also adjusted the other investments downward by
10 \$34,235,549.

11 **iii. Thomas Master Investments**

12 TMI reported on its 2001 Form 1065 that it had made a
13 capital contribution of \$7,682,535 during the year and that
14 this amount constituted an asset of TMI. TMI also reported
15 on its 2001 Form 1065 that HFI had increased its capital in
16 TMI by \$7,682,535. TMI also issued a K-1 to HFI for 2001
17 that reflected an increase in HFI's capital account of
18 \$7,682,535 due to the contribution of the transaction. TMI
19 reported on its 2002 Form 1065 that it had interest income of
20 \$14,505, and it claimed deductions of \$128,040 pertaining to
21 the transaction. It also reported other investments of
22 \$7,569,000. TMI did not account for the short option on
23 either the Form 1065 or the K-1s for 2001 and 2002. For
24 2001, the IRS issued an FPAA that adjusted downward the
25 capital contributed to and assets of TMI by \$7,682,535, and
26 sought to adjust the outside basis of HFI by \$7,682,535. For
27 2002, the FPAA adjusted downward income by \$14,505, and
28

1 disallowed the deduction of \$128,040. The IRS also adjusted
2 the other investments downward by \$7,569,000.

3

4 **C. Background Regarding the Transactions at Issue**

5 **1. The Arthur Andersen Call-Option Spread**

6 The transactions that were entered into by the Lumbee
7 Clan Trust and AIG and the Fox Trust and AIG were designed by
8 Arthur Andersen and referred to internally by various names,
9 such as the "call-option spread", the "synthetic put" and
10 "asset-hedging." The call-option spread consisted of two
11 call options - one long and one short - and a promissory
12 note.⁵ By using the call-option spread, a taxpayer would be
13 able to create a basis in an amount substantially greater
14 than the amount of money actually paid for the call-option
15 spread by taking the position that the transaction created a
16 "contingent" liability for purposes of I.R.C. § 752. In
17 order to create basis and obtain the tax benefit, the
18 taxpayer was required to contribute the call-option to a
19 partnership.

20 The call-option spread was viewed by Arthur Andersen tax
21 partners as one of many-tax-avoidance techniques marketed by
22 Arthur Andersen. In fact, from 1999 to 2001, Arthur Andersen

23

24 ⁵ Ken Mandel was a tax partner at Arthur Andersen who
25 worked on "leading edge tax solutions for both high-net-worth
26 clients and large public corporations." Defendant contends
27 that Mandel developed the call-option spread, which is an
28 allegation that Plaintiffs deny. In any case, it is clear
from the evidence in this case that Mandel is familiar with
the Arthur Andersen technique referred to as the call-option
spread. In fact, Mandel described the call-option spread as
suitable "for a handful of very large dollar, trust-client
transactions, where we excluded the participation from
outside attorneys and other non Firm professionals."

1 arranged approximately ten call-option spread transactions,
2 and in all but one of these transactions AIG was the counter-
3 party. The call-option spread was considered a "proven
4 solution" by Arthur Andersen, which included techniques
5 offered by Arthur Andersen to minimize taxes. It is
6 estimated that the call-option spread transactions generated
7 about \$14.7 million in fees for Arthur Andersen in fiscal
8 years 2000 and 2001.

9 **2. Thomas and Fox Learn About the Call-Option**
10 **Spread**

11 In 2001, Martin Griffiths, a tax partner in the Los
12 Angeles office of Arthur Andersen, was the engagement partner
13 and the main point of contact for Thomas and Fox. In fact,
14 Thomas, Fox, and another real estate investor, Robert
15 Maguire, represented approximately one hundred percent of
16 Griffiths's business. Because Griffiths was familiar with
17 the investment portfolios and tax needs of Thomas and Fox, he
18 considered it his duty to investigate and determine if any of
19 the "interesting planning ideas" presented to him by Arthur
20 Andersen had any applicability to Thomas or Fox. He
21 testified that it was his job to bring Arthur Andersen's
22 "industry expertise" to bear on Thomas and Fox's interests.

23 Sometime before September 11, 2001, Griffiths became
24 aware of the call-option spread, and decided to investigate
25 it for Thomas, Fox, and Maguire. Before September 11, 2001,
26 Griffiths contacted his fellow tax partner Mandel to learn
27 more about the call-option spread. After discussing the
28 call-option spread with Mandel, Griffiths and Mandel met with

1 Thomas and, separately, with Fox on September 27, 2001.
2 During these meetings, Mandel explained to Thomas, a former
3 trial attorney with the I.R.S., and Fox the increased basis
4 that could result from the call-option spread, which Mandel
5 described as a hedge, if the options and note were
6 contributed to a partnership. In the weeks after the
7 September 27, 2001 meetings, Griffiths continued to discuss
8 the call-option spread with Thomas and Fox, including
9 detailed discussions regarding the structure of the
10 transaction.

11 In December 2001, Paul Rutter, outside transactional
12 counsel to Thomas and Fox, met with Mandel to discuss the
13 transaction. He also reviewed the transactional documents
14 prepared by Sullivan & Cromwell, counsel to AIG. Rutter was
15 not an expert on options or hedging, and did not provide
16 business advice to Thomas or Fox regarding the transaction.
17 Instead, Rutter's representation was limited to reviewing the
18 documents prepared by AIG's counsel, which included the
19 contribution agreements by which the transaction would be
20 contributed to the partnerships. Rutter testified that it
21 was his understanding "that they [AIG] were doing this
22 transaction with other people and had a pre-existing set of
23 documents they used[.]"

24 Rutter also testified that the decision to contribute the
25 transactions to Thomas and Fox's respective partnerships had
26 already been made by the time he became involved in the
27 transaction. In fact, Thomas and Fox admitted that it was
28 always their intention to contribute the transactions to

1 their respective partnerships. The partnership contributions
2 were always viewed by Thomas, Fox, Griffiths, and Rutter as
3 integral to the entire transaction.

4 On December 20, 2001, Thomas and Fox entered into the
5 call-option spread transactions, described above, with AIG.

6 7 **II. Discussion**

8 **A. The Lumbee Clan Trust Transaction And The Fox Trust** 9 **Transaction Lack Economic Substance.**

10 A taxpayer is not permitted to reap tax benefits from a
11 transaction that lacks economic substance.⁶ *Coltec*
12 *Industries, Inc. v. United States*, 454 F.3d 1340, 1352-55
13 (Fed. Cir. 2006) (discussing Supreme Court precedent invoking
14 economic substance since 1935). As the Federal Circuit
15 explained in *Coltec*, the economic substance doctrine requires
16 "disregarding, for tax purposes, transactions that comply
17 with the literal terms of the tax code but lack economic
18 reality," and, thus, "prevent[s] taxpayers from subverting

19
20 ⁶ Defendant argues that Plaintiffs are not entitled to
21 the increased basis created by the transactions at issue
22 under the economic substance doctrine, the substance-over-
23 form doctrine, or the step-transaction doctrine. As the
24 *Stobie Creek* court noted, "[t]hese doctrines vary in origin
25 and somewhat in application, yet apply to the same analysis."
26 (citing *King Enters., Inc. v. United States*, 418 F.2d 511,
27 516 n. 6 (1969) ("[C]ourts have enunciated a variety of
28 doctrines, such as step transaction, business purpose, and
substance over form. Although the various doctrines overlap
and it is not always clear in a particular case which one is
most appropriate, their common premise is that the
substantive realities of a transaction determine its tax
consequences."); and *H.J. Heinz Co. & Subsidiaries v. United*
States, 76 Fed.Cl. 570, 583-85 (2007) (discussing multiple
formulations employed by courts to consider whether
transaction has economic substance or whether it is a
"sham"))).

1 the legislative purpose of the tax code by engaging in
2 transactions that are fictitious or lack economic reality
3 simply to reap a tax benefit." *Id.* at 1352-54.

4 **1. Legal Standard for Economic Substance Analysis**

5 To determine whether a transaction is merely an economic
6 sham, the court must determine whether the transaction had
7 any practical economic effect other than the creation of tax
8 benefits. *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th
9 Cir. 1990); *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th
10 Cir. 1988). Therefore, the court must exam the objective
11 economic substance of the transaction and the subjective
12 business motivation of the taxpayer. *Sochin*, 843 F.2d at
13 354; *Casebeer*, 909 F.2d at 1363. However, the objective and
14 subjective inquiries are not "discrete prongs of a rigid two-
15 step analysis," but "are simply more precise factors to
16 consider in the application of [the Ninth Circuit's]
17 traditional sham analysis; that is, whether the transaction
18 had any practical economic effects other than the creation of
19 income tax losses." *Id.*

20 **a. The Objective Economic Substance Inquiry**

21 Under the objective economic substance inquiry, the Court
22 must determine "whether the transaction ha[s] economic
23 substance beyond the creation of tax benefits." *Casebeer*,
24 909 F.2d at 1365 (*citing Bail Bonds by Marvin Nelson, Inc. v.*
25 *Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987)). To do so,
26 the court must analyze whether the "substance of the
27 transaction reflects its form" and whether, objectively, "the
28

1 transaction was likely to produce economic benefits aside
2 from a tax deduction." *Id.*

3 A transaction lacks objective economic substance where it
4 does not appreciably affect a taxpayer's beneficial interest
5 except to reduce his taxes. *Knetsch v. United States*, 364
6 U.S. 361, 366 (1960); *ACM Partnership v. Commissioner*, 157
7 F.3d 231 248 (3d Cir. 1998). For example, *de minimis*
8 economic effect - such as the accumulation of small amounts
9 of cash value in an annuity contract or the assumption of
10 marginal risks in a partnership arrangement - are
11 insufficient to create economic substance. *Knetsch*, 364 U.S.
12 361, 365-66 (finding transaction involving leveraged
13 annuities to be economic sham because possible \$1,000 cash
14 value of annuities at maturity was "relative pittance"
15 compared to purported value of annuities); *ASA Investerings*
16 *Partnership v. Commissioner*, 201 F.3d 505, 514 (D.C. Cir.
17 2000); *ACM*, 157 F.3d at 251-52.

18 **b. The Subjective Business Purpose Inquiry**

19 The Court analyzes a taxpayer's subjective business
20 purpose by determining "whether the taxpayers have shown that
21 they had a business purpose for engaging in the transaction
22 other than tax avoidance." *Casebeer*, 909 F.2d 1363-64. This
23 analysis "often involves an examination of the subjective
24 factors that motivated a taxpayer to make the transaction at
25 issue," such as the experience of the taxpayer, the extent of
26 the taxpayer's investigation into a transaction, the extent
27 of any advisor's investigation into the deal, and the
28 taxpayer's trial testimony regarding their motivation for

1 entering into the transaction." *Bail Bonds*, 820 F.2d at
2 1549; see, also, *Casebeer*, 909 F.2d at 1364.

3 One factor that can be considered in analyzing a
4 taxpayer's subjective business purpose is whether the
5 taxpayer was acting like a prudent economic actor or contrary
6 to rational business interests in the transaction. See,
7 e.g., *Gilman v. Comm'r*, 933 F.2d 143, 146-47 (2d Cir.1991)
8 (requiring taxpayer to demonstrate that prudent investor
9 could have concluded that "realistic potential for economic
10 profit" existed) (internal quotation marks omitted); *Rice's*
11 *Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91 (4th Cir.1985)
12 (equating lack of economic substance with finding that "no
13 reasonable possibility of a profit exists"); *Long Term*
14 *Capital*, 330 F.Supp.2d at 172 (finding that transaction
15 lacked economic substance because, "at the time the
16 transaction was entered into, a prudent investor would have
17 concluded that there was no chance to earn a non-tax based
18 profit return in excess of the costs of the transaction");
19 *Estate of Strober v. Comm'r*, 63 T.C.M. (CCH) 3158, 3160
20 (1992) ("We conclude that ... a prudent investor, relying
21 upon independently obtained appraisals and research, would
22 not have concluded that [the] transaction offered a
23 reasonable opportunity for economic gain exclusive of tax
24 benefits."). Thus, as the Federal Circuit found in *Coltec*,
25 there must be an objective inquiry into economic reality that
26 would ask "'whether a reasonable possibility of profit from
27 the transaction existed,'" *Coltec*, 454 F.3d at 1356 (quoting
28 *Black & Decker*, 436 F.3d at 441), and "whether the

1 transaction has 'realistic financial benefit.'" *Id.* at 1356
2 n. 16 (quoting *Rothschild*, 407 F.2d at 411); *see, also, Jade*
3 *Trading*, 80 Fed. Cl. At 47-48 ("The inquiry is not whether
4 the [taxpayers] *believed* the Jade transaction was a real
5 investment capable of making a profit, but whether the Jade
6 transaction in fact objectively was a real investment capable
7 of making a profit and altering their financial positions.").
8 In addition, where a taxpayer is sophisticated in economics
9 and/or taxation, entering a bad deal may shed light on the
10 taxpayer's true tax-avoidance motivation. *Id.* ("the absence
11 of reasonableness sheds light on Long Term's subjective
12 motivation, particularly given the high level of
13 sophistication possessed by Long Term's principals in matters
14 economic."). Similarly, a conspicuous lack of concern over
15 the particulars of the transaction by the taxpayer may be
16 evidence that the transaction is a sham. *See, Mahoney v.*
17 *Commissioner*, 808 F.2d 1219, 1220 (6th Cir. 1987).

18 **2. The Transactions At Issue Lack Economic**
19 **Substance**

20 The presence or lack of economic substance for federal
21 tax purposes is determined by a fact-specific inquiry on a
22 case-by-case basis. *Frank Lyon*, 435 U.S. at 584. In this
23 case, the Court finds that the evidence demonstrates that the
24 transactions at issue do not have economic substance because
25 Thomas and Fox received no economic benefit, other than the
26 increase in basis, from the transactions. In addition, the
27 Court finds that the evidence demonstrates that Thomas and
28

1 Fox were motivated by this increased basis and not by any
2 purported "hedging" benefit.

3 Plaintiffs argue that factual differences between this
4 case and the recent economic substance cases of *Stobie Creek*
5 and *Jade Trading* mean that the transactions at issue in this
6 case do, in fact, have economic substance. However, an
7 examination of how the economic substance analysis was
8 applied in *Stobie Creek* and *Jade Trading* demonstrate that the
9 transaction at issue in this case, like the transactions in
10 those cases, do not have economic substance.

11 **a. Under the Economic Substance Analysis as**
12 **Applied in *Stobie Creek*, The Transactions**
13 **At Issue in This Case Lack Economic**
14 **Substance**

15 *Stobie Creek* involved the contribution of offsetting long
16 and short foreign-currency options to single-member LLCs.
17 The plaintiffs in *Stobie Creek* alleged that the principal
18 involved was a "reasonable investor" who "made a reasonable
19 assessment regarding profitability." *Id.* at 693. In
20 evaluating this claim, the court stated that it could not
21 "ignore the functional and historical reality that the
22 [offsetting option pairs] were part of the prepackaged J&G
23 strategy marketed to shelter taxable gains." *Id.* In
24 addition, the Court in *Stobie Creek* relied heavily on the
25 expert testimony offered by the Government in concluding that
26 "plaintiffs' attempts to establish a legitimate profit motive
27 wither against the devastating, much more credible expert
28 testimony that established the objective economic reality

1 that the [offsetting option pairs] were severely over-priced,
2 had a negative expected-rate-of-return, and consequently had
3 a scant profit potential." *Stobie Creek*, 823 Fed. Cl. At
4 696. The Government's expert concluded that the transaction
5 "was priced at levels that far exceeded [the components']
6 theoretical value[,]" where those values were computed using
7 an adaptation of the Black-Scholes model. *Id.* At 685.

8 The court dismissed the plaintiffs' expert's criticism of
9 the Government's expert's reliance on the Black-Scholes
10 model. While the court recognized the validity of the
11 criticism that "the model involves assumptions of perfect and
12 static markets[,]" it found that the plaintiffs' expert
13 "could not offer a more appropriate substitute." *Id.* at 689-
14 90. The court concluded that the expert testimony "suggests
15 that no reasonable and prudent investor would have expected a
16 possibility of a profit on these transactions." *Id.* at 693.

17 In evaluating the subjective business purpose prong of
18 the economic substance analysis, the court rejected the
19 testimony of the principal that he "believed a 30% chance of
20 doubling his investment existed" because the court found that
21 "the [offsetting option pairs] had no objectively reasonable
22 possibility of returning a profit and therefore lacked an
23 objective business purpose." *Id.* at 698. The court found
24 that the transactions were "integral to a 'preconceived' tax
25 shelter scheme that was not structured to create a viable
26 profit-producing investment, but, rather, to inflate the
27 basis in an unrelated asset that would yield large capital
28 gains upon sale." *Id.* Moreover, the court found that while

1 there was "limited evidence" of an investment motive, the
2 evidence was "not sufficient to overcome the evidence that
3 the [offsetting option pairs] were economic nullities beyond
4 producing the claimed tax benefits." *Id.*

5 Similarly, in this case, Defendant's expert, Professor
6 Grendier, used recognized option-pricing-modeling techniques
7 to conclude that the value of the Thomas transaction was
8 \$574, and the value of the Fox transaction was \$259.⁷
9 Therefore, based on a thirty-five percent volatility, Thomas
10 and Fox paid approximately 2,700 and 2,600 times the value of
11 the transactions they purchased.

12 Although Plaintiffs' experts, Professors Manaster and
13 Edelstein, criticized Professor Grendier's Black-Scholes
14 method, Professor Manaster testified that, in the absence of
15 comparative prices, he would have performed the same analysis
16 while Professor Edelstein offered no acceptable alternative
17 to Professor Grenadier's analysis.

18 Moreover, like the transaction in *Stobie Creek*, the call
19 option spread was a prepackaged deal offered by Arthur
20 Andersen that focused on the creation of basis. Arthur
21 Andersen did not offer any advice on whether the transaction
22 was a hedge, and Mandel, who offered the call option spread
23 to Thomas and Fox, had no expertise on hedging or options.

24 Finally, there is no credible evidence that the
25 transactions performed as hedges. First, there is no

26 ⁷ Professor Grenadier used a thirty-five percent implied
27 volatility, which is validated by the implied volatility of
28 the Bank of America and JP Morgan quotes Plaintiffs received
for similar transactions.

1 credible evidence that a close correlation exists between the
2 value of the broad-based REIT basket and the value of any of
3 Thomas's and Fox's real estate investments. Second, even if
4 the transactions served as hedges, the price paid by Thomas
5 and Fox vastly exceeded any benefit they could have received.
6 In addition, despite claiming to follow the REIT market
7 closely, Fox did not know the difference between the average
8 drop required to produce a return of one dollar on his
9 transaction, and the historical drop that occurred in 1974.
10 Therefore, as in *Stobie Creek*, the Court does not find that
11 the self-serving testimony of the principals, Thomas and Fox,
12 sufficient to overcome the substantial and objective evidence
13 that the transactions at issue are economic nullities entered
14 into for the purpose of fabricating tax basis in amounts that
15 are vastly disproportionate to the actual cost.

16 **b. Under the Economic Substance Analysis as**
17 **Applied in *Jade Trading*, The Transactions**
18 **At Issue in This Case Lack Economic**
19 **Substance**

20 *Jade Trading*, another recent case involving economic
21 substance analysis, involved the contribution of a long
22 option and a short option to a partnership. *Jade Trading*, 80
23 Fed. Cl. at 11-13. The three taxpayers each paid \$150,002,
24 and each obtained an increased basis of \$15 million. *Id.*
25 The court disallowed the claimed tax benefits and determined
26 that the transaction was an economic sham. *Id.* at 14. The
27 court reached its conclusion based on five reasons. First,
28 the claimed losses "were purely fictional" because the

1 taxpayers "did not invest \$15 million in the spread and did
2 not lose \$15 million when exiting Jade without exercising
3 either option." Second, the plaintiffs contentions that the
4 transaction had a profit potential was contradicted by the
5 large limitation on the maximum net profit that could be
6 earned and the "large and unusual" fees that the plaintiffs
7 paid. Third, the transaction was "devised and marketed by a
8 tax accounting group . . . as a tax product, not by an
9 investment advisor as a vehicle to earn a profit," and, thus,
10 the court found it "was developed as a tax avoidance
11 mechanism and not an investment strategy." Fourth, the
12 initiation of the transaction outside the partnership
13 followed by the contribution to the partnership "had no
14 effect whatsoever on the investment's value, quality, or
15 profitability, except to add cost and burden," but "packaging
16 the investment in the partnership vehicle was an absolute
17 necessity for securing the tax benefits." Fifth, there was a
18 "highly disproportionate tax advantage to the underlying
19 monetary outlay - the tax loss per [taxpayer], \$14.9 million,
20 was roughly 65 times greater than each LLC's \$225,002
21 financial commitment to Jade, almost 100 times each LLC's
22 \$150,002 investment in the spread transaction which generated
23 the loss, and approximately 100 times the \$140,000 potential
24 net profit each LLC could have earned."

25 Similarly, the Court finds that consideration of these
26 same five reasons in this case leads to the same result -
27 that the transactions at issue in this case lack economic
28 substance. First, the claimed basis is fictional, because

1 Thomas and Fox paid only \$1.5 million and \$675,000,
2 respectively for the integrated transactions they purchased,
3 but gained an increased basis of \$101,500,000 and
4 \$45,675,000, respectively. The increase in basis is
5 approximately sixty-seven times what they paid for the
6 transactions. Second, as Professor Grenadier explained,
7 there is virtually no likelihood of a thirty percent average
8 drop over ninety days - the drop required to yield a one
9 dollar return - much less the average fifty percent drop
10 required to yield the maximum payout possible.⁸ Third, the
11 design of the call option spread demonstrates that it was
12 designed for the creation of tax benefits. Mandel, who was
13 intimately familiar with the call option spread transaction
14 format and was integral in selling these transactions to
15 Thomas and Fox, was a tax expert specializing in "leading
16 edge tax solutions," not an options or risk-management
17 expert. Moreover, there is no evidence that the call option

18
19 ⁸ In post-trial filings in January 2009, Plaintiffs ask
20 the Court to take judicial notice of the fact that had
21 options with identical terms been purchased on October 1,
22 2008, there would have been a payoff. In fact, Plaintiffs
23 allege that the actual drop in the REIT basket for the
24 ninety-day period from October 1, 2008 to December 29, 2008,
25 using Asian-style options was 43.47 percent. Defendant does
26 not dispute that this information is accurate, but asserts
27 that it is irrelevant because Defendant did not argue that a
28 payoff from the transactions at issue was "impossible", but
merely "extremely low" and, thus, any economic substance from
the transactions at issue was *de minimis*. The Court agrees
with Defendant that the fact that Plaintiffs are able to
demonstrate one instance of an Asian-style European option
drop in the nearly fifty-year history of REITs occurring
seven years after the transactions in question does not
change the Court's conclusion that a payoff from the
transactions at issue was, at best, highly unlikely. In
addition, the Court's conclusion that the transaction at
issue lack economic substance is based on, as explained
above, a variety of other factors.

1 spread was designed as a hedge generally, or that it operated
2 as a hedge with respect to the transactions at issue in this
3 case. Fourth, there is no evidence that the contribution to
4 the partnerships, which was part of the design of the
5 prepackaged transactions, had any effect "on the investment's
6 value, quality, or profitability." However, the contribution
7 was required for the creation of an increased basis. In
8 addition, in the weeks after Mandel first discussed the call
9 option spread with Thomas and Fox, Griffiths provided tax
10 advice to them about the increased basis they would achieve
11 if they purchased the transactions. Fifth, the tax benefit
12 is highly disproportional - sixty-seven times - to the actual
13 economic outlay. As a result the Court finds that the
14 transactions at issue lack economic substance.

15 **c. The Transactions At Issue In This Case Are**
16 **Economic Shams.**

17 In this case, it is clear that Plaintiffs are not
18 taxpayers "who structured their transactions and ordered
19 their affairs in a way so as to reduce their liability for
20 taxes or to achieve the greatest tax benefits; rather, the
21 tax benefits shaped the structure of the investment in order
22 to achieve the goal of tax avoidance." *Stobie Creek*, 82 Fed.
23 Cl. at 698; *see, also, Coltec*, 454 F.3d at 1357 ("there is a
24 material difference between structuring a real transaction in
25 a particular way to provide a tax benefit (which is
26 legitimate), and creating a transaction, without a business
27 purpose, in order to create a tax benefit (which is
28 illegitimate)."). Because of the mismatch between the

1 purported purpose of "hedging" and the inability of the
2 Asian-style options to satisfy that purpose, the dramatic
3 overpayment by Thomas and Fox for the *de minimis* value they
4 received in return, and the virtual impossibility of
5 receiving even one dollar in return versus the certain
6 increase in basis by \$101,500,000 Thomas and 445,675,000 by
7 Fox, the Court finds that the only appreciable benefit gained
8 by the transactions at issue was an increased basis. This
9 conclusion is supported by the fact that Thomas and Fox were
10 sophisticated economic actors. In fact, Thomas was a former
11 trial attorney with the IRS. Thomas and Fox, along with
12 Griffiths, their tax advisor, obviously recognized the value
13 that would result from the increased basis, such as shielding
14 distributions of cash and property from their partnerships by
15 characterizing that property as a return on capital, or
16 reducing the obligation to restore a negative capital account
17 on termination of their partnerships.

18 The Court finds that the weight of evidence, including
19 the persuasive expert testimony by Professor Grenadier,
20 established that the transactions at issue did not
21 appreciably improve the economic position of Thomas and Fox
22 beyond the creation of an increased basis. Any subjective
23 belief by Thomas and Fox that the transaction constituted a
24 hedge was not objectively supported by the evidence, and any
25 subjective belief that there was an economic benefit is not
26 objectively reasonable. No prudent business person, such as
27 Thomas or Fox, would pay between 2,600 and 2,700 times the
28 value of the transactions in this case for this type of a

1 hedge. Because the transactions do not provide any
2 appreciable economic benefit to Thomas or Fox, the Court
3 finds that the transactions at issue are economic shams, and
4 any evidence of a non-tax avoidance subjective motivation is
5 not sufficient to give the transactions economic substance.
6 Therefore, the transactions must be disregarded under the
7 prevailing economic substance doctrine, and are without
8 effect for purposes of federal taxation.

9

10 **B. Application of the Step Transaction Doctrine Yields**
11 **a Cost-Basis of \$1.5 Million for Thomas and \$675,000**
12 **for Fox.**

13 As an alternative to the economic substance doctrine,
14 Defendant also seeks to invalidate the tax effects claimed by
15 Plaintiffs under the step transaction doctrine. "The Supreme
16 Court has expressly sanctioned the step transaction doctrine,
17 noting that 'interrelated yet formally distinct steps in an
18 integrated transaction may not be considered independently of
19 the overall transaction.'" *The Falconwood Corp. v. United*
20 *States*, 422 F.3d 1339, 1349 (2005) (quoting *Comm'r v. Clark*,
21 489 U.S. 726, 738 (1989)). "[T]he objective of the doctrine
22 is to 'give tax effect to the substance, as opposed to the
23 form of a transaction, by ignoring for tax purposes, steps of
24 an integrated transaction that separately are without
25 substance.'" *Id.* (quoting *Dietzsch v. United States*, 204
26 Ct.Cl. 535, 498 F.2d 1344, 1346 (1974)).

27 Courts principally rely on two tests to determine whether
28 to apply the step-transaction doctrine: the interdependence

1 test and the end result test. *See, Kornfield v.*
2 *Commissioner*, 137 F.3d 1231, 1235 (10th Cir. 1998); *Brown v.*
3 *United States*, 782 F.2d 559, 563-64 (6th Cir. 1986); *Security*
4 *Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th
5 Cir. 1983); *McDonald's Rests. v. Commissioner*, 688 F.2d 520,
6 524-25 (7th Cir. 1982). While the two tests have different
7 formulations, both tests have as their central purpose the
8 implementation of "the central purpose of the step
9 transaction doctrine; that is, to assure that tax
10 consequences turn on the substance of a transaction rather
11 than on its form." *King*, 418 F.2d at 517.

12 **1. The End-Result Test**

13 The end-result test applies when "a series of separate
14 transactions were prearranged parts of what was a single
15 transaction, cast from the outset to achieve the ultimate
16 result." *Greene v. United States*, 13 F.3d 577, 583 (2d Cir.
17 1994)(citing *Penrod v. Commissioner*, 88 T.C. 1415, 1429 (T.C.
18 1987). "[p]urportedly separate transactions will be
19 amalgamated into a single transaction when it appears that
20 they were really component parts of a single transaction
21 intended from the outset to be taken for the purpose of
22 reaching the ultimate result." *Brown*, 782 F.2d at 564
23 (quoting *King*, 418 F.2d at 516). While the taxpayer's intent
24 is relevant under the end-result test, it is not the intent
25 to avoid taxes; instead, it is whether the taxpayer intended
26 to achieve a particular end-result, legitimate or not,
27 through a series of interrelated steps. *True*, 190 F.3d at
28 1175. Thus, if a taxpayer structures a single transaction in

1 a certain way that involves multiple steps, "he cannot
2 request independent tax recognition of the individual steps
3 unless he shows that at the time he engaged in the individual
4 step, its result was the intended end result in and of
5 itself." *Id.* at 1175 fn. 9.

6 In this case, both Thomas and Fox contend that the reason
7 they engaged in the transactions at issue was to "hedge"
8 against a catastrophic collapse in the real-estate market.
9 Thus, as they described it, Thomas and Fox essentially placed
10 a "bet" that they now contend amounted to a hedge.
11 Therefore, the long option, the short option, and the
12 promissory note are simply the "interrelated steps" through
13 which Thomas and Fox accomplish this "bet" or "hedge." Under
14 the end results test, these interrelated steps of the
15 transaction should be collapsed into a unified whole and the
16 tax consequences determined accordingly.

17 In addition, any attempt by Plaintiffs to argue that they
18 had a valid business purposes, such as the plaintiff in the
19 *Falconwood* case, in engaging in the transactions at issue
20 does not "immunize" these transactions from the step
21 transaction doctrine. *See, Stobie Creek*, 82 Fed. Cl. at 701.
22 While the court in *Falconwood* held that the step transaction
23 doctrine did not apply to the series of transactions at
24 issue, it did so because the taxpayer had an independent
25 business purpose for the initial step, and then was bound by
26 regulation to follow the remaining steps that the Government
27 had sought to collapse. *Falconwood*, 422 F.2d at 1351-52
28 ("Upon completing a downstream merger for independent

1 business reasons, Falconwood therefore had little choice in
2 the face of quasi-legislative mandates but to file a final
3 consolidated tax return for the group that covered
4 Falconwood's operations for its entire taxable year.").
5 However, as in *Stobie Creek*, Plaintiffs "cannot align
6 themselves with the factual circumstances presented in
7 *Falconwood*" because they "were not bound by any legislative
8 or regulatory mandate to proceed along the tortuous steps
9 that resulted in the claimed basis enhancement." *Stobie*
10 *Creek*, 82 Fed. Cl. at 702.

11 2. The Interdependence Test

12 "The interdependence formulation of the step transaction
13 doctrine requires an inquiry into whether the individual
14 transactions in the series would be "fruitless" without
15 completion of the series." *Id.* at 699 (*quoting Falconwood*,
16 422 F.3d at 1349). Under this test, courts analyze whether
17 or not one part of the overall transaction would have
18 occurred without another part. *Kornfield*, 137 F.3d at 1235;
19 *Security Indus. Ins.*, 702 F.2d at 1247. If not, the
20 transaction is then integrated and the step transaction
21 applies. *Id.* Thus, under this test, courts "disregard the
22 tax effects of individual transactional steps if "it is
23 unlikely that any one step would have been undertaken except
24 in contemplation of the other integrating acts." *True*, 190
25 F.3d at 1175 (*citing Kuper v. Commissioner*, 533 F.2d 152, 156
26 (5th Cir. 1976)).

27 In this case, the components of the transactions at issue
28 were interdependent because each component was required to

1 accomplish the desired economic result, which was, as
2 Plaintiffs describe it a "bet" or "hedge" against a collapse
3 in the real estate market. This is best demonstrated by the
4 fact that the documents executed as part of the transactions
5 created interlocking contractual obligations. For example,
6 the Certificate re: Consent and Authorization discusses a
7 "Master Transaction." The Master Transaction "would be
8 effectuated through the execution and delivery by the Trust
9 of the following agreements: (a) Master Agreement to be
10 entered into by . . . the Trust and [AIG] . . .; (b) Note . .
11 . ., to be entered into by and between the Trust and [AIG]. .
12 .; (c) Pledge Agreement by and between Trust and [AIG]; (d)
13 Option and Equity Derivative Account Agreement by and between
14 Trust and [AIG], and (e) Confirmation Letter Agreements re:
15 share option transaction I and re: share option transaction
16 II to Trust from [AIG]." Moreover, the Master Agreement
17 specifies that all transactions and confirmations constitute
18 a single agreement.

19 The creation of these interlocking obligations with
20 respect to the long option, the short option, and the note
21 accomplished the goal of creating the "bet" sought by Thomas
22 and Fox. Neither the long or short option independently
23 could have created the required "bet." For example, Thomas
24 and Fox would have only benefitted from an independent
25 purchase of the long option if prices of the stocks in the
26 REIT basket increased, which is the opposite of what they
27 were trying to accomplish in "hedging" against a drastic
28 downturn in the real estate market. In addition, an

1 independent purchase of the short option would have exposed
2 Thomas and Fox to unlimited losses if the price of the stocks
3 in the REIT basket increased. Thus, the purchase of the long
4 option, the short option, and the AIG note were required to
5 accomplish the desired "hedge." Therefore, the transactions
6 making up the steps of the "hedge" strategy pursued by the
7 Plaintiffs "are interdependent and have no independent
8 functional justification outside of the series." *Stobie*
9 *Creek*, 82 Fed. Cl. at 700. "Under the interdependence test,
10 the individual steps must be disregarded and collapsed into a
11 single transaction." *Id.*

12 The Court finds that, under either the interdependence
13 test or the end result test, the step transaction doctrine
14 applies to Plaintiffs' transactions. *Id.* Accordingly, the
15 tax consequences should be determined on the substance of the
16 transactions at issue, and not on the form used by
17 Plaintiffs. *Id.*

18

19 **C. Application of the Substance Over Form Doctrine**
20 **Yields a Cost-Basis of \$1.5 Million for Thomas and**
21 **\$675,000 for Fox.**

22 In 1945, the Supreme Court stated: "The incident of
23 taxation depends on substance rather than form of the
24 transaction." *Commissioner v. Court Holding Co.*, 324 U.S.
25 331, 334 (1945); *see, also, True v. United States*, 190 F.3d
26 at 1174 (10th Cir. 1999); *Allen v. Commissioner*, 925 F.2d 348,
27 352 (9th Cir. 1991). In applying this principle, a court
28 "must look beyond the taxpayers' characterization of

1 isolated, individual transaction steps, and also review the
2 substance of each series of transactions in its entirety."
3 *True*, 190 F.3d at 1174. Thus, taxpayers may not characterize
4 a transaction solely based on the labels they have used,
5 because such an approach "would completely thwart the
6 Congressional policy to tax transactional realities rather
7 than verbal labels." *Crenshaw v. United States*, 450 F.2d
8 472, 477-78 (5th Cir. 1971). Therefore, it is the "true
9 nature" of the transaction, not its "mere formalisms" that
10 control. *Court Holding*, 324 U.S. at 334; *see, also, Allen*,
11 925 F.3d at 352; *True*, 190 F.3d at 1174.

12 The countervailing consideration to application of the
13 substance over form doctrine is the principle that taxpayers
14 may generally structure their transactions as they wish.
15 *Brown v. United States*, 329 F.3d 664, 671 (9th Cir. 2003).
16 Thus, courts do not invalidate claimed tax benefits if the
17 form of the transaction yields tax benefits which are
18 consistent with Congressional intent as to the particular
19 Internal Revenue Code provisions at issue. *Id.* at 672.
20 Therefore, courts must make a fact-specific inquiry to
21 determine if the facts fall within the intended scope of the
22 applicable statute. *Stewart v. Commissioner*, 714 F.2d 977,
23 988 (9th Cir. 1983).

24 In this case, Thomas and Fox entered into the
25 transactions at issue, which they described as "bets" or
26 "hedges" against a collapse in the real estate market.
27 Thomas contends that he "paid approximately \$1,500,000 to
28 take a chance that he could receive up to \$38,400,000."

1 According to Thomas, "[t]he \$1.5 million is, in effect, the
2 TDP transaction cost, the cost of inducing Banque AIG to make
3 a bet on real estate values. Similarly, Fox contends he
4 "paid approximately \$675,000 to take a chance that he could
5 receive up to \$17,242,574." According to Fox, "[t]he
6 \$675,000 is, in effect, the Fox transaction cost, the cost of
7 inducing Banque AIG to make a bet on real estate values."

8 Once these initial payments of \$1.5 million and
9 \$675,000 were made, Thomas and Fox had no downside exposure
10 from their "bets," and only an extremely remote possibility
11 of receiving a return. These contractually interlocking
12 transactions were carefully structured so that the amount
13 payable under the short option would never exceed the amounts
14 to be received from the long option and the AIG note. The
15 assets - the long option and the note - were pledged to AIG
16 to secure the liability created by the short option.

17 For purposes of the application of the form over
18 substance doctrine, the substance of the transaction is
19 clearly a net payment of \$1.5 million by Thomas and \$675,000
20 by Fox for a possible payout with no downside exposure.
21 Therefore, Thomas's true economic cost is \$1.5 million, not
22 \$101.5 million. Similarly, Fox's true economic cost is
23 \$675,000, not \$45,675,000.

24 Because the basis of property is its cost per I.R.C. §
25 1012, and because Thomas's economic cost for the entire
26 transaction was \$1.5 million, his basis was \$1.5 million.
27 Thomas's partnerships succeeded to that basis. Similarly,
28 because Fox's economic cost for the entire transaction was

1 \$675,000, his basis was \$675,000. HFI succeeded to that
2 basis, while MP-MI and TMI succeeded to their proportional
3 share of that basis. The partnerships' characterization of
4 the contribution at more than sixty times what Thomas and Fox
5 actually paid for their unified position is plainly
6 inconsistent with the fundamental principle that basis equals
7 cost as expressed by Congress in I.R.C. § 1012. Accordingly,
8 under the substance over form doctrine, the tax consequences
9 should be determined on the substance of the transactions at
10 issue, and not on the form used by Plaintiffs.

11

12 **D. Even if the Transactions At Issue Have Economic**
13 **Substance and the Step-Transaction and Form Over**
14 **Substance Doctrines Do Not Apply, the Obligation**
15 **Created by the Short Option is a Liability for**
16 **Purposes of I.R.C. § 752.**

17 When a partner contributes property to a partnership, the
18 partnership succeeds to the contributing partner's basis in
19 the property under I.R.C. § 723. In addition, the
20 contributing partner increases his basis in the partnership
21 by his cost basis in the property under I.R.C. § 722.

22 On the other hand, when a partnership assumes a liability
23 of a partner, the partner's basis in his partnership interest
24 is: (1) decreased by the amount of the liability; and (2)
25 increased by the partner's share of the partnership liability
26 resulting from the assumption of the liability. I.R.C. §§
27 722, 733(1), and 752(a) and (b). Once the liability is
28 satisfied, the partner's basis in his partnership interest is

1 decreased by the amount of the liability. I.R.C. §§ 733(1)
2 and 752(b).

3 In this case, Plaintiffs argue that the short option was
4 not a liability for purposes of Section 752. Therefore, for
5 example, Thomas argues that the \$101.5 million increase in
6 basis that he received when he contributed the long option
7 and the AIG note should not be reduced to account for the
8 offsetting \$100 million short option. However, as explained
9 above, when the liability is satisfied, Thomas's basis should
10 be reduced by \$100 million pursuant to Section 752.
11 Therefore, the increase in Thomas's basis would be merely
12 \$1.5 million, or the equivalent of Thomas's net payment for
13 the transaction. Thus, the characterization of the
14 partnership's short option as a liability for purposes of
15 Section 752 is consistent with the cost basis - and the
16 economic reality - of Thomas's contribution. See, I.R.C. §
17 1012.

18 The above interpretation of Section 752 is consistent
19 with Revenue Ruling 88-77, where the I.R.S. determined that
20 when an obligation creates or increases the basis of the
21 obligor's assets, the obligation is a "liability" for the
22 purposes of Section 752. In Revenue Ruling 88-77, the I.R.S.
23 defined liability for purposes of Section 752 to "include an
24 obligation only if and to the extent that incurring the
25 liability creates or increases the basis to the partnership
26 of any of the partnership's assets (including cash
27 attributable to borrowings)."
28

1 In this case, the short option, the long option, and the
2 AIG note were contractually interlocked, and the acquisition
3 of the obligation (the short option) clearly created basis
4 (via the long option and the note) and should be recognized
5 as a liability for purposes of Section 752. In fact, the
6 long option and the AIG note were purchased with the proceeds
7 of the sale of the short option.

8 The above interpretation of Revenue Ruling 88-77 is
9 consistent with the Fifth Circuit's interpretation in *Korman*
10 & Associates, Inc., v. United States, 527 F.3d 443 (5th Cir.
11 2008), and the Court of Federal Claim's recent interpretation
12 in *Marriott International Resorts, L.P., v. United States*, 83
13 Fed. Cl. 291 (2008).⁹ At the time of the transactions at
14 issue in this case and prior to the Fifth Circuit's decision
15 in *Korman*, the *Helmer* line of cases found that certain
16 liabilities assumed by partnerships should not be recognized
17 for basis purposes because they were too indefinable or
18 "contingent." See, *Helmer v. Commissioner*, T.C. Memo. 1975-
19 160 (1975); see, also, *Long v. Commissioner*, 71 T.C. 1
20 (1978), and *La Rue v. Commissioner*, 90 T.C. 465 (1988).

21 For example, in *Helmer*, a corporation held a purchase
22 option on real estate owned by a partnership, and made
23 periodic payments to maintain the option. T.C. Memo. 1975-

24
25 ⁹ The recent Court of Federal Claims case of *Marriott*
26 *International Resorts*, relied on Revenue Ruling 88-77 to
27 determine that the obligation created by a short sale was a
28 liability for purposes of I.R.C. § 752. *Marriott*
International Resorts, L.P. v. United States, 83 Fed. Cl. 291
(2008) (finding that, in light of the promulgation of Revenue
Ruling 88-77, symmetrical treatment that "would call for
recognition of the corresponding obligation to replace the
borrowed securities" was required under Section 752).

1 160 (1975). Because the partnership was obligated to apply
2 the option payments to the purchase price if the corporation
3 exercised its option, the partners argued that its receipt of
4 these payments created a partnership liability that increased
5 their basis in the partnership. *Id.* However, the Tax Court
6 found that the payments "created no liability on the part of
7 the partnership to repay the funds paid nor to perform any
8 services in the future."¹⁰ *Id.*

9 However, in *Korman*, the Fifth Circuit addressed the
10 question whether the assumption of a liability from a short
11 sale of Treasury notes is a liability under Section 752, and
12 determined that it was a Section 752 liability because the
13 assumption was accompanied by the contribution of the
14 proceeds from the short sale. In *Korman*, the taxpayer
15 borrowed \$100 million in Treasury bills and sold them for
16 \$102.5 million. The taxpayer then contributed the \$102.5
17 million to a partnership, and the partnership assumed the
18 liability for covering the short sale. The taxpayer then
19 conveyed the partnership interest to another partnership,
20 which sold the interest for \$1.8 million. The taxpayer
21 claimed a loss of \$100 million, and ignored the liability

22 ¹⁰ That the option holder in *Helmer* was able to exercise
23 his option or not is a key distinction between *Helmer*, and
24 its progeny, and this case where the funds received from the
25 sale of the short option are used to purchase the long option
26 and the AIG note, and the proceeds of which are pledged to
27 secure the liability created by the short option. *Helmer* and
28 its progeny also are distinguishable from this case because
they did not involve the assumption of a payment obligation
by a partnership from a partner.

1 created by the obligation to cover the short sale because it
2 was "contingent."¹¹

3 The Fifth Circuit noted that the taxpayer acknowledged
4 "only suffer[ing] a \$200,000 economic loss" but "claim[ing] a
5 \$102.6 [m]illion tax loss on its return." *Id.* at 456. The
6 Fifth Circuit found the taxpayer was making a "premeditated
7 attempt to transform this wash transaction (for economic
8 purposes) into a windfall (for tax purposes)" that was
9 "reminiscent of an alchemist's attempt to transmute lead into
10 gold." *Id.*

11 In this case, as in *Korman*, Plaintiffs are seeking to
12 "treat[] [their] contingent assets and . . . contingent
13 liabilities asymmetrically." *Id.* at 460 (internal citation
14 omitted). Moreover, the proceeds from the initial short sale
15 and the subsequent covering transaction in this case are
16 "inextricably intertwined." *Id.* at 460-61. Therefore, to
17 apply the *Helmer* line of cases to this case would, as the
18 *Korman* court found, "fl[y] in the face of reality" and result
19 in an "unwarranted aberration." *Id.* at 461.

20

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26 ¹¹ However, as the Fifth Circuit found, "[t]he Internal
27 Revenue Code deals with dollars, and the basis adjustment
28 provisions of section 752 presume that the value of the
liability is ascertainable." *Korman*, 527 F.3d at 452.

28

1 **E. Even if the Short Option is Not an I.R.C. § 752**
2 **Liability, the Obligation Created by the Short**
3 **Option Must Still be Taken into Account under**
4 **Treasury Regulation § 1.752-6.**

5 Section 1.752-6 of the Treasury Regulations applies to a
6 partnership's assumption of liability occurring after October
7 18, 1999, and before June 24, 2003, if I.R.C. § 752(a) and
8 (b) do not apply to that liability.¹² 26 C.F.R. 1.752-6. On
9 June 24, 2003, the Treasury Department proposed regulations,
10 including temporary Treasury Regulation § 1.752-6, that would
11 define "liability" in the partnership context under I.R.C. §
12 752, and which relied on the interpretation of "liability"
13 found in I.R.C. § 358(h)(3)¹³ and Revenue Ruling 88-77. See,
14 *Assumption of Partner Liabilities*, 68 Fed.Reg. 37,434 (June
15 24, 2003) (Prop. Treas. Reg. §§ 1.752-0 to -7). These
16 temporary regulations became final on May 26, 2005, and the
17 Treasury Department specified that Treasury Regulation §
18 1.752-6 would apply retroactively. See, 70 Fed.Reg. 30,334,
19 30,335 (May 26, 2005). Treasury Regulation § 1.752-6 was
20 adopted by Congressional directive pursuant to Section 309 of
21 the Community Renewal Tax Relief Act of 2000 ("2000 Act"),
22 which added Section 358(h) to the I.R.C., and which defines

23 _____
24 ¹² Section 1.752-7 applies to assumptions of liability
25 occurring after June 24, 2003, and taxpayers could elect to
26 apply it to assumptions of liability occurring between
October 18, 1999, and June 24, 2003. Treas. Reg. §
1.752-7(k).

27 ¹³ Section 358(h)(3), which defines "liability" in the
28 context of determining basis on corporate transactions as
including "any fixed or contingent obligation to make
payment."

1 "liability" as including contingent obligations for purposes
2 of certain corporate stock exchanges. Section 309(c)(1) of
3 the 2000 Act required the Secretary of the Treasury to adopt
4 comparable rules for transactions involving partnerships, and
5 expressly authorized retroactivity of those rules by stating
6 that the Treasury Regulations adopted under Section 309(c)
7 "shall apply to assumption of liabilities after October 18,
8 1999, or such later date as may be prescribed in such rules."

9 If Treasury Regulation § 1.752-6 is applied retroactively
10 in this case, the short options at issue would constitute
11 liabilities for purposes of I.R.C. § 752, and, thus, would
12 require a reduction in the partnership basis claimed by
13 Plaintiffs.

14 Plaintiffs argue that, as the court in *Stobie Creek*
15 recently found, the requirement under Section 1.752-6 that a
16 partner's basis in a partnership interest must be reduced by
17 the value of the contingent liabilities assumed by the
18 partnership is "contrary to the then existing policy to
19 exclude contingent liabilities from the computation of
20 partnership basis." *Stobie Creek Investments, LLC v. United*
21 *States*, 82 Fed. Cl. 636, 668 (2008) (citing *Helmer*, 34 T.C.M.
22 (CCH) 727 (1975)). Both Plaintiffs and the court in *Stobie*
23 *Creek* base the conclusion that Section 1.752-6 represented a
24 change from previous policy on the Treasury Department's
25 statement that "[t]he definition of a liability contained in
26 these proposed regulations [including Section 1.752-6] does
27 not follow *Helmer*." *Stobie Creek*, 82 Fed. Cl. At 668 (citing
28 68 Fed.Reg. at 37,436).

1 However, other courts have found that Treasury Regulation
2 § 1.752-6 does apply retroactively. For example, in *Cemco*
3 the United States Court of Appeals for the Seventh Circuit
4 observed that Treasury Regulation § 1.752-6 was "explicit" in
5 stating that it applied retroactively to assumptions of
6 liabilities occurring before its enactment. *Cemco Investors,*
7 *LLC v. U.S.*, 515 F.3d 749, 752 (7th Cir. 2008). The *Cemco*
8 court relied on I.R.C. § 7805(b)(6) which specifically allows
9 retroactivity.¹⁴ *Cemco*, 515 F.3d at 752. The *Cemco* court
10 found that the effect of Treasury Regulation § 1.752-6 was to
11 "instantiate the pre-existing norm that transactions with no
12 economic substance don't reduce people's taxes." *Cemco*, 515
13 F.3d at 752.

14 This Court agrees with the *Cemco* court that Treasury
15 Regulation § 1.752-6 should be applied retroactively. The
16 Court finds that the rationale of the First Circuit in *Stobie*
17 *Creek* and Plaintiffs with respect to Treasury Regulation §
18 1.752-6 "misrepresents the state of prior law" by
19 interpreting the statement that "[t]he definition of a
20 liability contained in these proposed regulations does not
21 follow *Helmer v. Commissioner*" as an indication that *Helmer*
22 represented the prevailing prior law. Burke, Karen C. and
23 McCough, Gayson, M.P., *Cobra Strikes Back: Anatomy of a Tax*
24 *Shelter* (June 19, 2008), at 33 and 39 n. 121. In addition,
25 the Treasury Department also stated that "following the
26 principles set forth in § 1.752-1T(g) and Rev. Rul. 88-77,

27
28 ¹⁴ Retroactivity is also permitted to prevent abuse
pursuant to I.R.C. § 7805(b)(3).

1 the proposed regulations provide that an obligation is a
2 liability if and to the extent that incurring the obligation:
3 (A) Creates or increases the basis of any of the obligor's
4 assets (including cash)." 68 Fed. Reg. 37434, 37437 (2003).

5 Recognizing that "[t]here is no statutory or regulatory
6 definition of liabilities for purposes of section 752" (68
7 Fed. Reg. 37434, 37435 (2003)), the Treasury Department
8 relied upon Revenue Ruling 88-77 and *Salina Partnership v.*
9 *Commissioner*, T.C. Memo 2000-352 (T.C. 2000), and concluded
10 that "[c]ase law and revenue rulings, however have
11 established that, as under section 357(c)(3), the terms
12 liabilities for this purpose does not include liabilities the
13 payment of which would give rise to a deduction, unless the
14 incurrence of the liability resulted in the creation of, or
15 increase in, the basis of property." 68 Fed. Reg. 37334,
16 37435 (2003). Thus, the Treasury Department found that
17 "[t]he question of what constitutes a liability for purposes
18 of section 752 was addressed in Revenue Ruling 88-77," and
19 that the definition of liability in Revenue Ruling 88-77 was
20 consistent with the Internal Revenue's position in Revenue
21 Ruling 95-26. *Id.* at 37436. Therefore, the Treasury
22 Department simply applied the pre-existing rule contained in
23 Revenue Ruling 88-77 to address the possibility of abuse
24 caused by contingent liabilities not being recognized under
25 I.R.C. § 752.¹⁵

26
27 ¹⁵ Treasury Regulation § 1.752-6 also incorporates the
28 definition of liability contained in I.R.C. § 358(h)(3),
which defines "liability" to include contingent liabilities.

1 Moreover, Notice 2000-44 placed Plaintiffs on notice that
2 the transactions it described would be scrutinized and
3 penalized. Because Notice 2000-44 was issued in August 2000,
4 and notified taxpayers that the contribution of paired long
5 and short options to partnerships in order to artificially
6 increase outside basis were abusive, and would not be
7 allowed, the Secretary's exclusion of these transactions from
8 the exceptions in Treas. Reg. § 1.752-6(b) should not have
9 been a surprise to sophisticated taxpayers such as Thomas and
10 Fox, and their advisor, Arthur Andersen tax partner
11 Griffiths. Moreover, while Plaintiffs argue that Notice
12 2000-44 did not give them notice because the transactions at
13 issue are not identical to those described in Notice 2000-44,
14 Plaintiffs conveniently ignore the "substantially similar"
15 language contained in the Notice. Accordingly, the Court
16 finds that even if the short options at issue in this case
17 are not liabilities under I.R.C. § 752, the obligations
18 created by the short options still must be taken into account
19 under Treasury Regulation § 1.752-6.

20

21 **F. The Partnerships Made a Gross Valuation Misstatement**
22 **Under I.R.C. § 6662.**

23 Section 6662 of the Internal Revenue Code governs
24 accuracy-related penalties. The purpose of penalties is "to
25 deter taxpayers from playing the 'audit lottery,' that is,
26 taking undisclosed questionable reporting positions and
27 gambling that they [will] not be audited. *Caulfield v.*
28 *Commissioner*, 33 F.3d 991, 994 (8th Cir. 1994). As

1 Plaintiffs have argued, Thomas and Fox have not yet used any
2 of the tax benefits associated with the transactions at issue
3 in this case. Because this case is a partnership-level
4 proceeding, the Court must determine "the applicability of
5 any penalty . . . which relates to an adjustment to a
6 partnership item." I.R.C. § 6221. However, the actual
7 computation of the penalty is not done at the partnership
8 level. In this case, the partnership returns reported the
9 valuation of the transaction at sixty-seven times the
10 appropriate value under either I.R.C. § 752 or the substance
11 over form or step-transaction analysis. For example, the
12 Thomas partnerships reported an increase in its capital
13 account of \$101,500,000, which is sixty-seven times the
14 actual economic outlay of \$1.5 million that Thomas paid for
15 the transaction. A gross valuation misstatement is one in
16 which the value of any property claimed on any tax return is
17 four hundred percent or more of the amount determined to be
18 the correct amount. Therefore, the valuations of the
19 transactions by the partnerships in this case are well over
20 the four hundred percent threshold for a finding of a gross
21 valuation misstatement. The reasonable cause and good faith
22 defense is a fact and circumstance test that focuses on the
23 taxpayer's affirmative actions to determine its correct tax
24 liability: "[g]enerally, the most important factor is the
25 extent of the taxpayer's effort to assess the taxpayer's
26 proper tax liability." Treas. Reg. § 1.6662-4(b). The
27 taxpayer's "experience, knowledge, and education" may be
28 taken into account. *Id.* Reliance on a tax advisor "does not

1 necessarily demonstrate reasonable cause and good faith."
2 *Id.*

3 In this case, the partnerships did not have reasonable
4 cause to disregard the liabilities created by the short
5 options in valuing the Arthur Andersen call option spreads
6 contributed to the partnerships. The transactions were
7 entered into over one year after the IRS issued IRS Notice
8 2000-44 entitled "Tax avoidance using artificially high
9 basis." This notice alerted taxpayers and their
10 representatives that purported losses arising from certain
11 transactions designed to create artificially high basis in
12 partnership interests would be disallowed. In addition, the
13 partnerships have failed to provide evidence that they
14 diligently attempted to properly assess their proper tax
15 reporting. The partnerships also have failed to demonstrate
16 any attempt to determine whether the transactions would
17 potentially be covered by Revenue Ruling 88-77. Furthermore,
18 the partnerships have failed to demonstrate that they
19 attempted to determine whether the transactions had any
20 economic substance. Finally, the partnerships have failed to
21 demonstrate that they sought and received disinterested and
22 objective tax advice because the tax advice that they did
23 receive came from Arthur Andersen, which also arranged the
24 transactions resulting in the increased basis that is at
25 issue in this case. Therefore, the partnerships have failed
26 to demonstrate that they acted in good faith as required by
27 the reasonable cause exception of I.R.C. § 6664(c)(1).

28

1 Conclusions of Law

2 1. The Court has original jurisdiction over the federal
3 claims asserted in this action pursuant to Section 6226 of
4 the Internal Revenue Code. The Court's jurisdiction extends
5 to all items of the partnership for the period at issue.
6 I.R.C. § 6226(f). Contributions to partnerships and
7 distributions from partnerships are partnership items.
8 Treas. Reg. § 301.6231(a)(3)-1(a)(4)(I) and (ii). The
9 characterization of offsetting options when contributed to
10 partnerships is a partnership item. *See, Jade Trading, LLC*
11 *v. United States*, 80 Fed. Cl. 11, 41-43 (Fed. Cl. 2007);
12 *Nussdorf v. Comm'r*, 129 T.C. 30, 43-44 and n. 16 (2007).¹⁶

13 2. Venue is proper in the United States District Court
14 for the Central District of California under 28 U.S.C.
15 § 1391(b) because the alleged acts complained of occurred and
16 are occurring in this district.

17 3. In applying the economic substance analysis to the
18 transactions at issue in this case, the Court concludes that
19 the transactions at issue are economic shams for tax
20 purposes.

21 4. Application of the step-transaction doctrine,
22 through either the end result test or interdependence test,
23 yields a cost basis of \$1.5 million for Thomas and \$675,000
24 for Fox.

25 ¹⁶ The parties do not dispute the facts requisite to
26 federal jurisdiction.

1 5. Application of the substance over form doctrine
2 yields a cost basis of \$1.5 million for Thomas and \$675,000
3 for Fox.

4 6. The obligations created by the short options in the
5 transactions at issue are liabilities for purposes of I.R.C.
6 § 752.

7 7. The obligations created by the short options in the
8 transactions at issue are liabilities for purposes of
9 Treasury Regulation § 1.752-6.

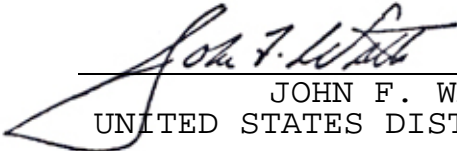
10 8. I.R.C. § 6221 requires that "the tax treatment of
11 any partnership item (and the applicability of any penalty,
12 addition to tax, or additional amount which relates to an
13 adjustment to a partnership item) shall be determined at the
14 partnership level." I.R.C. § 6226(e) authorizes this Court
15 to conduct partnership-level proceedings and determine "the
16 applicability of any penalty, addition to tax, or additional
17 amount which relates to an adjustment to a partnership item,"
18 I.R.C. § 6226(f). In this case, the Court concludes that the
19 partnerships made gross valuation misstatements and,
20 therefore, accuracy-related penalties are applicable in this
21 case.

22 Defendant is ordered to prepare a proposed Judgment
23 consistent with this Order, and submit it to counsel for
24 Plaintiffs for approval as to form and content by February
25 11, 2009. In the unlikely event that counsel cannot agree on
26 a proposed judgment, they shall meet and confer and prepare a
27 joint statement setting forth their respective arguments for
28

1 each disputed paragraph of the proposed judgment. The
2 proposed judgment and joint statement shall be filed by
3 February 18, 2009.

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Dated: February 4, 2009



JOHN F. WALTER
UNITED STATES DISTRICT JUDGE